Marketing communication

Next decade investing

The seismic shifts shaping the investment landscape today, and the key trends that will continue to define investor thinking over the next ten years.

For professional investors only

Fabrice Chemouny
Head of International Distribution
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"While none of us has a crystal ball to see into the future, the client perspective is perhaps one of the most important lenses I have for understanding how the world of asset management is changing.

Speaking to some clients, it's clear that they are seeking new sources of return through ever more sophisticated investment strategies, including access to alternatives like private assets. Listening to others, they are trying to protect wealth by safely navigating what feels like an ever more complex geopolitical landscape.

Many client conversations highlight just how much the global financial system has changed in the past 10 years and how much more it is likely to change over the next decade. For example, we are being forced to think differently about how we are saving for and investing in our future. Pension systems, particularly defined benefit plans, are under strain due to ageing populations, while the transition to defined contribution plans places more responsibility on individuals to save for retirement.

Perhaps unsurprisingly, the impact of the demographic transition is a key focus of this report. Ageing populations in many developed countries are affecting wealth distribution, with older generations holding significant assets. However, intergenerational wealth transfer is expected to shift some of this to younger generations, who will likely have different investment priorities and risk appetites.

Change is afoot geographically, too. Emerging markets, particularly in Asia, are experiencing significant growth, while countries like China and India are seeing rapid economic expansion and a growing middle class, which is contributing to a shift in the global wealth balance.

Across many countries in the West, high levels of public and private debt remain a concern. Governments and individuals are exploring sustainable debt management strategies, which may include fiscal reforms, debt restructuring, or innovative financial products. The low interest rate environment that lasted for the decade after the global financial crisis in 2008/9 encouraged borrowing, but rising rates since the Covid crisis in 2020 continue to pose challenges for debt servicing.

As an asset management industry, we are at a crossroads – under pressure to enhance operational efficiencies, simplify processes, and reduce costs, while also being creative in structuring funds and engaging with clients. It's a pivotal moment. And it's one that not all asset managers will survive. The successful ones will be those flexible enough to adapt and provide clients with what they need to grow their wealth over the long term.

Each of the major transitions – demographic, environmental, technological, and industrial – are compelling us to invest differently. That's why I urge you to read Next Decade Investing. This report provides a comprehensive overview of the risks and opportunities facing investors today, and it goes beyond the standard 'outlook for the year ahead' to peer a little farther into the future. More than anything else, it crystalises many of the thoughts I discuss with clients on a regular basis."

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Navigating a world of transitions

The global economy is undergoing significant transitions that will shape the future of industries and markets. What do they look like today, how do we expect them to unfold over the next ten years, and what are their implications for businesses, investors, and policymakers?

From the rise of artificial intelligence and automation to the maturing conversations around sustainability and renewable energy, transitions are already underway that will reshape the way we live, work, and do business. At the same time, the investment landscape continues to evolve, with new opportunities and risks emerging across asset classes.

The likelihood is that the next ten years will look very different from the pre-Covid decade. That was a period where, in the aftermath of the Global Financial Crisis (GFC), banks became more capitalised and less exposed to risk – there was also a significant shift from bank lending to bond issuance, as nonbank lenders like private equity and hedge funds became major credit sources. The era of ultra-low interest rates led to a search for yield, impacting investor behaviour and asset allocation strategies.

Meanwhile, emerging markets, particularly China, played a crucial role in global economic growth, buffering against negative shocks from the GFC. In that period, investors also emphasised diversification and fixed-income allocations to manage risk and maintain portfolio stability during market corrections.

For business leaders, some of the biggest shocks of the past decade have emerged from climate change, pandemics, gender rights, political strife, and war. According to EY's latest survey of CEOs, most expect to see more — not less — political risk in the future, and only 30% think they understand this issue fully[1]. Looking ahead, it's likely that existing risks may resurface and in some cases deepen.

The World Economic Forum's Global Risks Report 2024 highlights that environmental risks make up half of the top 10 global risks over the next decade[2]. Some $44 trillion of economic value generation is currently at risk from nature loss due to moderate or high dependence on nature and its services[2]. The environmental transition, the goals of the Paris Agreement, and net-zero strategic pathways, are increasingly likely to come under the spotlight over the next decade.

As investors seek to navigate this changing environment, understanding the key trends and transitions that are shaping the future will be crucial for making informed decisions and capturing value. And that's what ***Next Decade Investing*** is all about: we've brought together experts from across Natixis Investment Managers and asked them how they are assessing the key trends today, to provide you with the insights that can help you tomorrow.

Jon Barker,
Head of Thought Leadership,
International Marketing,
Natixis Investment Managers

Sources:
[1] EY CEO Global Outlook Report, September 2024 https://www.ey.com/en_gl/ceo/ceo-outlook-global-report
[2] WEF Global Risks Report 2024 https://www.weforum.org/publications/global-risks-report-2024/digest/

Identifying the key transitions

From climate change to AI, geopolitical shifts to ageing populations, there are four clear and interrelated transitions that are likely to continue shaping the investment landscape over the next ten years.

As Philippe Waechter, Chief Economist at Paris-based Ostrum Asset Management, put it: "It feels like we have never had such a challenge as those currently in front of us, with the environmental, demographic, and industrial transitions".

Technology
By 2035, technological advances like automation, machine learning, and artificial intelligence will likely have a major disruptive impact on job markets, making millions of jobs obsolete[1]. Technologies like self-driving cars are expected to proliferate, raising governance and adaptation challenges[1]. Quantum computing could revolutionise fields like materials science and drug discovery[4]. Artificial General Intelligence (AGI) and potentially Artificial Superintelligence (ASI) may emerge, necessitating robust ethical frameworks[4].

Climate change
The consequences of climate change are likely to become increasingly apparent by 2035, leading to more climate-related political disputes[1]. Renewable energy could proliferate but trigger instability in fossil fuel-dependent countries[1]. Integrated AI climate models, renewable tech, and geoengineering are expected to become crucial for global infrastructure[4].

Geopolitical tension
While the US should remain the largest military power, China's influence is expected to grow substantially[1]. Russia may focus on asymmetric advantages to counter its declining population[1]. New arenas of state competition could emerge around space, cyberwarfare, internet governance, and the Arctic[1]. Meanwhile, global trade is unlikely to sustain the high growth rates reached in recent decades as China reorients toward domestic consumption[1]. Regional trade agreements excluding major powers like the US and EU should expand[1] and a push for higher environmental and labour standards in developing countries is expected[1].

Ageing humanity
Ageing populations, predominately in developed countries, are likely to strain resources and prompt political tensions around migration[1]. The transition to an information economy could shift partisan coalitions and incentive structures in politics[1]. Hyper-personalisation through AI will likely transform industries from education to marketing[2]. Brain-computer interfaces are expected to blur human-machine boundaries[4,2].

Sources:
[1] Global Trends to 2035 - European Parliament https://www.europarl.europa.eu/RegData/etudes/STUD/2017/603263/EPRS_STU%282017%29603263_EN.pdf
[2] Unveiling the Future: 10 Predictions for a Transformative 2035 https://datafloq.com/read/unveiling-future-10-predictions-transformative-2035/
[3] Global trends to 2035 | Oxford Analytica https://www.oxan.com/insights/global-trends-to-2035/
[4] 2035 Vision: Ten Predictions for the Future - The Digital Speaker https://www.thedigitalspeaker.com/2035-vision-ten-predictions-future/

An artificial view of the future

The speed and increasing accuracy of large language models and generative artificial intelligence continues to delight and disrupt us. So, we thought it only appropriate to ask our proprietary generative AI tool to gaze into its digital crystal ball and map out what the key milestones in each of the transitions may be over the next ten years. Like all predictions, some might appear farfetched, while others are eminently plausible...

2025

- Widespread adoption of 5G technology globally.
- World economic recovery continues post-pandemic, with significant growth in green energy sectors.
- Major international climate agreement comes into effect, aiming to reduce carbon emissions by 30% by 2030.
- Increase in automation and AI integration in manufacturing processes.
- Global population reaches 8 billion.

2026

- Breakthrough in AI technology leads to widespread automation in various industries, causing shifts in the job market.
- Launch of large-scale reforestation projects in deforested areas.
- Expansion of electric vehicle (EV) infrastructure, including charging stations.
- Ageing population in developed countries leads to increased demand for healthcare services.

2027

- Introduction of advanced AI-driven personal assistants in households.
- Implementation of stricter regulations on plastic use and waste management.
- Universal Basic Income (UBI) pilot programs expand in several countries, showing promising results in reducing poverty.
- Growth in renewable energy sector, particularly solar and wind power.
- Urbanisation rate hits 60% globally.

2028

- Major advancements in healthcare technology, including personalised medicine and gene editing, become more accessible.
- Development of autonomous public transportation systems in major cities.
- Major advancements in carbon capture and storage technologies.
- Rise of smart factories utilising IoT and AI for optimised production.
- Significant increase in migration due to climate change impacts.

2029

- Widespread use of augmented reality (AR) in education and training.
- Global temperature rise reaches critical threshold, prompting emergency climate actions.
- Significant political shifts in several major countries as new leaders are elected on platforms of economic reform and climate action.
- Increased investment in sustainable and circular economy practices.
- Global workforce sees a shift towards gig economy and remote work.

2030

- Transition towards Industry 5.0, focusing on human-machine collaboration.
- Commercial availability of human-like robots for various applications.
- Global carbon emissions peak and begin to decline.
- Global population reaches 8.5 billion. Urbanisation intensifies, with smart cities becoming more prevalent.
- Achievement of several UN Sustainable Development Goals (SDGs) related to health and education.

2031

- Breakthroughs in biotechnology and genetic engineering.
- Large-scale adoption of green building practices in urban development.
- Expansion of 3D printing technology in manufacturing and construction.
- Major international trade agreement signed, boosting global economic cooperation, and reducing tariffs.
- Significant advancements in life expectancy due to medical innovations.

2032

- Breakthrough in renewable energy storage technology, making solar and wind power more reliable and widespread.
- Integration of AI in healthcare for personalised medicine.
- Restoration of major ecosystems and biodiversity hotspots.
- Growth in the use of biodegradable materials in production.
- Increased focus on mental health and well-being in public health policies.

2033

- Significant progress in space exploration, with manned missions to Mars and the establishment of lunar bases.
- Significant reduction in air and water pollution levels.
- Adoption of blockchain technology for supply chain transparency.
- Shift towards multi-generational living arrangements.

2034

- Development of brain-computer interface technologies.
- Implementation of global policies for ocean conservation.
- Rise of sustainable agriculture practices using precision farming.
- Global efforts to address income inequality lead to new economic policies and social programs.
- Increased global collaboration on addressing aging population challenges.

2035

- Major advancements in quantum computing revolutionise various fields, including cryptography, materials science, and pharmaceuticals.
- Emergence of fully immersive virtual reality experiences.
- Achievement of net-zero carbon emissions in several countries.
- Dominance of renewable energy sources in global energy mix.
- Global population growth stabilises.

Sources:

Natixis IM MAIA Generative AI – we asked: *'Build me a timeline of dates that may be significant for the demographic, environmental, technological and industrial transitions, from the years 2025 to 2035'*

Visual Capitalist, https://www.visualcapitalist.com/timeline-of-us-events-that-defined-generations/

WEF, https://www.weforum.org/agenda/2023/02/this-timeline-charts-the-fast-pace-of-tech-transformation-across-centuries/

History tools, https://www.historytools.org/stories/the-industrial-revolution-a-timeline-of-key-dates-and-developments

Cracking the demographic conundrum

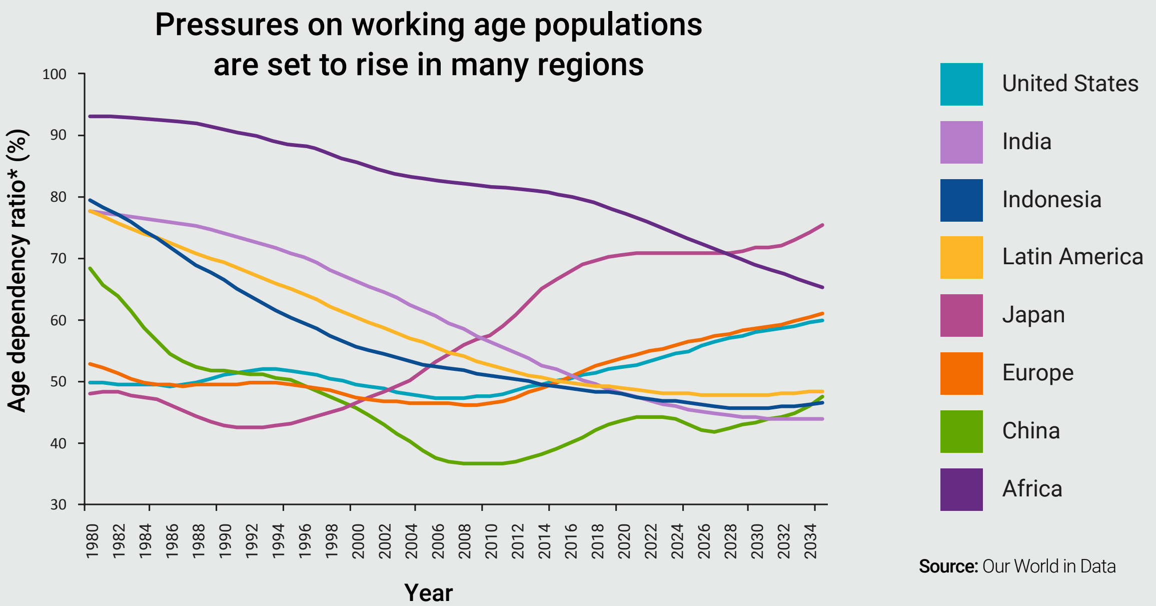
The world is getting older: people are living longer and the number, and overall percentage, of older people is increasing. It's a fact that is expected to have several significant impacts on the global economy:

- **Labour force and productivity:**
An ageing population will likely lead to a decrease in labour-force participation and productivity. As more people retire, the working-age population shrinks, potentially leading to labour shortages and increased pressure on remaining workers[1,3]. However, if older workers remain healthy, they can continue contributing economically, mitigating some negative effects[3].

- **Public finance pressures:**
Ageing populations will increase dependency ratios, leading to higher public spending on pensions, healthcare, and social services. This will put significant pressure on public finances, especially in countries with generous state support for the elderly[2,4].

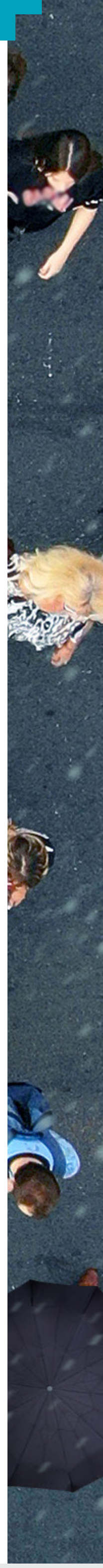
- **Economic growth:**
The shift in demographics is expected to lower real GDP growth rates. The extent of this impact will vary by country, with advanced economies facing more immediate challenges due to their already high age-related spending[2,4].

- **Regional variations:**
The demographic shift will be most pronounced in East and Southeast Asian economies like South Korea and Singapore, where the old-age dependency ratio is expected to increase significantly. In contrast, regions like sub-Saharan Africa, with higher birth rates, will experience these demographic changes more gradually[4].



Source: Our World in Data

Sources:
[1] Implications of Population Aging for Economic Growth https://www.nber.org/system/files/working_papers/w16705/w16705.pdf
[2] The Economic Consequences of Ageing Populations https://ec.europa.eu/economy_finance/publications/pages/publication11151_en.pdf
[3] Health, an ageing labour force, and the economy - NCBI https://www.ncbi.nlm.nih.gov/pmc/articles/PMC8505790/
[4] The challenges of aging: Fast and slow - S&P Global https://www.spglobal.com/en/research-insights/special-reports/look-forward/the-challenges-of-aging-fast-and-slow
* The age dependency ratio is the number of people who are either younger than 15 or aged 65 and older, relative to the number of people of working age, ie aged 15-64.



Nicolas Malagardis
Global Market Strategist
Natixis IM Solutions

The impact of demography on investment behaviour

Demographics play a crucial role in shaping the long-term dynamics of the economy, influencing potential growth, monetary policy, and public finances. Slower population growth, for example, often leads to reduced investment, negatively affecting capital formation and exerting deflationary pressures.

Shifting life cycles also alter consumption and saving patterns; older individuals typically allocate more spending towards services like healthcare and housing while reducing their expenditure on goods and clothing compared to younger age groups. Furthermore, an ageing population places increasing pressure on fiscal budgets due to rising costs in pensions and healthcare, coupled with a shrinking tax base, potentially challenging debt sustainability.

Individuals generally follow predictable financial patterns, borrowing in youth, saving in middle age, and drawing on savings during retirement. With increasing life expectancy, the need for larger retirement savings grows, especially when retirement ages do not keep pace with longevity. The baby boomer generation's impact on economic trends has been particularly significant.

In the 1960s, they fuelled growth by driving demand for housing, infrastructure, and jobs. By the 1980s, their entrance into the workforce led to higher savings rates, which contributed to lower equilibrium interest rates, alongside a global focus on controlling inflation[1].

This period also coincided with China's integration into the global economy and the dissolution of the Soviet Bloc, which contributed to global disinflation.

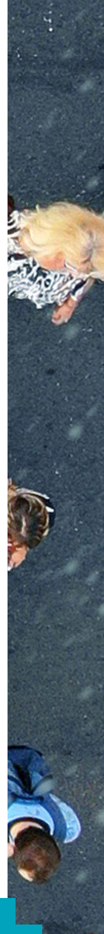
As life expectancy has risen, so too has the need for retirement savings, reinforcing these disinflationary trends. The result was a prolonged era of low inflation and moderate growth, often referred to as 'the Great Moderation'. However, as baby boomers retire, savings rates are expected to decline, potentially pushing up both equilibrium interest rates and inflation.

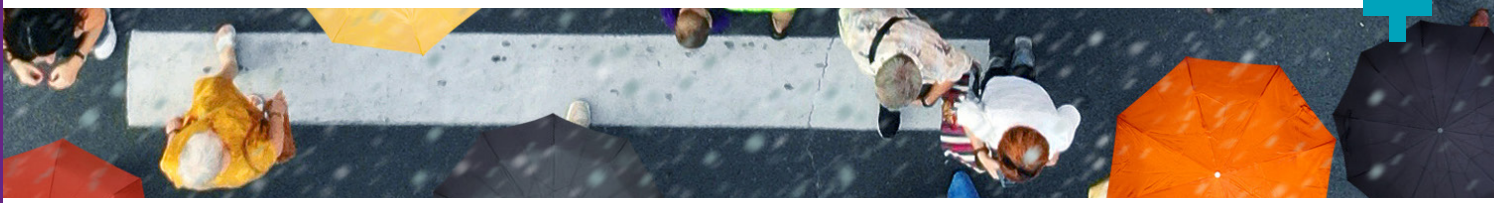
Source:
[1] Equilibrium interest rate corresponds to the rate level that is consistent with stable inflation and full employment.

A study by the Bank for International Settlements (BIS) in 2018 identified a strong link between demographic trends and inflation, suggesting that both younger and older population segments are associated with higher inflation, while the working-age population tends to suppress inflation[2]. This U-shaped pattern has remained robust across different countries and time periods, accounting for roughly a third of the variation in inflation rates among OECD nations. Indeed, BIS projections indicate that this inflationary trend will likely persist as the share of individuals in their prime working and saving years declines over the next two decades.

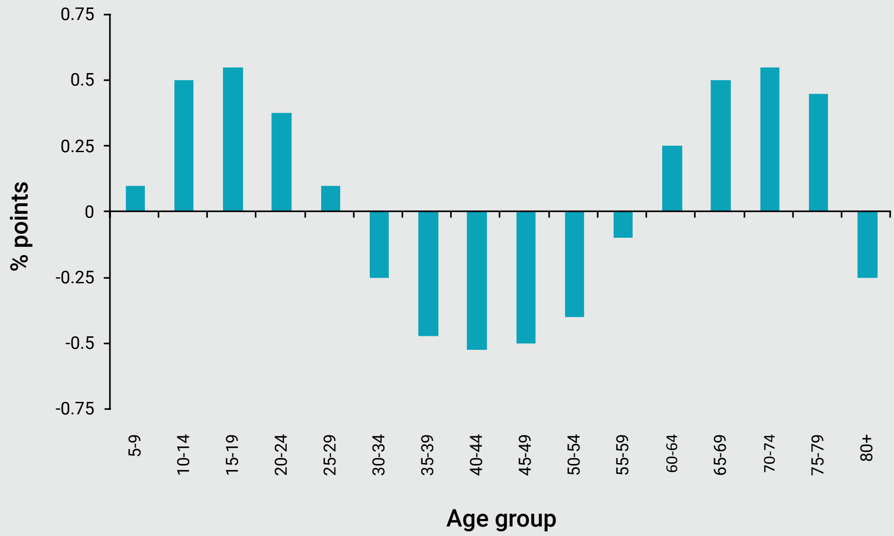
The Covid-19 pandemic accelerated these demographic impacts by prompting early retirements among older workers, exacerbating labour shortages, and increasing the bargaining power of younger workers. This, in turn, has driven wage growth.

Unlike Japan, which managed to avoid wage inflation during labour shortages by offshoring manufacturing to China, the global labour force is now contracting—a trend amplified by the pandemic and geopolitical tensions such as the Ukraine war. As the forces of globalisation reverse, the inflation suppression that accompanied it is also fading, suggesting that persistent labour shortages and higher inflation could become long-term challenges.





Working age populations tend to suppress inflation



Source: Bank for International Settlements, 2018

Source:
[2] BIS, https://www.bis.org/publ/work656.pdf and https://www.bis.org/publ/work722.pdf

Philippe Waechter
Chief Economist,
Ostrum AM

The world in 2035

Q How do you think we might be reflecting on some of the major geopolitical, social, economic and market trends ten years from now? What's the narrative?

"Well, if we think about where we are today, we are looking at the unwinding of globalisation. In 2006, the New York Times journalist Tom Friedman wrote a book called 'The World is Flat', where he highlighted how there are opportunities everywhere.

Today, the world is becoming more vertical, with strong competition between blocks – China, the US, Europe – notably on technology. We see that clearly between China and the US. But we all want autonomy. We want to have an industrial policy that says I want to be able to build my own electric vehicles, my own batteries. I don't want to depend too much on China.

In the former environment, economic decisions were based mainly on economic optimisations – the best way of developing my job or my business is to invest in Vietnam, Malaysia, or South Africa. This is no longer the case. The world is becoming more local, more vertical. We all want to depend on ourselves, not on others. This is a consequence of the pandemic and the shortages we had.

This has changed the global picture and had a deep impact on states and companies' strategies. One interesting indicator is foreign direct investment in China, which has dropped dramatically since the beginning of 2023. Nobody wants to be invested in China except Germany.

Meanwhile, in the US, the Inflation Reduction Act has encouraged the view of wanting every manufactured product needed in the US to be produced in the US. So, everyone has to be more autonomous in the way they are doing business.

The second point is that we are all engaged in climate change frameworks. And the only way to succeed is to take on more political measures. I don't believe that spontaneously we will be able to converge to the right trajectory that will lead to carbon neutrality. Decisions need to be taken by governments in China, the US and Europe.

And the consequence of these two points – autonomy and climate change – is that the decision will probably be founded on a political basis rather than an economic one. In other words, we will probably have second-best decisions. For instance, the truth might be that it would be better to invest in China, but because of the politics we have to invest in Germany, Austria, or France.

The hierarchy in economic policy has been monetary policy first, fiscal policy second. It began this way with Ronald Reagan at the beginning of the 1980s. And while monetary policy will remain important, I think we're going the other way around now. Economic and government policy will be the game changer."

Q Ageing populations are also expected to have several significant impacts on global economies. What are your thoughts about the demographic transition?

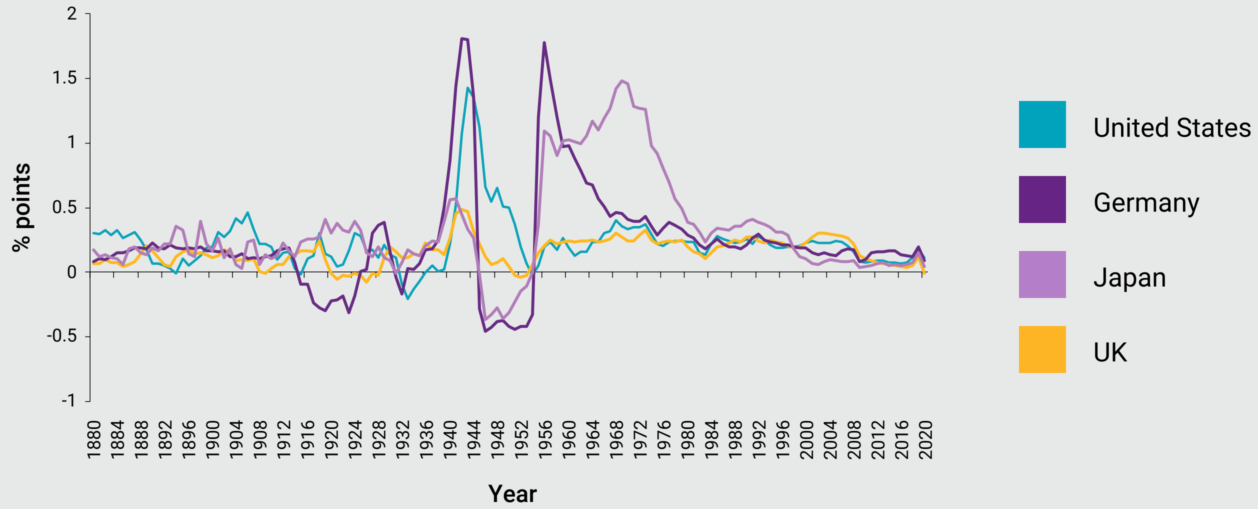
“Demographics are impacting everything. In China, and in Europe, the population is ageing rapidly, and this will have a strong impact on all our futures. We could say Japan already knows this situation, but Japan invested in the UK, the US and Asia throughout the 1970s and 80s, so they could repatriate a lot of profit from Toyota in the US, from Mitsubishi in Asia, and so on. When the situation calls for it, they use that capital to reverse their fortunes.

We cannot do that in Europe because we have not invested as much as Japan has done in the past, so we will have to arbitrage between pensions to retirees and income from the active population. This is a very tough choice and the only way to limit this arbitrage is to open the door of migration, to allow people from elsewhere to come to work, to produce, to create revenues. And this revenue must be able to support retirees and other non-active participants in the economy.

It will be a nightmare somewhere and we don’t know how to handle it because there are considerable political constraints, from the AfD in Germany to Le Rassemblement national in France. If we are not able to increase revenues through migration or large increases in productivity, ageing populations will require us to accept unpalatable truths, like a lower standard of living. But it’s complicated. In Europe, we have to reinvent our model, to rethink our way of living, and undergo a kind of revolution. But revolutions are done by young people, not by retirees.

At the same time, we are probably at the beginning of a new industrial revolution. We have to reduce our consumption of fossil fuel by 80% in 20 years, and we don’t know how to do that. It feels like we have never faced such challenges as those currently in front of us with the environmental, demographic, technological, and industrial transitions.”

Productivity growth by country over a 10-year rolling average



Source: Òscar Jordà, Moritz Schularick, and Alan M. Taylor. 2017. ‘Macrofinancial History and the New Business Cycle Facts’ in NBER Macroeconomics Annual 2016, volume 31, edited by Martin Eichenbaum and Jonathan A. Parker. Chicago: University of Chicago Press.

Q It sounds like you're not as optimistic as some about the all-conquering power of technology to save us. Is that fair?

“My view is, first of all, when we speak about technology at the moment, we all speak about AI. In the last 30 years we have had three types of revolution. The microcomputer. The mobile phone. The internet. With each revolution, we thought that the problems of productivity would be solved. It has not been the case. The macro productivity in Europe is not growing. And even in the US, even if it is better than in Europe, it's not as strong as hoped. So, I don't know what will happen with AI, but I'm not sure that it will be all that positive on the economic side.

Second, it will be interesting to see whether the US or China will set the standards for technology. Who will create the technology that will be copied and mass produced by everyone? The advantage of creating the standard is that you get rental income which is very profitable. It is not clear at the moment. At one time it was Japan. It has often been led by the US. But in the future, it could be China. How do we in the West feel about it? The important point here is that China is a real competitor to the US. It's a large economy with innovations, a large population, and it has political will and strategy. This was not the case during the Cold War or with Japan in the 1980s.

My third point is on climate change. When you look at the IPCC report, it's apparent that we'll have to be able to capture carbon and store it if we want to converge to a carbon neutrality by 2050. But the current technology can't do it. There's a huge new carbon absorbing plant which opened up in Iceland earlier this year. It can absorb something like 40,000 tons of carbon from the air annually, which is the equivalent of removing over 7,000 cars from the road. It sounds impressive, but it's still nowhere near enough. It's a bit like asking a computer in the 1950s to calculate two plus two, and the computer takes up a small office block. It takes time to go from that size of computer to a mobile phone and the point is that we don't have time. We have to reduce our consumption and our capacity to limit carbon emissions in 10 years from now, not in 20 or 30 years. Yet the technology in 10 years is not expected to be able to capture what is needed.

And the last point is on geo-engineering. Putting something in the sky to reflect the sun. I hope we will never go this way because it means we will need to have the agreement of every country at every moment in time in the world to do it. We have to send rockets up every day to achieve this. And what will happen when the US or China says no? The temperature will increase dramatically but we cannot assume that everyone will agree on the same course of action forever.

The number of climate events has increased dramatically in the last couple of years and it will not stop. We have to think deeply on these challenges and we must find ways to adapt, to change our way of doing things. Are we ready for that?”

Emerging markets outlook

China's stumbling economic growth has opened the door for India to take centre stage. And while global markets are still monitoring the health of the US economy, emerging markets are less tied to the US dollar than in the past.

Everywhere you look, emerging markets (EM) are changing. The term itself now covers a far wider array of constituents within the various EM indices than was originally envisaged in the late 1980s. It was intended to mobilise foreign portfolio investments to developing economies by spreading the risks across a range of markets and continents with different levels of development.

It made sense for a while – certainly when MSCI's index for the US and China used to move together almost in tandem. However, since China started to clamp down on the private sector in 2021, these indices have widely diverged[1]. And as a consequence of China's recent growth problems, does it even makes sense to treat EM as a single asset class anymore?

Sebastien Thenard, Senior Portfolio Manager, Emerging Market Debt at Paris-based Ostrum AM, said: "Seasoned EM investors are for sure frustrated with the term 'emerging markets'. This term made sense at the onset when there were only six or seven countries to invest in, however, over the years, the universe has broadened out to include around 80 countries. Today, EM is clearly a term that could be misleading when a significant part of the universe is rated investment grade.

"So, yes, there is now debate as the term no longer does justice to the wide array of constituents within the various EM indices. In terms of country ratings for example, within the same index, you have China and some Middle Eastern countries which have very high ratings, along with other countries like Venezuela, who are still considered in default."

> EM countries have matured and have become more autonomous, thus more financially independent, and therefore, less tied to the US dollar.
>
> **Brigitte Le Bris,**
> Head of FX and EM Debt, Ostrum AM

It's a similar story with 'the BRICs' – Brazil, Russia, India and China. Coined by former Goldman Sachs economist Jim O'Neill in an effort to rally investment around EM funds, that term has also largely outstayed its welcome – even after the addition of South Africa in 2011 to make it 'BRICS'.

According to Rafael Ch, Partner, Senior Analyst, Latin America Emerging Markets, at policy and strategy consultants Signum Global Advisors, it's time for EM to evolve.

He commented: "If you look at the last two to three years, it has become very evident for Latin American countries, that regional trade blocks are not that effective for advancing their economic agendas. That includes CARICOM [the Caribbean Community and Common Market] and even the MERCOSUR [the Southern Common Market, comprising Argentina, Brazil, Paraguay, and Uruguay].

"The signal is that BRICS pose a more attractive type of block that they could either adhere to or grow closer to. Ultimately, in a multipolar world, multipolar blocs might be more tempting for emerging markets to join rather than traditional trade blocks at the regional level."

Source:
[1] Bloomberg, Sep 2024, 'Don't let Fed noise drown out the signal from China', https://www.bloomberg.com/opinion/articles/2024-09-18/fed-noise-shouldn-t-drown-out-the-signal-from-china?srnd=undefined

Taking stock of EM growth

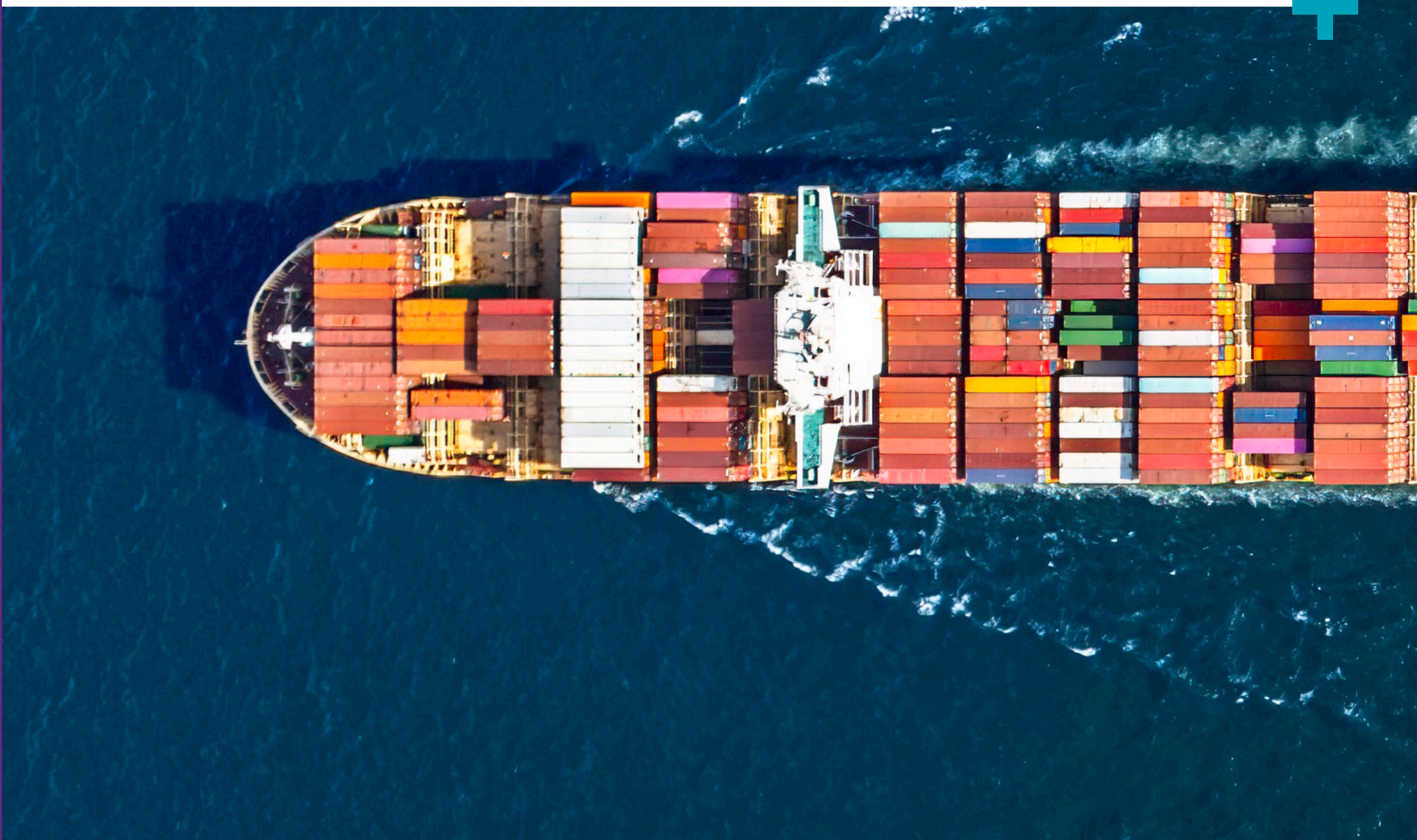
Problematic acronyms and nomenclature aside, there's certainly renewed optimism for economic growth across EM, coupled with more stable fiscal environments and lower dollar-denominated debt.

Brigitte Le Bris, Head of FX and EM Debt at Ostrum AM, explained: "For many years, EM have been dependent on international flows. An investment decision started out with an analysis of the US dollar and an opinion on where we were in the global economic cycle. Today, there are notable endogenous forces within EM for investors to consider. Countries have matured and have become more autonomous, thus more financially independent, and therefore, less tied to the US dollar.

"Meanwhile, numerous EM now have local pension funds to finance their growing local debt issuance. All of which adds confidence to our view that the performance of the asset class can continue to outpace DM bond performance in the years to come."

The opportunities are clear across EM equities too. Mike Tian, Portfolio Manager, Emerging Markets Equities at WCM Investment Management, commented: "We are bullish on consumer internet companies in EM, especially outside of China. We see strong secular growth, with relatively low levels of penetration, and increasing rationality. In almost every country, the winners and losers are becoming a lot clearer, and the winners are separating themselves from the pack.

"In the mid-term we are also very interested in South Korea's 'Corporate Value Up initiative' [which aims to enhance the appeal of the South Korean capital market to investors by encouraging companies to distribute more dividends]. It's early days, but we are seeing some companies embrace it and, if they prove successful and are rewarded in the market, we can certainly see this becoming a powerful theme."



India on the rise

China's recent launch of a broad package of monetary stimulus measures cheered the region's subdued markets – at one point, the CSI 300 index of Shanghai- and Shenzhen-listed shares was up nearly 30% from its February trough[1].

But the jury's out on whether there's enough in the Chinese "big bazooka" to tackle persistent deflationary pressure and an entrenched property crisis[2]. Indeed, Bank of America's latest Global Fund Manager Survey found growth expectations for China at a record low, with a net 18% expecting a weaker Chinese economy[3].

Conversely, Indian equities have performed strongly – India's share of the free-float, 'investable', version of the MSCI All-Country World index, which tracks almost all global stocks that can be bought on the open market, rose to 2.33% in September, eclipsing China's 2.06%[4]. A protracted downturn in the property market, tepid export demand, and subdued consumer spending are all weighing on China's post-Covid economic recovery[5].

Sources:

[1] Reuters, September 2024, 'China stocks surge in biggest single-day rally since 2008 on stimulus cheer', https://www.reuters.com/markets/asia/china-stocks-set-best-month-nearly-decade-stimulus-cheer-2024-09-30/

[2] Reuters, September 2024, 'China's failure to fire policy bazooka may keep markets in deep freezer', https://www.reuters.com/world/china/chinas-failure-fire-policy-bazooka-may-keep-markets-deep-freeze-mcgeever-2024-09-23/

[3] Fund Selector Asia, September 2024, 'Bank of America: Investors 'nervous bulls' as four in five anticipate soft landing', Investment Week, https://fundselectorasia.com/bank-of-america-investors-nervous-bulls-as-four-in-five-anticipate-soft-landing/

[4] Financial Times, September 2024, 'India overtakes China in world's biggest investable stock benchmark' https://www.ft.com/content/72864f6a-8b48-4638-84e1-1da5f03d3484?segmentId=6dc77dd0-43a2-1e35-202b-e0fd47da158c

[5] Financial Times, July 2024, 'The young investors gambling on Indian stocks', https://www.ft.com/content/398fde10-6e63-4b01-b834-1897d6265dcd

Indeed, our own survey of financial advisers found that they are equally concerned about the risk presented by US/China relations (61%), and 65% are worried that a breakdown in those relations is underappreciated. The question of trade is greater than growth, as only 47% see China's economy as a high risk[1].

Ashish Chugh, Portfolio Manager, Global Emerging Market Equities at Boston-based Loomis Sayles, thinks the biggest challenge for China over the long term stems from the real estate sector.

"We've seen this in other emerging markets and it takes many years for it to work out," he said. "The Chinese government announced they are going to create a fund that's going to buy up unsold property, but that's not sustainable – it's not the solution. Every time you build infrastructure and real estate it needs to lead to productivity improvement for it to create GDP growth.

"But they overbuilt, basically boosting GDP through the real estate sector, which makes up 40% of the economy[2]. And a large portion of consumer wealth is tied up in property assets. Related to that is the fact that real estate loans have stretched Chinese banks, which are 100% state owned."

Meanwhile, India is projected to be among the fastest-growing major economies over the next decade, with GDP growth expected above 6%[3]. A third consecutive term for the ruling National Democratic Alliance – led by the Bharatiya Janata Party (BJP) and its leader, Prime Minister Narendra Modi – is expected to provide policy continuity and stability.

"By 2035, India will potentially become the third largest economy in the world, far bigger than Germany and Japan," commented Mike. "If current trends continue, it will also be much more relevant in global supply chains, as well as in geopolitics. The western world will likely be struggling to deal with India in the same way it struggles to deal with China today, which will be made harder by India's increasingly assertive foreign policy."

Sources:

[1] Natixis Investment Managers, Global Survey of Financial Professionals 2024, conducted by CoreData Research between June 2024 and August 2024. Survey included 2,700 respondents in 20 countries, https://www.im.natixis.com/en-intl/insights/investor-sentiment/2024/financial-professionals-report

[2] Natixis IM, 'The emerging attraction of India', https://www.im.natixis.com/en-intl/insights/equities/2024/the-emerging-attraction-of-india

[3] Deloitte, August 2024, 'India economic outlook, August 2024', https://www2.deloitte.com/us/en/insights/economy/asia-pacific/india-economic-outlook.html

Who will emerge?

Investors will naturally be watching India and China particularly closely over the coming years. Yet we shouldn't forget the other EM regions that have the potential to shift the global economic landscape.

"The big question for the next 10 years is will the Latin American emerging markets manage to solve the fiscal crisis?", said Rafael. "We're coming from the past 10 years of cheap money, with a sudden shock between 2020 and 2022 where money was no longer cheap. All of which made it evident that most emerging markets were in very tight fiscal positions. So, over the next ten years, can they continue to kick the can down the road or will they have to address this situation?"

Moreover, while much of the hype associated with artificial intelligence (AI) has been driven by a handful of companies in the developed markets, the real opportunity in AI from a long-term investment perspective could well be in EM.

For Ji Zhang, Senior Research Analyst at Loomis Sayles, this is largely due to increased computing power, higher storage, and applications that use AI for tangible purposes. He explained: "When you think about increasing computing power, the world's leading semiconductor manufacturing – both in terms of technology, as well as manufacturing capability – is based out of Taiwan[1]. When you think about storage, the majority of the world's development for memory is based out of South Korea[2]. And when you think about development of new AI applications that are used in real life applications, much of the software development and architecture that's being concepted right now is coming out of Latin America and India.

"So, when you think about emerging markets for AI, you're not talking about companies that are hype type of companies. You're talking about many companies that may enjoy years and years of structural growth because they could be the true enablers of longer-term AI adoption."

Certain challenges will need to be overcome, such as ensuring there's the necessary internet and electricity infrastructure for AI to flourish. But these are not insurmountable. For the winners, there's real potential to kickstart a golden decade of innovation and growth.

"In the next 10 years, AI will become much more developed than it is today," added Mike. "Middle-income EM countries will be wrestling with the implications of AI, which has the potential to prevent them from climbing the value curve, both on the services side and the manufacturing side.

"How they adapt to these new technologies will determine which countries are successful longer term. Failure to adapt will likely lead to poor growth, higher inequality, and social unrest. We will see some winners and losers emerge, and the winners will likely be the 'new BRICS' countries we are going to be talking about in 2035."

Sources:

[1] World Population Review, 2024, https://worldpopulationreview.com/country-rankings/semiconductor-manufacturing-by-country

[2] CNBC, 'South Korea wants to be a top AI hub - its memory chip dominance could be an advantage', 2023, https://www.cnbc.com/2023/07/06/south-koreas-dominance-in-memory-chips-an-advantage-in-ai-race.html

Mabrouk Chetouane
Head of Global Market Strategy
Natixis IM Solutions

Regulation, investing and Europe – an impossible trilemma?

While the US has enjoyed a dynamic and resilient economic environment that supports market growth, the eurozone has been hampered by many factors that have restricted investment and its capabilities for growth. Will the gap continue to widen over the next decade, or does the EU have some surprises up its sleeve?

The US is outperforming the eurozone. By any measure – economic growth, stock market index performance, productivity of production factors and, above all, investment – the gaps have constantly widened over the past two decades. The difference between the two regions, particularly on the investment front, is such that catching up in Europe is now a pious hope (see chart).

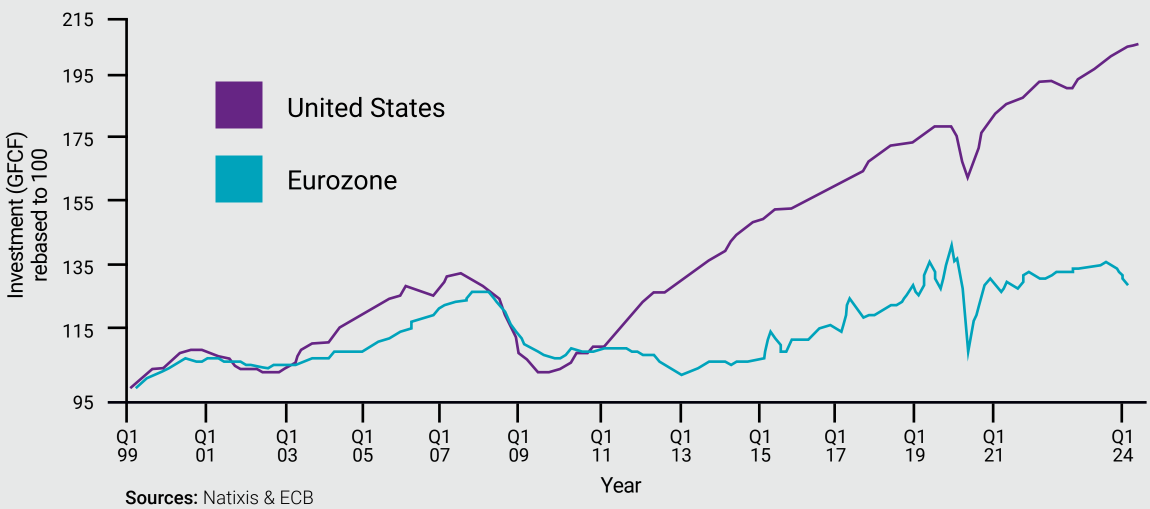
A justification frequently put forward to explain this gap is based on the opposition between Anglo-Saxon pragmatism and European lack of realism – an almost dogmatic stance that takes the form of regulatory inflation. Are European leaders lacking in pragmatism?

Are European institutions overzealous when it comes to regulation? What would be the consequences for our ability to invest and generate future growth?

These questions are even more strategic given that Europe's financing needs are estimated at €5.4 trillion over the next five years – including €900 billion in the digital sector[1]. It's no understatement to say that this is a huge amount of tomorrow's money to be found.

And it's clear that the eurozone is very different from the US. On the one hand, we have a union, and on the other a federation of states. This characteristic alone justifies many of the fundamental differences between the two

US vs eurozone investment since 1999 - a widening gap



Sources: Natixis & ECB

Source:
[1] Othman Bouabdallah, Ettore Dorrucci, Lucia Hoendervangers and Carolin Nerlich 'Mind the gap: Europe's strategic investment needs and how to support them', 2024 ECB Blog

zones and, therefore, the speed with which each is adapting to economic and financial conditions.

In effect, the very essence of a union requires the definition of a common regulatory, legal, and economic framework. Moreover, the level of flexibility between a union is negatively correlated to the level of homogeneity of the countries that compose it – the more heterogeneous the zone, the more precise the regulatory framework, leaving little room for manoeuvre.

A federation, on the other hand, defines a common set of values, which it crystallises via a common normative vector such as a constitution, leaving more room for manoeuvre and hence more flexibility. It is therefore clear that the regulatory inflation experienced by the eurozone is inherent to its very structure.

However, it is possible to create a protective regulatory framework without it being restrictive. This was emphasised in the Draghi report – the 2024 paper authored by former ECB president and former Prime Minister of Italy, Mario Draghi, which addressed European competitiveness and the future of the European Union – in which it was summed up as a trade-off between "quality of regulation versus quantity of regulation[2]. Nevertheless, examples proliferate (such as regulations for ESG, energy and digital) that lead us to believe Europe has opted for "quantity".

Is this difference, which stems from the structure of each zone, sufficient to explain the investment gap between the eurozone and the US?

Quality not quantity

In the case of the eurozone, the answer is stark. Between 1999 and 2013, gross fixed capital formation (GFCF) – the acquisition of produced assets, including purchases of second-hand assets – grew by 6% in the eurozone compared with 29% in the US. The sovereign debt crisis may have undermined recovery efforts, but such a discrepancy can be justified by economic considerations only.

Indeed, beyond the "quantity" of investments made, the "quality" and type of companies behind the investments is decisive. Moncada and Grassano (2020)[3] have analysed the top 1,250 R&D investors worldwide between 2005 and 2017. The authors examine which sectors and companies are most important to overall R&D intensity performance.

Interestingly, the structure and intensity of R&D efforts are both a function of factors that are under-represented in Europe. The study shows that only a few companies within key hi-tech sectors (in terms of their relative impact on overall R&D intensity) determine (positively and negatively) the bulk of the sector's intensity. It also highlights the EU has a much smaller number of R&D investors, regardless of company size, than the US in key hi-tech sectors.

Furthermore, the study finds there is strong heterogeneity in the R&D intensity of companies within these key sectors, particularly in Europe. Each of these findings are essential for a better understanding of the global gap in R&D intensity among transatlantic companies, and ultimately of Europe's lag.

In another report from 2022, the European Investment Bank (EIB) and the European Patent Office (EPO) draw similar conclusions – particularly regarding Europe's weakness in the new technologies sector. The EIB/EPO report shows that American "deep tech" companies file the most patent applications in so-called "smart and connected" technologies.

What's more, nearly 75% of small European deep-tech companies developing smart and connected technologies consider access to financing to be insufficient, and the lack of qualified personnel to be a powerful brake on their development. The expansion of EU companies could be boosted by easier access to financing at a later stage of growth, targeted subsidies, and early-stage deployment policies to help start-ups get off the ground.

Source:
[2] The future of European competitiveness: Report by Mario Draghi, 2024, https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en
[3] Pietro Moncada-Paterno-Castello & Nicola Grassano, 2020, 'The EU vs US corporate R&D intensity gap: Investigating key sectors and firms', JRC Working Papers on Corporate R&D and Innovation 2020-02, Joint Research Centre

These results hark back to the theory of Friedrich List, who in the first half of the 19th century evoked the principle of 'educational protectionism'. According to List, it is imperative to erect barriers to enable innovative industries to benefit from an environment favourable to their development, and to subsidise them in order to perpetuate their activity. Protective mechanisms such as tariff barriers (taxes or customs duties), regulatory barriers or subsidies are precisely the instruments used by the American and Chinese administrations to achieve their goals.

At the same time, the question of financing raised in this report has been largely taken up by the Draghi report (2024), one of the pillars of which is the emergence of a Europe-wide capital market. List's proposal, unanimously supported, has yet to see the light of day.

No respite

In many respects, catching up with the US seems difficult – if not impossible – for the eurozone to hope to achieve. Where could the shockwaves come from that would enable Europe to suddenly organise itself better, move faster and show lucidity? And what if the 47th US President, Donald Trump, who could be the cause of a few short-term ills, were at the same time the solution to some of Europe's medium-term problems?

History has shown that Europe knows how to be creative and pragmatic in crisis situations – just look at the response to the Covid crisis, or the development of the Next Generation EU plan.

Meanwhile, Donald Trump is acting as a gas pedal, and the new American administration will leave Europeans no respite. Indeed, they will have to use the same weapons as their main competitors to avoid stalling.

The second shockwave could come from the growing awareness of the increasingly devastating effects of climate volatility. Extreme weather events have cost the EU €487 billion over the past 40 years[4]. Almost a quarter (22%) of the world's clean and sustainable technologies are developed in the European Union , and 61% of them consider the EU single market to be their most important market of the future[5].

The challenges ahead, and the huge sums of money at stake, mean that Europe will have to invest heavily. If it does so, it could once again become a global centre of innovation. But only if it gives itself the means to do so.

Source:

[4] Eurostat, 'Europe's climate in data: Everything from heatwaves to the cost of disaster'
https://www.euronews.com/green/2023/02/07/europes climate-in-data-everything-from-heatwaves-to-the-cost-of-disaster

[5] European Investment Bank report, 'Financing and commercialization of cleantech innovation', 2024

Future of equities

Looking back at 2024, it's clear that US equity markets had become concentrated, thanks to the AI hype and bubbly tech stocks. At one point, the Magnificent 7 (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla) comprised nearly 30% of the S&P 500[1].

- Thematic equity investments continue to offer an alternative way to harness disruptive and innovative technologies without the limitations that come with a concentrated sector bet[2].
- Moreover, the concentration of today's stock market, both geographically and at the individual company level, coupled with rates that will be higher for longer, means diversification, analysis, and time-tested investment themes are more important than ever.
- According to our 2024 survey, 63% of fund selectors believed active would outperform passive in 2024 – of which, 75% said active will be essential for generating alpha[3]. So, while passive funds overtook active funds in terms of assets under management at the close of 2023, the next ten years could be very different.

Clearly, the investment environment we lived in from 2010 to 2020 was abnormal – after all, there's nothing normal about living with non-existent inflation and zero interest rates. Looking ahead, 'back to normal' is likely to spell stickier inflation and higher rates for longer, making active portfolio management potentially the best way to manage the next ten years.

Sources:
[1]CNBC, https://www.cnbc.com/2024/07/01/how-magnificent-7-affects-sp-500-stock-market-concentration.html
[2]Thematics AM, March 2024, https://www.im.natixis.com/en-intl/insights/equities/2024/why-investing-in-innovation-goes-beyond-the-magnificent-seven
[3]Natixis Investment Managers, Global Survey of Fund Selectors 2024, conducted by CoreData Research in November and December 2023, https://www.im.natixis.com/en-intl/insights/investor-sentiment/2024/fund-selector-outlook

Aziz Hamzaogullari,
Founder, CIO and portfolio manager for Growth Equity Strategies at Loomis Sayles, on why his long-term vision for assessing profitable growth equities is the same as it has always been:

"We really focus on the long-term secular drivers and sources of sustainable and profitable growth. Historically, these key structural drivers do not change very frequently, and they sustain themselves for long periods of time.

We are talking about things such as the evolution of payments from paper to electronic; the migration of retail from bricks and mortar to online; and the migration of advertising from the physical world to online and the transformation of our world through the development and integration of AI. Durable growth is very rare, and once we find these rare businesses, circumstances frequently allow for us to stay invested for a long time."

Danny Nicholas,
Client Portfolio Manager at Harris | Oakmark, on why there is a case to be made for a more sustained period of value outperformance:

"It's not unusual for the S&P 500 to achieve a new high. Over the past 5 years it reached a new high 165 times, that's nearly three times a month on average[1]. Experienced investors know that timing the market is very difficult and for fundamental stock pickers and value investors any time can be a good time to invest – the key is picking the right stocks at the right time."

Source:
[1] Bloomberg, 5 years prior to June 2024.

Jens Peers
CIO, Mirova US

Karen Kharmandarian
CIO, Thematics AM

Equity themes for the next decade

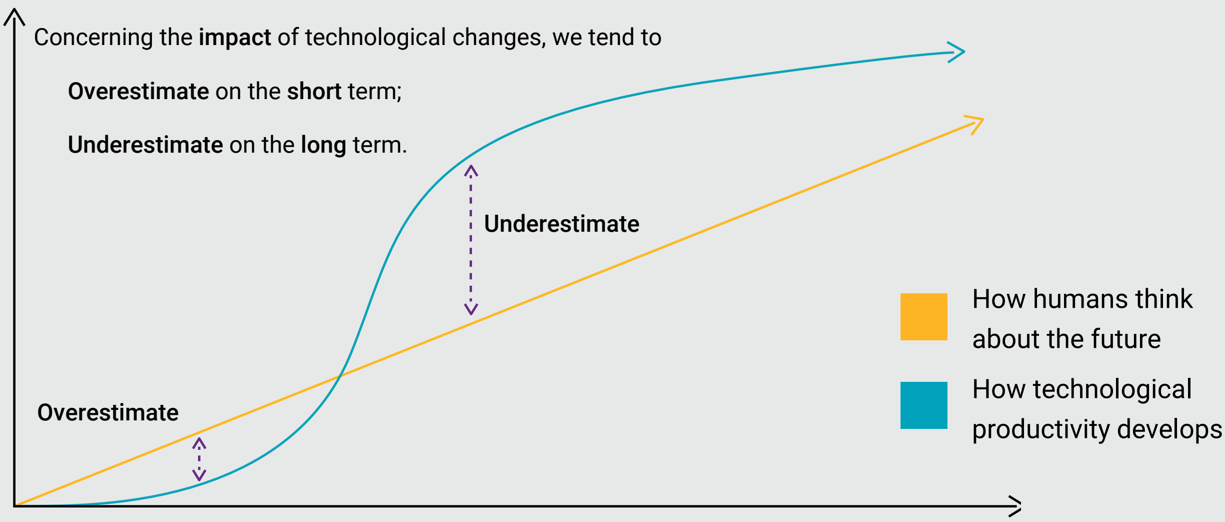
According to the World Economic Forum's Top 10 Emerging Technologies of 2024 report, it's perhaps no surprise that the speedy acceleration of artificial intelligence (AI) – and what it means for scientific research – tops this year's list of major tech developments[1].

While scientists have long been experimenting with how AI can advance their knowledge and capabilities, recent breakthroughs in deep learning, generative AI and foundation models are changing the game when it comes to rates of discovery and prediction.

The WEF's report explains how 'AI for Scientific Discovery' is transforming how new knowledge is discovered and used: AI systems such as Deep Mind's AlphaFold, for instance, can accurately predict the 3D models of protein structures[1]. Indeed, AI has also been applied in research that discovered a new family of antibiotics and created materials for more efficient batteries[1].

However, it's important to put some of the AI hype into perspective. Karen Kharmandarian, CIO at Paris-based equities investor Thematics AM, commented: "Amara's law cautions that we tend to overestimate the effect of a technology in the short run and underestimate the effect in the long run. While the long-term opportunities related to AI are significant and far reaching, there are always risks that the hype associated with the underlying technologies subsides before those same technologies are widely adopted."

Amara's Law



Source:
[1] WEF, 2024, https://www.weforum.org/agenda/2024/06/top-10-emerging-technologies-of-2024-impact-world/

Karen went on to explain why the most exciting breakthroughs sometimes come from not so obvious applications. He cited how it's often the most creative and fantastical applications of AI that make the headlines. For instance, the potential of Generative AI to create personalised movies, with the ability for audiences to pick their own actors or even insert themselves into the storyline, or AI powered robotic bees that could support pollination and crop development to help stem biodiversity loss against a backdrop of declining honeybee populations. But behind the headlines, AI is being put to work in areas such as drug development and chip design.

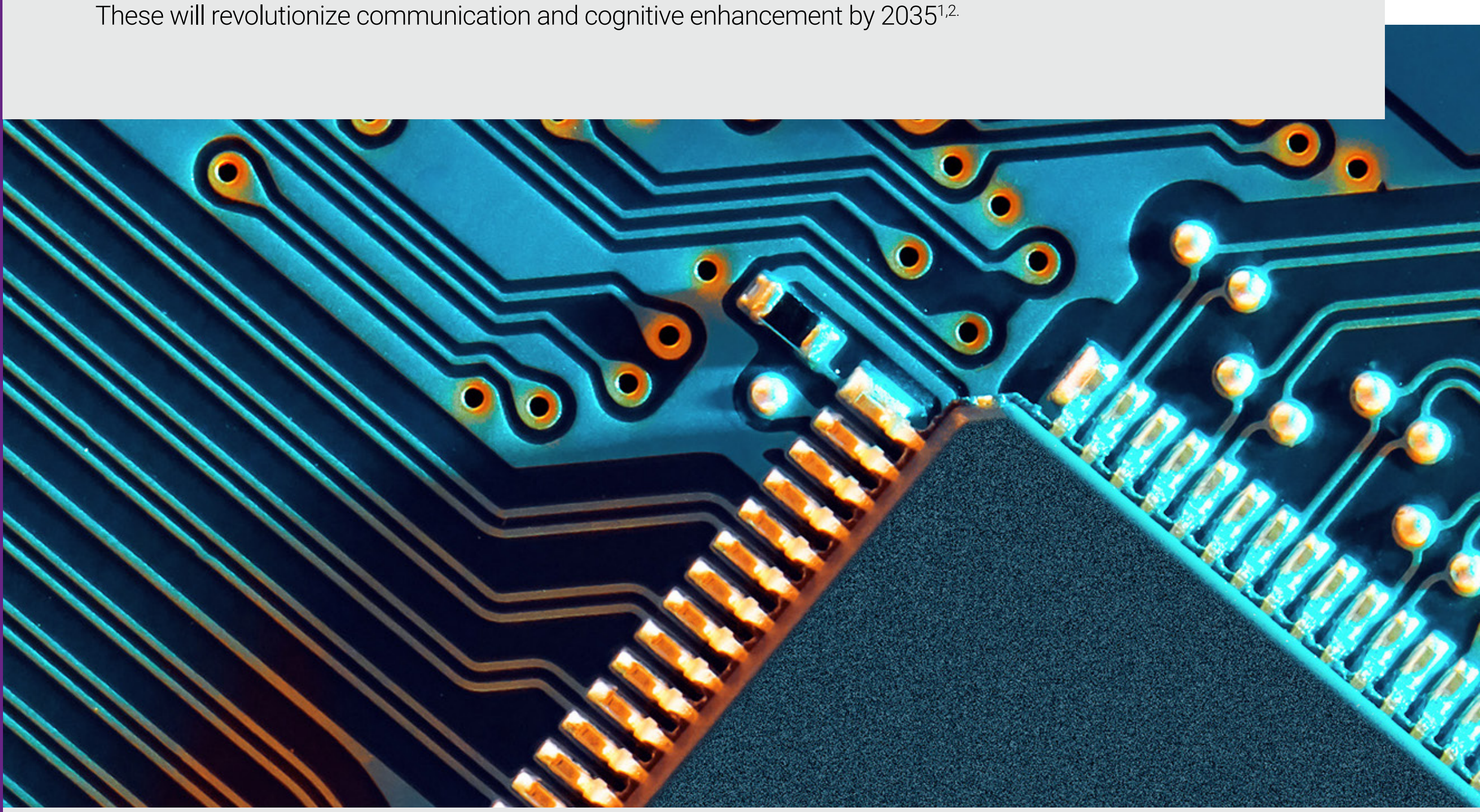
The world in 2035: Predicted tech advancements

- **Quantum computing:**
Expected to revolutionize materials science, drug discovery, and complex system modelling, rendering standard encryption obsolete by 2035[1,2].

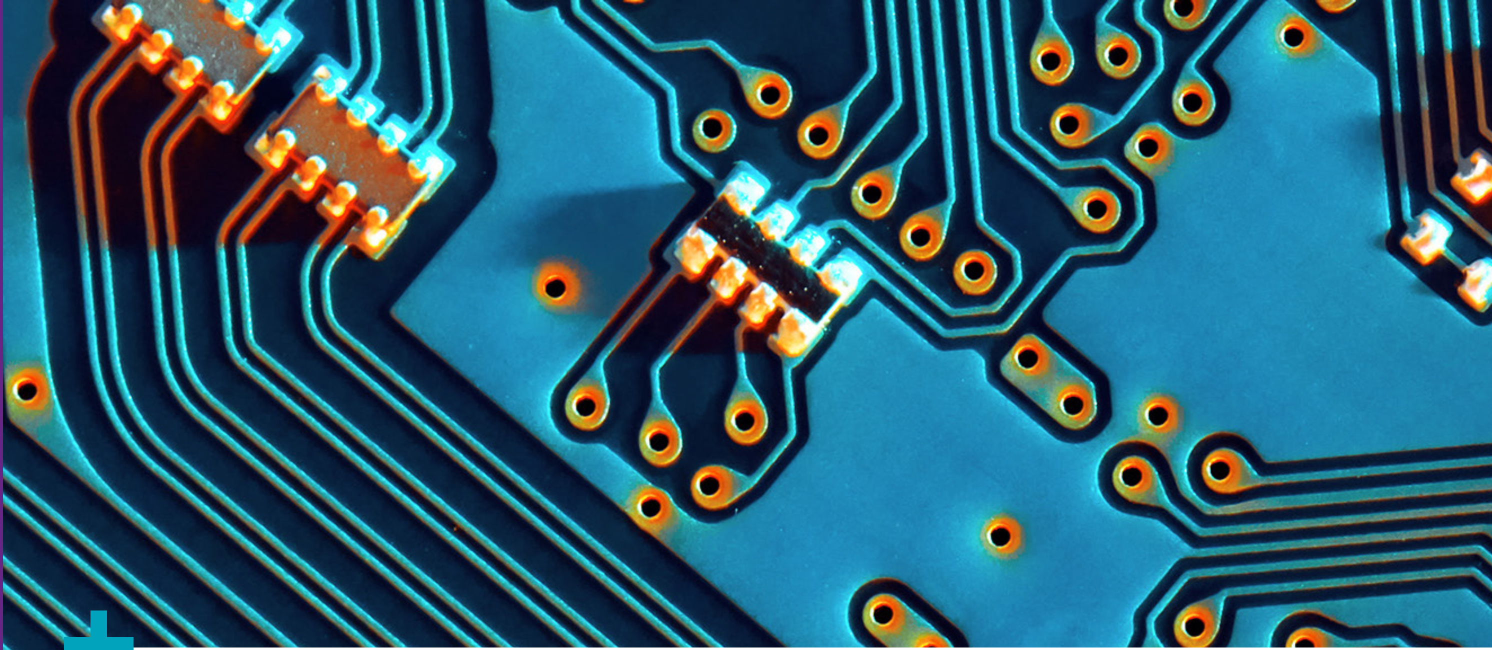
- **Artificial Intelligence (AI):**
AI will evolve into fully immersive environments, transforming social interactions and communication by 2035[2].

- **ClimateTech:**
Integration of AI-driven climate models and renewable technologies will become crucial for sustainable urban planning and climate adaptation[1,2].

- **Brain-Computer Interfaces (BCIs):**
These will revolutionize communication and cognitive enhancement by 2035[1,2].



Sources:
[1] Unveiling the Future: 10 Predictions for a Transformative 2035 | Datafloq https://datafloq.com/read/unveiling-future-10-predictions-transformative-2035/
[2] 2035 Vision: Ten Predictions for the Future - The Digital Speaker https://www.thedigitalspeaker.com/2035-vision-ten-predictions-future/
[3] The World Between 2024 and 2035: A 10-Year Prediction of Future https://eagmark.net/future-agriculture/



A case in point: in November 2020, Google DeepMind's AI technology AlphaFold was recognised by a community forum of scientists as having found a solution to a 50-year old biology problem.

Karen explained: "For decades scientists had been trying to devise a method to reliably determine how the attraction and repulsion of amino acids leads to seemingly spontaneous protein structures with intricate curls and loops, called protein folds. The AI model that DeepMind developed, using the same foundational techniques that powered AlphaGo to victory against the legendary Go player Lee Sedol in 2016, is able to accurately predict the 3D structure of protein folds. AlphaFold's updated database, that today contains over 200 million structures, was made freely available to the world in July of 2022.

"Thanks to AI innovations like AlphaFold, companies are now able to sift through billions of different molecules to simulate and understand how various drugs interact with the human body on a molecular, cellular, or even genetic scale. This has the potential to significantly reduce drug development timeframes, improve success rates and ultimately reduce costs."

Within this dynamic and rapidly evolving investment opportunity set, investors have the challenge and the opportunity of identifying the long-term winners early on but, more importantly, avoiding 'over-hyped' areas of the market that could be materially detrimental to performance.

"It is likely that the winning strategies of tomorrow will be those that maintain consistent and long-term exposure to the most attractive opportunities in the universe, while adopting a strict valuation discipline to help smooth the inevitable ups and downs along the way," Karen continued. "Indeed, we believe that the true value lies in the enablers of artificial intelligence rather than the adopters, for these are the companies that are poised to benefit from the continued exponential advancements in the field that we've witnessed since the 1940s."

In addition to using the last decade of robotics and automation as a lens to look at what the future might hold for AI, combining these two areas can present a novel opportunity-set for investors that not only balances two fields at different stages of their development and adoption – as well as with different cyclicality and valuations – but two fields with a myriad of mutual and self-reinforcing benefits.

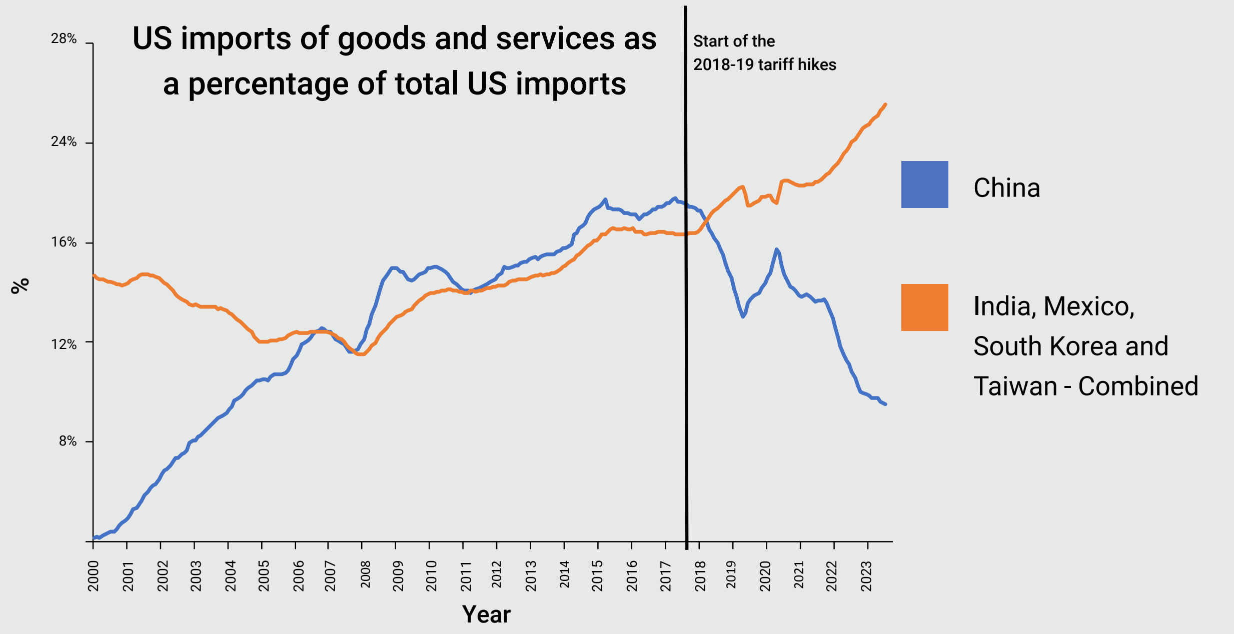
New routes to risk… and opportunity

While AI has been the driving force behind the majority of returns for large-cap global indices for most of 2024, there are other long-term themes that have not received as much attention from investors, so they are trading at lower valuations and could hold just as much investment potential over the next ten years.

For Jens Peers, CIO and portfolio manager at sustainable investing specialist Mirova US, there are three exciting areas to pay close attention to: global supply chains, healthcare, and water sanitation.

After decades of globalization, countries and companies have begun to rethink how their supply chains are organized. It's a shift driven by a changing geopolitical landscape, the emergence of new global powers and recent global events which have revealed global supply chain weaknesses and risks.

Global supply chain diversification has become more apparent, especially since 2018 when major US tariffs on Chinese goods were implemented, with trade data indicating de-coupling and de-risking of supply chains. Moreover, as a result of Covid and Russia's war with Ukraine, there were many supply chain issues and companies had difficulty getting the products they needed to the right place at the right time.



Source: Bloomberg, 2024

Jens explained: "Since that time, companies have been rethinking their global supply chains and outsourcing more to companies that are located in countries that are friendlier and closer to their main markets. We call this friendshoring or nearshoring. This trend has continued with the increased geopolitical uncertainty between the US and China, as well as Russia and the Middle East.

"There are a lot of opportunities in this thematic related to manufacturing and transportation with significant costs involved, as companies relocate parts of their production to other countries. For some companies, it is a risk, and for others, it is an opportunity."

Investing in longevity

Opportunities for advancements in obesity drugs and cancer treatments make innovations in the healthcare sector another theme to watch. Research by Morgan Stanley finds obesity has a 2.4% drag effect on GDP and is associated with more than 200 health complications, contributing to a five-fold US health spend increase since 1970[1]. With search interest in obesity medications up 100% year-on-year, their base case is a $105 billion market by 2030[1].

"We have already seen big opportunities related to obesity in the last couple of years, and we think that is going to continue," said Jens. "However, we also see more and more positive evolutions with drugs getting through phase II and phase III in oncology, the battle against cancer, and we expect that to be a big driver of future returns for the pharmaceutical industry."

For Jens, a third theme to monitor over the long term is water treatment. Polyfluoroalkyl substances, better known as PFAS, are manufactured chemicals used in industrial production. Traces of PFAS are found in everyday household objects, and we inhale these so-called 'forever chemicals' on a daily basis – named as such since they can take centuries to break down in nature.

Although home treatment systems that use filtration technology won't reduce the amount of PFAs produced, a collective effort to remove them from drinking water could help to limit the number of health conditions that might develop as a result of imbibing PFAS.

Jens explained: "In the US, a new regulation has been put in place that requires drinking water to be treated for permanent chemicals, such as PFAS. These permanent chemicals are used in the production of Teflon or waterproof clothing, for example. Through rain, wear and tear, and so on, a lot of these chemicals ultimately get absorbed into our soil and water.

"These chemicals are very toxic for humans. That water needs to be treated, and it is a significant opportunity for the handful of companies that have a solution right now. This could lead to a multi-billion-dollar opportunity in the US and around the world."

Whether it's distinguishing the hype from the high performance around AI, or tracking the trajectory of innovations across supply chains, healthcare and water, there are plenty of equity themes for investors to keep an eye on over the next ten years.

Source:
[1]Morgan Stanley research, 'The World in 2030 in 10 short stories'

Future of fixed income

The fall in headline inflation in the last quarter of 2023 led many market participants to expect central banks to cut interest rates as early as the first quarter of 2024. Those expectations did not materialise due to the persistent nature of underlying inflation and, more specifically, inflation in the services sector, which didn't weaken.

Meanwhile, heightened geopolitical risk has increased volatility and, at the same time, there's been the realisation that deglobalisation and the energy transition will be both complicated and costly. In this environment, with risk levels and investor uncertainty high, diversification remains essential from an asset allocation stand point.

- Over the past 30 years, following the bond market has often been a successful strategy[1]. However, the return of inflation, rates volatility and geopolitical uncertainties mean today's markets demand a more active approach.
- Debt levels weigh on investor minds. The IMF has warned that deficits have stoked inflation and pose 'significant risks' to the global economy[2]. Given this, many countries will have to walk a tightrope, especially given high foreign ownership of their public debt and any missteps could soon be punished severely by so-called 'bond vigilantes'. Fiscal dominance is also likely to mean higher rates over the long term, as investors come to terms with a new paradigm of stronger fiscal driven growth, economic uncertainty, and higher 'neutral rates'.
- Many market participants have never experienced this sort of market. Indeed, one of the key challenges facing investors in today's market is their lack of understanding about bonds, interest rates, and fixed income investing. Our 2023 survey of individual investors showed that as rates were rising, only 2% knew what it meant for bonds[3] – current value went down, while future income potential went up. That lack of knowledge, plus attractive rates on cash, made it difficult to move clients back into bonds.
- In other research, of the 2,700 advisers surveyed, 89% said one of their key challenges is to increase fixed income allocations in client portfolios. Perhaps unsurprisingly, at the top of the list of challenges is the uncertainty around interest rate policy. This sentiment may be changing, as inflation reaching target levels in many countries has resulted in rate cuts, and the assumption is that there are more to follow[4].

Over the medium and longer term, flexibility will continue to be the watchword for fixed income investors. The frequency and number of rate cuts, in a cycle that began in 2024, will determine to what degree investors can take advantage of both rising and falling rates.

As François Collet, Deputy CIO and portfolio manager at Paris-based DNCA Investments, pointed out: "It is always important to remember that starting points matter. If they are too expensive, even great ideas can turn out to be bad investments."

Sources:

[1] Morgan Stanley, 'Return of the 60/40', https://www.morganstanley.com/im/publication/insights/articles/article_bigpicturereturnofthe6040_ltr.pdf

[2] IMF, https://www.imf.org/en/News/Articles/2024/04/17/tr041724-transcript-of-fiscal-monitor-april-2024-press-briefing

[3] Natixis Investment Managers, Global Survey of Individual Investors conducted by CoreData Research in March and April 2023, https://www.im.natixis.com/en-intl/insights/investor-sentiment/2023/individual-investor-survey

[4] Natixis Investment Managers, Global Survey of Financial Professionals conducted by CoreData Research between June and August 2024, https://www.im.natixis.com/en-intl/insights/investor-sentiment/2024/financial-professionals-report

Fixed income themes for the next decade

Matt Eagan
Portfolio Manager and Head of the Full Discretion Team
Loomis, Sayles & Company

Xavier-André Audoli
Head of Multi Asset Expertise for Insurance
Ostrum AM

François Collet
Deputy CIO - Portfolio Manager
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The AI-driven bull run in equities markets may have celebrated its second birthday in October 2024, but the picture has been a little more mixed for fixed income investors. We want narratives in fixed income, too. Yes, numbers matter, but what really helps us understand something is a story – what's really going on, how the world is changing, and why.

It doesn't always lead to the correct conclusion of course – often, we end up with what Nassim Nicolas Taleb, of 'Black Swan' fame, refers to as 'narrative fallacies'[1], whereby we fit all incoming data points to a preconceived story, often after the fact.

For fixed income investors, it's difficult to avoid a narrative that isn't dominated by interest rates and inflation. There's no denying market conditions have changed, with a record global tightening cycle and fiscal uncertainties leading to something of a fixed income reset in 2022. Then there's yield curve dynamics, with the curve moving wildly to defy some of the traditional rules of fixed income.

Still viewed by some as a harbinger of recession, an inverted yield curve – as has been the case since April 2022 – can encourage investors to favour short-term bonds due to higher yields, even if this increases exposure to reinvestment risk if rates fall, and often prompts a reassessment of duration strategies. After all, if a recession or slowdown isn't on the cards, why take additional interest rate risk for no commensurate increase in yield?

Still, it remains rates that really count. And while the decline in short-term rates might already be underway, the trend for long-term rates seems much less clear – partly because of the uncertainty over inflation. After a sharp decline from May to September 2024 – from 4.70% to 3.60% for the 10-year yield – US long-term rates rose in October, on the back of better-than-expected economic data and rising consumer prices[2]. However, debate continues about the theoretical equilibrium level of long-term real interest rates, or the so-called R* or 'neutral rate'.

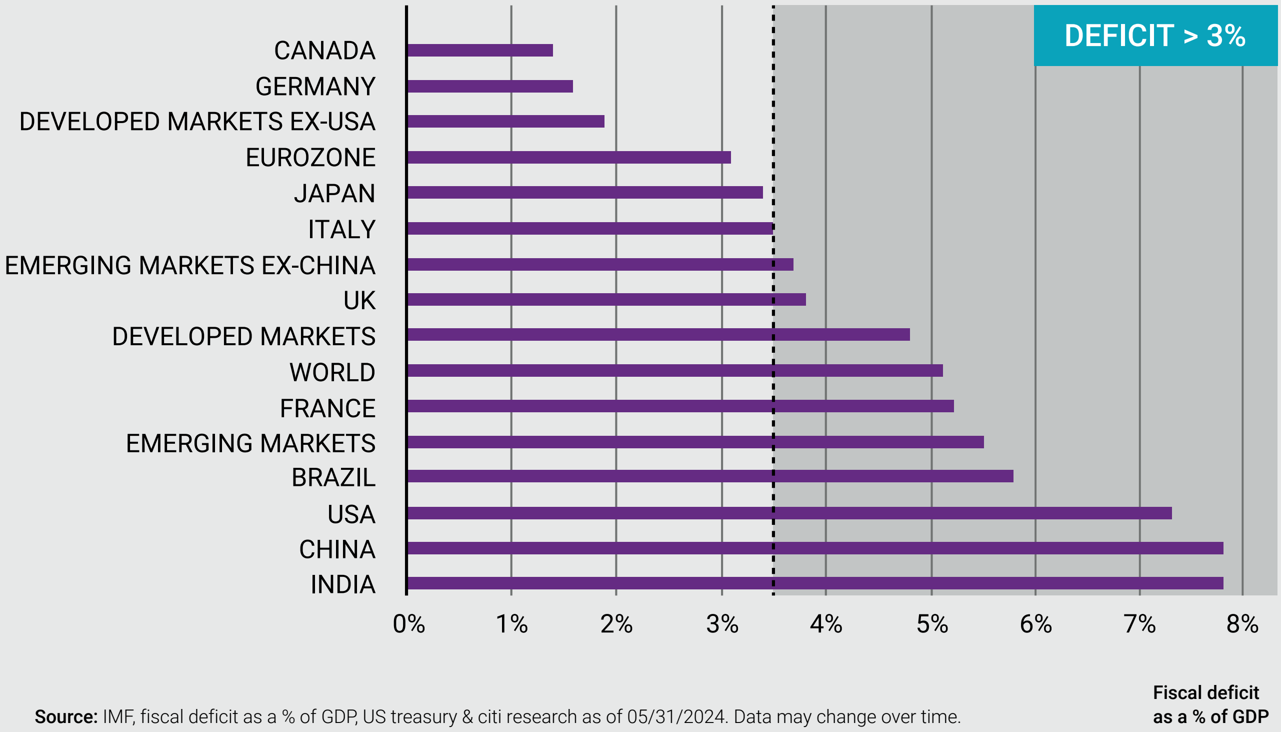
This matters. Since 2022, while real rates and potential growth have largely converged, nobody knows if this is sustainable, or where R* lies for sure. Some economists argue that the underlying reasons for the situation in the 2010s of so-called 'secular stagnation' – when real interest rates had to remain very low in order for economic growth to hold and unemployment to fall – are still present; others describe a new regime of structurally tighter employment, higher fiscal spending, higher nominal growth, and higher neutral rates.

Budgets under pressure

Whichever scenario is true, public debt is certainly one area that is being watched closely by François Collet, Deputy CIO and Portfolio Manager at Paris-based DNCA Investments, who believes it could pose a greater threat over the long term.

He commented: "Debt is a topic we have spoken about at length and it remains a concern and not just to us. As you can see from the chart below, a number of significant markets now boast a fiscal deficit greater than 3% of GDP[3]. And recently the IMF warned that deficits have stoked inflation and pose 'significant risks' to the global economy[4]. Given this, such countries will have to walk a tightrope, especially given high foreign ownership of their public debt, and any missteps could soon be punished severely by so-called bond vigilantes."

The IMF is concerned about large deficits



Source: IMF, fiscal deficit as a % of GDP, US treasury & citi research as of 05/31/2024. Data may change over time.

Meanwhile, deficit spending is also a concern for Matt Eagan, Head of Full Discretion Team and Portfolio Manager at Boston-based Loomis Sayles. He explained: "Government budgets are under intense pressure from a variety of spending needs, including entitlements, defence, and industrial policy. Deficit spending has gone from being a counter-cyclical measure to something structural in nature and governments around the world will need to issue more and more paper to pay the bills."

Sources:
[1] Farnam Street blog, 'Avoiding Falling Victim to The Narrative Fallacy', https://fs.blog/narrative-fallacy/
[2] Dorval research, as of 14th October 2024
[3] IMF, US treasury & Citi research as of 05/31/2024. Data may change over time
[4] IMF, https://www.imf.org/en/News/Articles/2024/04/17/tr041724-transcript-of-fiscal-monitor-april-2024-press-briefing

Matt says this can have a couple of effects that investors should consider. "First, it tends to be inflationary because government spending stimulates the economy on a persistent basis," he said. "Second, it tends to increase rates in both nominal and real terms as more and more supply of Treasury debt drives up the real, risk-free cost to borrow while simultaneously crowding out the private sector. The net result is that interest rates are likely to trend upward in both nominal and real terms over the coming decade."

Many of the structural transitions related to ageing populations, de-globalisation and climate change are likely to continue to foster inflationary tailwinds and higher real rates. For instance, demographics and the shrinking share of working age population are putting pressure on budgets from entitlement spending, fuelling labour-bargaining power.

Matt also points to security concerns stemming from the geopolitical risks of a multi-polar world and the intense rivalry between China and the US. He commented: "In this landscape, secure supply chains trump low-cost production. Nations, companies, and even individuals seek to reduce their vulnerabilities. And the result is a re-ordering of trade and capital flows into less-than-optimal areas."

A question of duration

Beyond the impact on inflation and rates, the structural transitions are also have a bearing on fixed income's place in a long-term investor's portfolio. Xavier-André Audoli, Head of Multi Asset Expertise for Insurance at Paris-based Ostrum AM, said: "When it comes to asset allocation, deglobalisation means decorrelation between countries and geographical areas. A more geographically diversified portfolio is a source of opportunities for our clients.

"On the flipside, deglobalisation implies more risks – especially through geopolitical change, trade wars, protectionism, and probably more extreme events. We need to hedge our portfolios against these deglobalisation-related risks in the coming decade. And we're not talking only about allocation, we are also talking about how to manage drawdown risk in this new environment."

For Xavier-André, the environmental transition in particular could have a huge influence on broader asset allocation. He continued: "For our institutional clients, climate change is likely to have an impact in terms of regulation and in terms of investment decisions.

For instance, regulations require insurance companies to consider stress tests on climate impacts. The insurers would then allocate sufficient capital to their balance sheet. We help insurance companies to invest this capital in less risky assets, primarily to bonds. Hence, climate change may require insurance companies to invest more in bonds to meet their regulatory requirements."

The world in 2035: Who's leading, you or the central banks?

The degree and frequency of the US Federal Reserve's rate cuts, and how other central banks around the world follow their lead, are likely to continue to impact fixed income investments for the foreseeable future in several ways:

- Yield changes: Rate cuts typically lead to lower yields, especially in short-term bonds, prompting investors to consider longer maturities for better returns.
- Portfolio shifts: Investors might shift from cash or money markets to bonds and equities as cash yields decline on the back of rate cuts, seeking capital appreciation and higher income.
- Economic outlook: A supportive Fed policy can boost risk assets like corporate credit, but strong economic growth may limit bond price gains despite rate cuts if yields rise.

Ultimately, careful portfolio adjustments are necessary to navigate these changes.

Xavier-André went on to explain how the impact of climate change also affects insurers' property and casualty business, commenting: "An increase in both the number and the frequency of extreme events, such as storms or droughts, as we have witnessed in Europe in recent times, means more compensation to the final clients in order to repair the damages, as well as a shorter liability. In our allocation, we therefore have to deal with the prospect of shorter duration."

Taken together, the future is unlikely to be straightforward for fixed income investors. In contrast to the previous decade, however, when bond investments were questionable due to their ultra-low yields, today's bond investors must consider traditional stock-bond correlations, even if government bonds can at least earn a respectable real yield for the first time in years.

Meanwhile, other areas of fixed income, like corporate credit and floating-rate instruments, are expected to benefit from structurally higher interest rates and continued investor demand for income-generating investments. As the economic landscape evolves, investors in this asset class will need to get comfortable with regular portfolio reviews and adjustments. It will mean taking a diversified approach, balancing risk and return while being responsive to macroeconomic changes and market conditions.

As Matt concluded: "A set-it-and-forget-it strategy is no longer optimal. Instead, duration needs to be managed through each cycle".

Asset allocation and the evolution of the 60/40 portfolio

Revolution is unlikely to come anytime soon for the 60/40 portfolio, which is a traditional combination of 60% allocated to stocks and 40% to bonds. Its death has been foretold many times in the past, yet it has remained an important and enduring tool in an asset allocator's kit.

And while it will likely remain a viable strategy for many investors, a challenger is emerging – one which uses a more evolved strategy that will likely be better adapted to meet the challenges posed by the investment landscape today, and potentially over the coming years.

- High equity valuations, particularly in the US market, suggest lower future returns for stocks over the next 5-10 years[1,2]. Goldman Sachs, for example, estimates that the S&P 500 index will deliver an annualised nominal total return of 3% during the next 10 years, far lower than the 13% it generated over the previous decade[3] (7th percentile since 1930) and roughly 1% on a real basis. This could weigh on the overall performance of a 60/40 portfolio.
- Many investors are no longer as convinced by the long-term stability of the historically negative correlation between bonds and equities, especially since the supply chain shocks of 2022. The hedging value of bonds within portfolios may diminish, therefore challenging traditional investment strategies such as the 60/40 asset allocation model[1,2].
- With traditional bond-equity correlations in question, interest in alternative sources of diversification have increased significantly at the same time that access to private markets is opening up.

Financial advisers certainly see clear benefits to adding private assets to client portfolios. According to our survey[4], almost half (49%) say private assets are more attractive given high correlations in public markets, while 56% say private assets have improved outcomes for clients.

Given increased investor demand, 56% also plan to increase the use of private assets in the next five years[4]. That said, more investor education is needed: 72% say that clients do not understand the holding period that comes with private investment[4]. Nevertheless, in a changing environment, one could argue that the days of the traditional 60/40 portfolio might be numbered after all.

Eric Deram,
Managing Partner at private equity specialist Flexstone Partners, on the potential of private markets:

"For me, the narrative over the next ten years continues to be that entrepreneurship is a winning system for ensuring wealth creation for the world population. Private capital has demonstrated time and time again that it is vital for innovation.

And while AUM in private assets still represents less than 10% of all investable assets, and private equity specifically remains a fraction compared to listed equities, more than 80% of companies globally are held in private hands and need financing through private equity[5]. As a result, the financing of private entrepreneurship will continue to be vital for economic development and innovation.

Of course, private equity is not immune to volatility and periods of recession, such as we have experienced over the last two years. But the long-term outlook remains very positive. Indeed, there are some fantastic investment opportunities not least because of the energy transition and more generally technological innovations that will help deal with climate change.

Moreover, the democratisation of private assets is highlighting the size of the opportunity set. I'd also argue that it is easier to build a truly diversified portfolio in private equity compared to listed equity, which is becoming more concentrated.

That being said, there are several issues that need to be considered carefully. There's liquidity for one: despite the emergence of semi-liquid funds, these investment strategies remain fundamentally illiquid and therefore not necessarily advisable to everyone directly – except, through pension schemes.

Then there's the cost: private equity products manufactured for private individuals are substantially more expensive than the ones for institutional investors. Clearly, we need to be careful how we educate different types of investors on this point or there's a danger that we spoil the momentum of potentially enhanced investment performance."

Sources:

[1] Money Marketing, 'Long live the 60/40 portfolio?', https://www.moneymarketing.co.uk/opinion/long-live-the-60-40-portfolio-should-the-60-40-portfolio-survive/
[2] Goldman Sachs, 'The 60/40 portfolio should offer a better risk-reward in 2024', https://www.goldmansachs.com/intelligence/pages/the-60-40-portfolio-should-offer-a-better-risk-reward-in-2024.html
[3] Goldman Sachs, 'Updating our long-term return forecast for US equities to incorporate the current high level of market concentration', gspublishing.com
[4] Natixis Investment Managers, Global Survey of Financial Professionals conducted by CoreData Research between June and August 2024. Survey included 2,700 respondents in 19 countries.
[5] Kohlberg Kravis Roberts & Co LP (KKR), Global Macro Trends, 2024.

A portfolio fit for the future

Julien Dauchez
Head of Portfolio Consulting & Advisory,
Natixis IM Solutions

Private assets, long the preserve of institutional investors and high net worth individuals, are increasingly on the minds of wholesale investors. Not only do they hold up the promise of diversification in a world that is increasingly too complicated for a simple 60/40 allocation, but recent performance and growing ease of access as a result of regulatory changes such as ELTIF 2 make them ever more attractive.

That said, while adding private assets to a portfolio is increasingly easy to do, wholesale allocators also need to carefully consider investment horizons and liquidity needs if they are to mitigate the risks and successfully harness the growth in AUM that is expected.

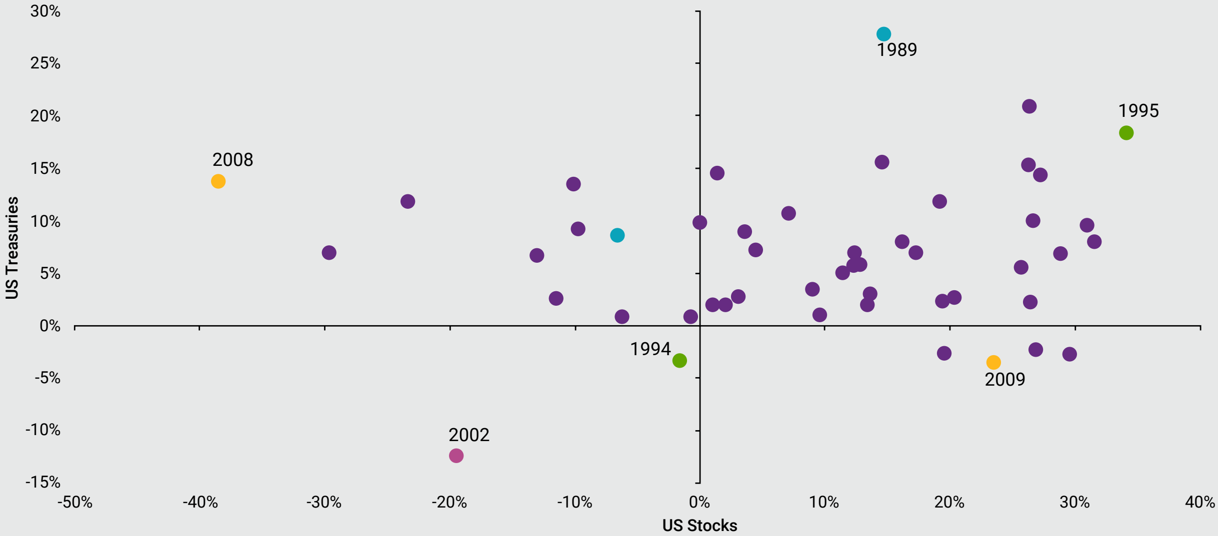
In this interview, Natixis IM Solutions' Julien Dauchez explains why alternatives have their place in modern portfolio thinking.

Q How are you thinking about portfolio construction in 2024? Is it time to retire the traditional 60/40 model?

“There are a number of factors supporting the 60/40 model. The first one is historical robustness. Looking back 100 years and considering a holding period of 5 years, as an investor in the 60/40 portfolio you would have incurred mild losses on three instances only: just after the Second World War, just after the global financial crisis in 2008, and in 2022 when we had the dual bear market in bonds and in equities that year, as shown in the chart. But if you broaden out the picture, looking at the 10-year rolling returns, then you are yet to lose money with the 60/40 portfolio.

Moreover, the simplicity of the 60/40 model shouldn't be overlooked. This is important for clients to understand and it matters in particular in an environment where regulations are getting tighter and tighter – even if there are new forces driving towards the emergence of a 50/30/20 portfolio.”

A standard 60/40 portfolio has been remarkably resilient: US stocks versus US bonds, annual total returns from 1975 to 2022



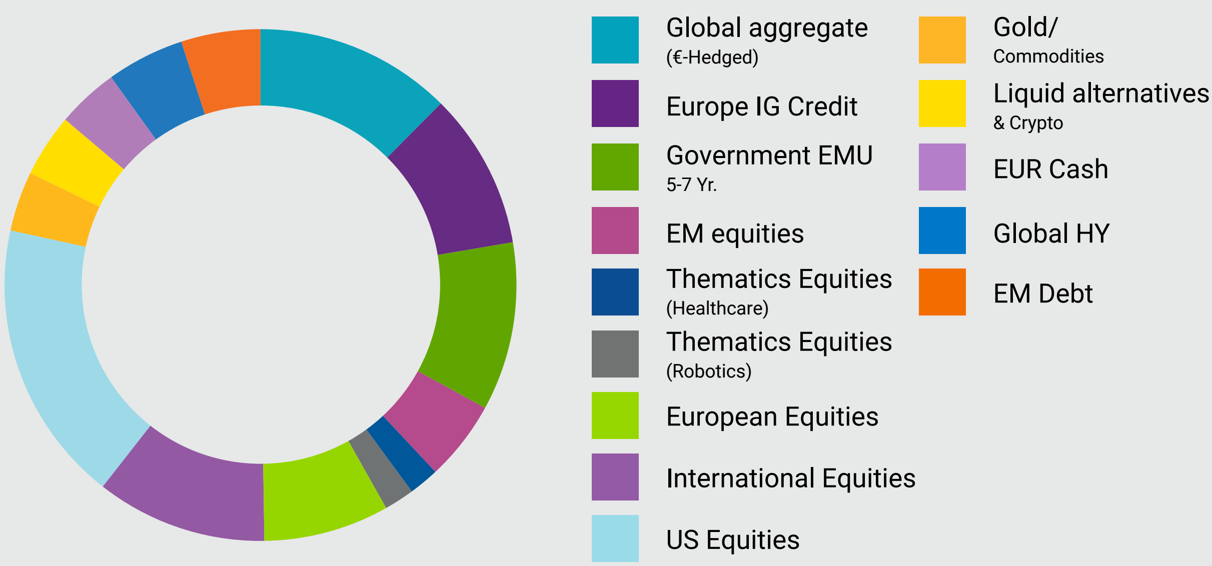
Source: Natixis IM Solutions, 2024

Q What are your thoughts on the 50/30/20 portfolio? Are the hopes and expectations around alternatives justified?

"The justification for a potential move away from 60/40 to a 50/30/20 model is all about access to new asset classes and instruments, which now form part of the whole of financial markets, as well as the appeal of diversification brought in by alternatives.

Unforeseen events – such as the expansion of wars or equity market flash crashes – tend to reinforce the safe haven status of government bonds. When this happens, there's an offsetting effect of equities by bonds, which is exactly what you expect in a 60/40 portfolio.

Composition of a typical moderate European wholesale portfolio without private assets



Source: Natixis IM Solutions, Preqin, 2024

However, some of the limitations of the 60/40 portfolio that were highlighted in 2022 can't be ignored. The double bear market in bonds and equities was triggered by inflation, which had a knock on impact on bonds triggering a market crash in treasuries and, in turn, an equity market correction. As I said, this was unusual.

But, while bonds and equities collapsed, other asset classes proved more resilient: money markets, volatility, and commodities – oil in particular. Money markets by definition have virtually no duration risk. Likewise, with commodities, if you'd had 5-10% exposure to the S&P GSCI – which serves as a benchmark for investment in the commodity markets – you would have offset a big chunk of your losses in your 60/40 portfolio. Remember, inflation is calculated by including energy and raw commodity prices[1].

Of course, we can learn lessons from what happened in 2022, even though this was an exceptional year.

If nothing else, it was a reminder that the negative correlation between bonds and equities is not an immutable truth and that there is merit in broader diversification into everything from commodities and real estate to liquid alternative strategies and private assets.

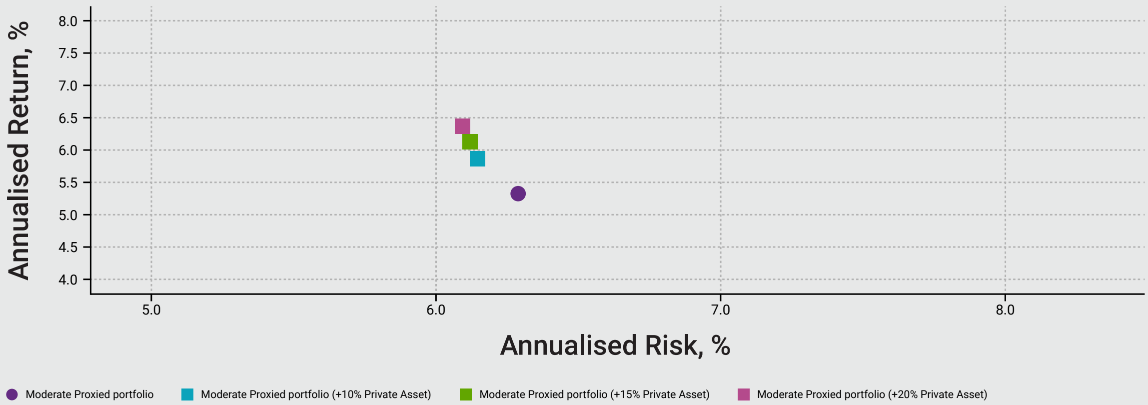
Indeed, the events of 2022 furthered the argument for a small allocation to commodities, including gold, for inflation hedging purposes. But it would be hard to argue that commodities should account for a full 20% allocation, especially when there is an increasingly large number of alternatives available, even to retail investors.

Take liquid alternatives, for example – strategies that would aim to generate performance regardless of the directions of bond or equity markets.

In a world where traditional fixed income products aren't always guaranteed to provide the shock absorbing qualities they once did, liquid alternative strategies may provide an answer.

Hypothetical risk-return positioning of portfolios with varying private asset exposure

(Private equity buyout and infrastructure in equal proportions, based on historical vintage returns Sep 2013 to Sep 2023 in EUR)



	Annualised Return %	Annualised Risk %	Sharpe Ratio Max	Drawdown Return, %
Moderate Proxied portfolio	5.31	6.32	0.86	-9.86
Moderate Proxied portfolio (+10% Private Asset)	5.90	6.19	0.96	-9.85
Moderate Proxied portfolio (+15% Private Asset)	6.15	6.15	1.01	-9.84
Moderate Proxied portfolio (+20% Private Asset)	6.39	6.13	1.05	-9.84

Source: Natixis IM Solutions, Preqin – Using de-smoothed data in EUR. 'Moderate proxied portfolio' is based on the typical moderate European wholesale portfolio, as shown on previous page, which is derived from the portfolio analysis offered by Natixis IM Solutions since 2018 as part of the Portfolio Clarity service.

Source:
[1] Reuters, 2023 https://www.reuters.com/markets/commodities/goldman-sachs-forecasts-higher-returns-commodities-2023-11-13/

Naturally, private assets are going to be scrutinised by financial advisors over the coming years. The expected enhanced return profile is obviously something that is going to be tested. People want to make sure that private equity and to a lesser extent, private debt are effectively delivering on their promise of enhanced performance and new sources of returns.

Then you have a number of 'wrappers' around these assets, whether it's with regulations or tax laws, as well as access through platforms, which have, and will likely continue to increase access to private assets and thus help to increase their inclusion in portfolios. In Italy, for instance, it's no secret that there is a tax advantage provided to investing in private equity. This obviously encourages investment into these areas and is not driven purely by expected performance.

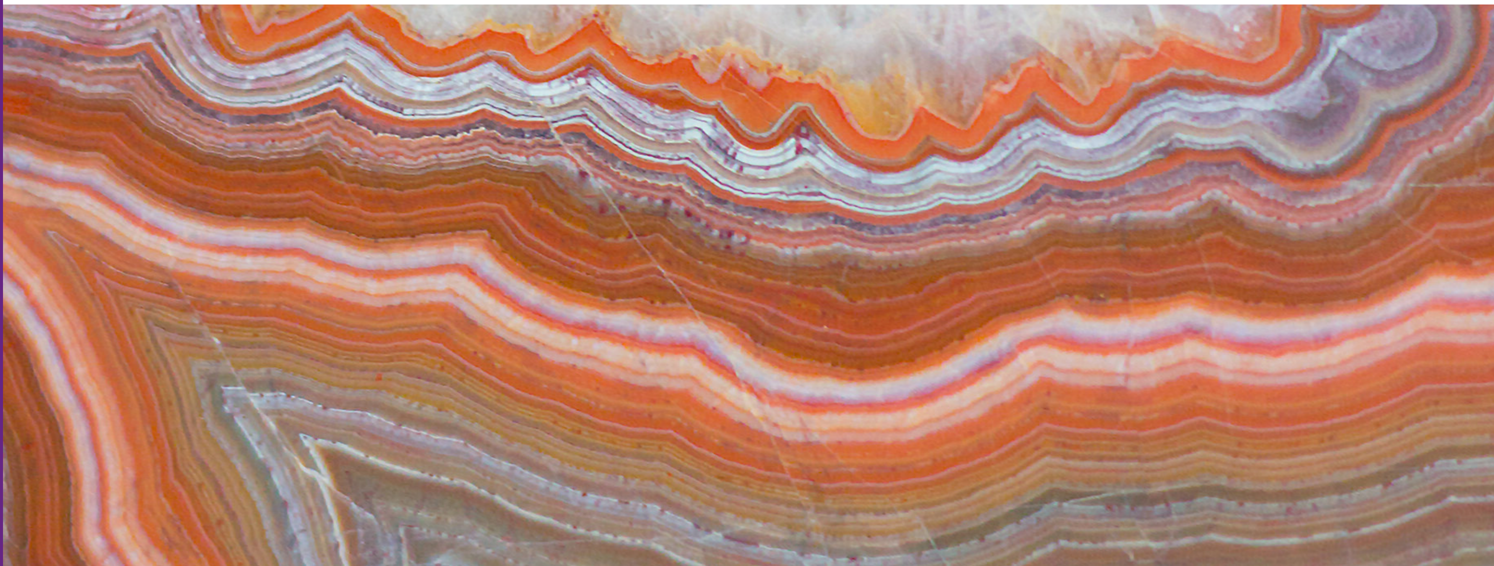
The direction of travel is clearly to leverage this democratisation of private assets more broadly into portfolios and, as a result we are likely to see growth in the prevalence of 50/30/20 portfolios. But, if they are to become a long-term feature of asset allocation they need to deliver on both their promise of enhanced returns and their promise of diversification from a risk standpoint. And, of course, exogenous elements such as the regulatory framework will need to continue to move in a favourable direction. ”

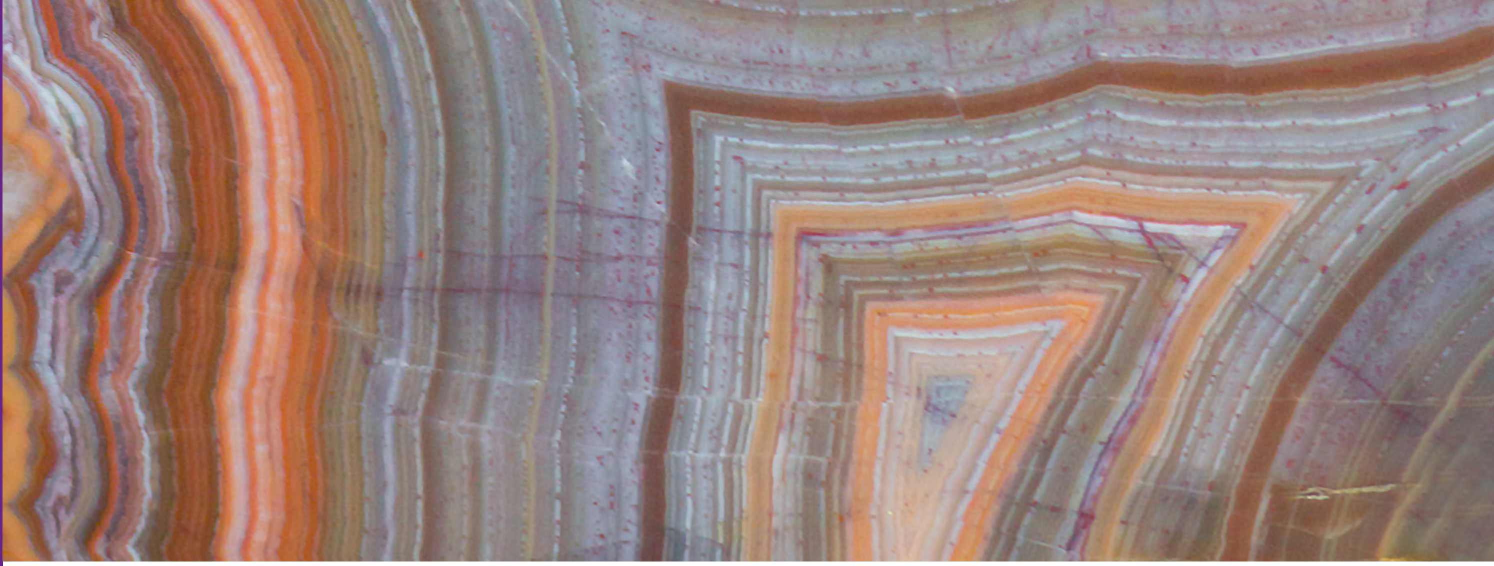
Q When we talk about democratisation, are all types of private assets suitable for all types of investors?

“ It's a very good question, and the answer is absolutely not. First, the democratisation of private assets seems to be working mostly, for now, for individuals who are effectively managing their own pensions contributions under defined contribution pension schemes, or for the wealthiest clients in their bucket of longer-term investments.

It's fair to say that each investor type has its own preference. Sovereign wealth funds will have a preference for infrastructure. A family office will prefer private equity. For insurance companies, it's mostly about private debt.

When it comes to individual investors, which is obviously in the context of the evolving 60/40 portfolio, it is likely to be mostly private equity, and a touch of private debt. This has to do with the overall investment horizon that we're looking at, as well as the expected 'bang for the buck' – in other words, the expected enhancement in performance that you can have with private equity. ”





Q In the 50/30/20 concept, there's obviously still half of the portfolio allocated to equities. What do you think will be driving the performance of the equities component in the years ahead?

“While factors such as market sentiment, economic and financial conditions, share buy-backs and geopolitical events may influence equity performance, company fundamentals remain a crucial determinant of long-term stock returns. Indeed, earnings and expected earnings growth have been a consistent gauge of future equity performance and are likely to remain so in the coming decade.

By reflecting firms' financial health and ability to grow, earnings are a bellwether of management effectiveness and industry positioning and constitute a strong indicator of a firm's ability to become profitable and return money to investors. That said, other company fundamentals are also worth considering on a complementary basis, in particular since their importance tends to rotate in investors' minds.

The continuing importance of earnings in equity performance can be illustrated by the US' share of the world's stock market capitalisation, which has climbed consistently since the Global Financial Crisis and now stands at 61%. In a study quoted by The Economist, the main reason for America's dominance is that earnings per share of the MSCI US index have risen by 162% since March 2008[1].

By contrast, the earnings per share of global markets excluding America have dropped by 2% in dollars terms over that time. And no factor other than earnings may statistically explain the rise in US shares relative to the world's stock market capitalisation.

In recent years, companies with the strongest fundamentals, also known as 'quality' companies, have performed best, in particular in the US. This was warranted by the economic environment which required business resilience. On the flipside, when economic growth accelerates, companies with weaker fundamentals may outperform their peers because of their inherent adherence to business cycle.

Any major deviation from core valuation principles usually is called a bubble and is corrected sooner rather than later. Rather, we believe that some fundamentals will most likely be scrutinised by investors in a rotational manner against the economic backdrop. Ultimately, the identification of firm fundamentals to follow may come down to an assessment of the phase of the macro-economic cycle we're in and the outlook for the coming decade.”

Source:
[1] The Economist, 2024 https://www.economist.com/finance-and-economics/2024/06/27/american-stocks-are-consuming-global-markets

The world in 2035

Jon Levy
A global strategist covering European markets for the macro strategies group at Loomis, Sayles & Company

Q How do you think we might be reflecting on some of the major geopolitical, social, economic and market trends ten years from now? What's the narrative?

"There are two meaningful trends taking shape that could come to define this decade. The first is an inverse of the deflationary environment and attendant monetary policy regime that prevailed between the global financial crisis and the Covid shock. This means a decisive move away from the responses to the global financial crisis (GFC), and policy tools like lower-for-longer rates, quantitative easing, the eradication of term premium from rates markets and the broader suppression of interest rate volatility.

This is because we are turning the page on a regime of low and stable inflation, where the risk was probably skewed to the downside, and I think that will force central banks to reach for a different tool kit. Indeed, we've already started to see signs of this, such as 2021-2022, when central banks declared unconditional warfare on inflation, as well as the end stages of the tightening cycles, during which they relied on the passage of time, while keeping rates at restrictive levels.

The second trend I see is governments playing a catalytic role in bringing about a wave of investment. This is a response to climate risk, energy transition objectives and geopolitical evolution. It will be important to view policy decisions through this lens and consider that there will be an element of adaptive competition to decisions made anywhere in the world. We are in something of a global infrastructure race, with that term applying very broadly. It is much easier to engage in this competition than in an arms race, so we should also consider that this process will likely lead to sustainably higher levels of both public and private investment. In turn, this may contribute to the persistence of upside risks to inflation targets – in contrast to the post-GFC environment.

Central banks will need to consider how to adapt inflation targeting frameworks. If inflation runs above targets as a result of investment that should ultimately alleviate this risk, central banks may need to look through upside misses - albeit for a longer period than they may have done in the past. These lags are a source of uncertainty. The element of variability is more variable. And rates markets will need to adapt. We may need to actually have more trust in central bank forecasting at precisely the point at which it becomes harder - and in the aftermath of some particularly poor forecasting results. And central banks will probably need to make serious investments in forecasting processes."

Q What can the years immediately after Covid tell us about how central banks should respond to supply shocks?

"That they should probably try to be very aggressive up front in diagnosing exactly what's happening, yet at the same time try to keep a very short leash on how durable their decisions are.

One of the understandable missteps of probably every major central bank in the early days of Covid was the decision to immediately turn to the post-2008 application of forward guidance, which includes the use of asset purchases in tandem with signals that rates will be very low for a very long time. We knew fairly early on how long the worst aspects of the Covid shock would last because of information on vaccine development and distribution. So, in a way, central banks didn't need to freeze interest rates for a long time: keeping them in place would have been sufficient. I think this was a case where it would have been advisable to allow markets to price re-opening effects.

If you go back and look at some central banker comments, those from Andy Haldane for instance, he's asking in 2020 and 2021 about the rationale for further QE. His point was that there is a reasonable risk of a reopening boom, so there's no need for the central bank to lock itself in. It was a case of using tools to transform the investor time perspective because of the deflationary shock, but without necessarily knowing up front what that shock would look like after the acute phase.

So, the short answer to the supply shock question is, I think it's going to be important to watch how the shock develops without committing to a range of tools that are probably demand-centric. Supply and demand are interrelated, so this constant effort to make one a different colour from the other in a chart risks oversimplification.

There will always be discussion, like the argument about whether the US fiscal response overheated demand, even though there was no way of knowing how that would play out at the outset. You simply don't know what the next supply shock will look like, nor how global it will be in nature, nor the extent and speed at which firms and households adapt. You don't know where it will cause risks to financial stability."

Q Do you see one of the trends of the next decade being linked to a period of higher for longer volatility?

"I don't think we should assume higher volatility, but I do think it's likely that we end up having higher average or trend policy rates than previously. In some ways, the policy rate environment may just look more like the early 2000s rather than the 1980s or 1990s.

Actually, I can make an argument that if policy rates hover around 3-4%, markets could be less volatile. Inflation might actually accelerate at some point if you operate policy at something that looks closer to normal or slightly restrictive, but if you have more frequent up and down adjustments of policy rates, that may actually limit volatility over time."

Q At the intersection of government policy and central bank decision making is the question of climate change and the energy transition. Ten years from now, what will we have achieved – and what will we have lost – in the 20 years since the Paris Agreement and the race to respond to the climate crisis?

"I think we'll see that we've achieved a pretty radical change in energy utilisation. We have already achieved a massive transition from fossil fuels to renewables, and in the expansion of the use of electric vehicles.

There will be points where targets were missed and actions were not aggressive enough. But with some benefit of hindsight, there are a lot of interested parties in this change. There's a lot of money on the table. That's why investment is happening.

I think it will be an incredibly tangible and far-reaching set of changes. There are evident costs in terms of storm damage, flood risks, which hits insurers, every piece of the financial supply chain and infrastructure. We may look back and date the point at which certain action should have been taken. But the innovation and the investment to cope with some of these issues will also have some pretty profound consequences.

Central banks may need to adjust their targets and time horizons in the face of major supply side changes. You certainly see this in the thinking of certain central banks. The ECB is a good example. They have indicated that they need to think about the impact to their mandate of the expenses and requirements of adapting to climate change. Other central banks may not articulate this because of the political economies in which they operate, but it doesn't mean they aren't very much aware of the economic impact.

A lot of central banking is analytical. What really matters is what the central banks think is happening and what kind of mistakes they're prepared to make. When there is such a far-reaching transition like climate change, policymakers need to be both aggressive and really careful analytically, because the growth and inflationary impacts can be wide and variable, and they don't want to go too far down a path as a result of a particular decision.

Yes, it's important to see how interest rate regimes have changed up and down over the course of a year and model where you expect rates will go over time because it has implications for investors' expectations – but I think that analytical openness is probably the key challenge."

Separating the politics from climate change

Conversations around climate change are evolving. Regional differences and the political landscape in the US and the European Union (EU) are largely driving these changes. Politicians on all sides are under pressure from lobbyists and their constituents as they seek to ease environmental constraints.

While environmental policies may change speed with each new election, the goal to achieve carbon neutrality by 2050 remains a non-negotiable: the carbon clock is always ticking. As a global society, we are entering a new phase in our fight against climate change – and the issue is becoming more embedded into businesses and policies every day.

Looking to the next decade and beyond, climate change is expected to have a significant impact on international political relations in the following ways:

- **Intensifying geopolitical tensions:**
As the consequences of climate change become more severe, competition over dwindling natural resources like water, arable land, and energy sources will intensify geopolitical tensions and conflicts, especially in vulnerable regions[1,4]. This could destabilize already fragile areas and trigger mass migration and humanitarian crises.

- **Shifting power dynamics:**
Countries' ability to mitigate and adapt to climate change will reshape global power dynamics. While advanced economies aim to decarbonize by 2035, many developing nations risk being left behind, lacking resources for an energy transition[2]. This could increase the influence of countries like China who can offer partnerships on green technology and financing[1,5].

- **Strained international cooperation:**
Diverging national interests and mistrust between major powers like the US and China over climate policies could further strain international cooperation and undermine the rules-based global order[5]. Fragmentation may impede collective action, as the world has already fallen behind emissions reduction targets[3].

- **New arenas of competition:**
Climate change will create new arenas of strategic competition between states, such as the Arctic, space, cyber governance, and climate engineering technologies[1,4]. This could exacerbate great power rivalries and militarization of regions.

- **Domestic political pressures:**

Domestic political pressures from ageing populations, economic disruptions, and climate impacts could constrain countries' climate policies and ambitions[1,4]. This could fuel nationalism, populism and a prioritization of narrow self-interests over global cooperation[5].

If left unaddressed, climate change has the potential to drastically reshape the geopolitical landscape by 2035, increasing conflicts, power shifts, fragmentation, new arenas of rivalry, and domestic political constraints – all of which could impede coordinated global action[1,2,3,4,5].

Sources:

[1] Global Trends to 2035' Geo-politics and international power
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Views from both sides of the Atlantic

Hervé Guez, Global Head of Listed Assets at Paris-based Mirova, a sustainable investing specialist and an affiliate of Natixis Investment Managers:

"Critics of responsible investment have often accused it of greenwashing during periods of strong fund performance and of pursuing political agendas when funds underperform. Faced with this for more than ten years, we have been defending nuances: we are convinced that combining financial performance and positive impact on the environment and society is not only possible but also desirable. That said, we recognize that finance alone cannot overhaul the entire economy and acknowledge the material impact of climate on economic actors, necessitating a concerted effort to realign concerns and build a more holistic economic model.

Investors are also expressing increased interest in biodiversity within the listed universe. Addressing biodiversity challenges within the realm of listed assets entails investing in companies that are best positioned to reduce the pressures on biodiversity and regenerate nature. Additionally, engaging with these companies can steer them toward strategies that factor in the systemic risks associated with biodiversity loss. Another avenue involves investing in companies that are developing innovative solutions to reduce the human footprint on nature, such as filtration or wastewater-treatment techniques."

Chris Wallis, CEO and CIO at Houston-based Vaughan Nelson, a small- and mid-cap equities specialist affiliate of Natixis Investment Managers:

"We've talked to clients about the fact that there's a role for every source of energy on the planet and that there are real economic consequences to the policy choices we make. We must think about projections and the returns on the capital deployed to see how we can value each project and whether they justify receiving capital for the levels of expected returns. The fact that we've finally accepted nuclear as a necessary green transition fuel, for instance, is incredibly positive, as it enables us to have a safe, low-cost base in electricity production around the world.

Moreover, the fact that we're bringing supply chains back to the US means we can become more resilient and less dependent on China. In turn, maybe we can push back on some of the issues that China is trying to press on the world. We can't right now because we need its penicillin and rare earths. So, while some view the ESG backlash as disruptive, I see it as a case of waking up and realizing that the path we've been on in the developed world just isn't sustainable. We're now on a more realistic path."

Buying into the long game of sustainability

Following strong performance for the sector in 2020[1], sustainable investors have had plenty to grapple with over the past few years – not in the least, the energy crisis in Europe, divisions over energy policy in the US, and underperforming ESG-labelled funds.

Under pressure, asset managers have been backpedalling on certain sustainability proclamations – a practice known as 'greenhushing' – for fear of being accused of either 'greenwashing' (conveying a false impression or providing misleading information about how a company's products are environmentally friendly) or overstating their ESG credentials.

This has left the sustainable investing industry grappling with how to reassure clients. Yet, while 2022 was a stress test year for ESG, it's important to remember the years of outperformance between 2010 and 2020 set against the non-ESG-performing sectors following Covid and the Russia-Ukraine war[1], according to Léa Dunand-Chatellet, Director of Responsible Investment at Paris-based investment manager DNCA. "In this context, the performance of socially responsible investing (SRI) and impact funds is not bad," said Léa.

Hervé Guez, Global Head of Listed Assets at sustainability specialist Mirova, similarly said that the nuances of sustainable investing need to be properly assessed.

"[Sustainable investing] is a complex investment style, where it is necessary to deliver both financial and nonfinancial results," he said. "The approach aims to improve the extra-financial aspects of companies, which would perform better in the long term. Our investors are also looking for real impact, and they accept financial performance similar to that of the market."

Source:
[1] Morningstar Research, 3 February, 2021, European Sustainable Funds Landscape: 2020 in Review

Reality check

While fund managers need to address short-term performance issues, there's no avoiding the fact that climate-related threats will continue to dominate the risks posed to global populations. According to the World Economic Forum, extreme weather, critical changes to Earth systems, biodiversity loss and ecosystem collapse, natural resource shortages, and pollution represent five of the top 10 most severe risks perceived to be faced over the next decade.

Laura Kaliszewski, Global Head of Client Sustainable Investing at Natixis IM, commented: "Climate change is clearly going to continue to be a key determinant of economic growth and one of the biggest drivers of policy decision making and social change over the coming decade. Massive investment will be needed, and this will require close cooperation between the public sector and the private sector, government, nongovernmental organizations (NGOs) companies, and, of course, the financial sector."

Nathalie Beauvir, Head of Sustainable Transitions at Paris-based Ostrum Asset Management, agreed. She added: "Our clients believe that the bond market can play a key role in the energy transition, and they prefer the integration of ESG criteria in the management of their assets."

Beauvir went on to explain that many investors still make the argument that such integration tends to result in a smaller investment universe and an increase in the probability of sector bias, but she believes the potential benefits outweigh such concerns over the long term. "Over the long-term, ESG integration better allows us to find securities that we believe will be less risky tomorrow and to avoid stranded assets," she said.

For Colleen Denzler, Chief Sustainability Officer at Boston-based Loomis Sayles, success in ESG investing means understanding what the client wants. She commented: "Some [clients] know exactly what they want, and they come to you with very tight specifications and we can handle those specifications. The other type of client is one who's on a journey… or they don't know exactly how to implement what they know their goals are.

"Integrated ESG research with a focus on financial materiality is so important because the world is changing, and as investors, it's incumbent on us to understand both the risks and the potential reward that's available to our clients."

Active managers clearly have an opportunity to swim against the tide of pessimism and let their authentic green credentials shine. After all, while other sectors and asset classes ride the volatility wave, true sustainable investing sets its sights beyond the immediate horizon. Backlash or not, climate change is happening – and there is no turning back.

"Climate change is clearly going to continue to be a key determinant of economic growth and one of the biggest drivers of policy decision making and social change over the coming decade."

Laura Kaliszewski,
Global Head of Client Sustainable Investing, Natixis IM

Private assets in a climate-friendly economy

In recent years, private asset investment has been highly significant in many areas of the economy, from digital technology to energy, where private investment is playing a significant role in renewables. And private asset investment will play a significant role in the transition to a more climate-friendly economy, too. It has been estimated that $4 trillion will need to be invested every year between now and 2030 for the world to hit the 2050 net zero carbon emission target[1].

The direction of travel among industry participants suggests the opportunity is there for the taking. For example, a report from PwC finds the majority of limited partners (LPs) and general partners (GPs) are shifting toward an 'ESG or nothing' investment philosophy, with over three-quarters planning to cease investing in or promoting non-ESG private market products by the end of 2025[2].

And the long-term investment required to transition to a sustainable economy is well suited to the private asset investment model. Its longer-term horizons enable it to invest with reduced market volatility that can encourage short-termism in public markets. Governments and regulators are increasingly recognizing that much greater investment in technology and sustainability is essential both for future growth and to meet climate targets.

Direct impact

Take the Sustainable Finance Disclosure Regulation (SFDR). Since 2021, SFDR has required asset managers to sort their funds into different sustainability categories based on the product's characteristics: funds are categorized as articles 6, 8 or 9, with 'Article 9' funds requiring 'sustainable investment' as their explicit objective.

That said, there is a growing number of sustainable solutions that invest in the real economy, such as solar panels, tramways, or buildings. "The sector that is currently keeping everyone super busy in Europe is the energy transition," said Gwenola Chambon, CEO of Paris-based Vauban Infrastructure Partners. "There is so much regulation incentivizing opportunities to adapt existing infrastructure to the new era of net-zero carbon targets.

"All our existing infrastructure was built in a time when we had cheap energy costs... We have to address that by adapting existing infrastructure and conceiving new kinds of infrastructure investments."

What's more, many asset managers are now integrating ESG criteria into their investment approach as standard – driven by increasing demand from their clients, the market, and regulation[3]. AEW, for example, is seeking to improve the energy efficiency of its buildings to reduce greenhouse gas emissions, but it's also focusing on the broader social impacts too.

"The reality is that the industry and markets are pushing us towards ensuring our buildings are efficient from an energy standpoint," explained Rob Wilkinson, CEO of real estate specialists AEW. "The more people want to invest in an asset that's greener... and the more people want to be in greener buildings, all of this will drive our returns."

Sources:
[1] Natixis Investment Managers, Growth Capital to Support the Energy Transition
[2] PWC, May 2023, GPs' Global ESG Strategies Disclosure Standards, Data Requirements & Strategic Options
[3] Natixis Global Fund Selector Outlook Survey 2024, https://www.im.natixis.com/en-intl/insights/investor-sentiment/2024/financial-professionals-report

Forward thinking

Over the pages of this paper, we wanted to assess the significance of the key transitions that are impacting the global economy today and explore their implications, primarily for investors, over the next ten years.

When it comes to the environmental transition, we've been on our own sustainable investing journey with our clients over the past 10 years – we've seen, firsthand, how conversations around climate change are evolving. Together, we've learned how we can manage climate investment risk, but that we cannot eliminate climate risk altogether.

We also understand the transition away from fossil fuels towards cleaner, renewable energy sources needs constant pressure. According to the International Energy Agency's latest World Energy Outlook, by the end of this decade, coal consumption is expected to be 6% higher than it was last year, and levels aren't set to drop to a meaningful level until well beyond 2050. As the report stated: "The outlook for coal has been revised upwards particularly for the coming decade, principally as a result of updated electricity demand projections, notably from China and India"[1].

Inevitably, solutions for climate change and the energy transition arrive at the intersection of government policy and central bank decision making. As Jon Levy, Global Strategist at Loomis Sayles, said: "What really matters is what central banks think is happening, what kind of mistakes they're prepared to make, and where they'll place their bets. When you have such a far reaching transition like climate change, you need to be both aggressive and really careful analytically because the growth and inflationary impacts can be wide and variable, and you don't want to go too far down one bad decision."

The $84 trillion question

We began this report by analysing the demographic transition. This included why demographics play a crucial role in shaping the long-term dynamics of the economy, as well as influencing potential growth, monetary policy, and public finances.

As Nicolas Malagardis, Global Market Strategist for Natixis IM Solutions, put it: "An ageing population places increasing pressure on fiscal budgets due to rising costs in pensions and healthcare, coupled with a shrinking tax base, potentially challenging debt sustainability. Individuals generally follow predictable financial patterns, borrowing in youth, saving in middle age, and drawing on savings during retirement. With increasing life expectancy, the need for larger retirement savings grows, especially when retirement ages do not keep pace with longevity."

For financial advisers, balancing long-term demographic threats with short-term economic risks is a challenge – especially, as we learned from Julien Dauchez, Head of Portfolio Consulting & Advisory at Natixis IM Solutions, that portfolio construction is becoming more complex as allocators look to incorporate private assets into their strategies.

Knowing that $84 trillion will pass from one generation to the next over the next 20 years[2], our research found 46% of advisers worldwide say the 'Great Wealth Transfer' represents an existential threat to their business; 43% are increasingly worried they will not retain assets from clients' spouses or next-generation heirs[3].

Dave Goodsell, Executive Director, Natixis Center for Investor Insight, wrote: "[Financial advisers] recognise that the investment challenge is twofold. Not only will they need to manage investments through a changing macro and market environment, but the bigger challenge will be managing clients though the change. To be successful, they will need to re-educate clients on key investment concepts, get them acclimatised to new risks, and help them manage their expectations."

Do the homework

The truth is, as we look into our crystal balls and try to describe the likely paths ahead, the only thing we can really be certain of is that there will be risks, disruption and changing expectations. Moreover, the transitions we've identified aren't operating in isolation.

If we do get a global disruption in the next ten years of the magnitude of a Covid-type event, it will likely be some kind of climate change or cybersecurity event. We have already had a taste of these and we are already investing with these risks in mind.

In some ways, perhaps it should come as comfort for investors that we actually have a good idea what to prepare for in the future. The real question is, are we prepared to do the homework?

As a high-conviction asset manager that invests for the long term, we believe that investing in a way that facilitates the major transitions – demographic, environmental, technological and industrial – presents a tremendous economic opportunity, and that failing to do so may present a substantial risk.

Sources:
[1] The International Energy Agency's World Energy Outlook 2024, https://www.iea.org/reports/world-energy-outlook-2024
[2] Cerulli Associates, 'US High-Net-Worth and Ultra-High-Net-Worth Markets 2021', https://www.cerulli.com
[3] Natixis Investment Managers, Global Survey of Financial Professionals conducted by CoreData Research between June and August 2024, https://www.im.natixis.com/en-intl/insights/investor-sentiment/2024/financial-professionals-report

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