2023 MARKETS AND RISK OUTLOOK

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EXECUTIVE SUMMARY

The rapid normalisation of interest rates is radically changing the environment in which financial market participants operate.

Since our Risk Outlook last year, inflation has become a permanent feature, leading central banks to accelerate monetary policy normalisation and put an end to more than a decade of low interest rates. Since June 2022, the European Central Bank has raised its policy rate eight times, thus going from 0% to 4% in one year. The US Federal Reserve, meanwhile, has made ten successive rate hikes since March 2022, bringing its policy rate up to the 2008 level of 5.25% in June 2023. Although the decline in commodity prices, especially energy, has contributed to a reduction in headline inflation, core inflation remains strong, arousing fears that interest rates will be kept high for longer than originally expected.

Faced with a series of major crises in the past three years (health crisis, energy crisis, invasion of Ukraine and the inflation shock that they generated), global economic activity proved resilient in 2022 and the first months of 2023, despite a less favourable macro-financial environment. However, if inflationary pressures persist, the process of monetary normalisation could cause a more significant deterioration of this environment, and hurt economies and economic agents already weakened by the health crisis and/or heavily exposed to the Russo-Ukrainian conflict.

The risk of a market correction remains very high and largely depends on market participants' ability to adapt to this new interest-rate environment.

Asset prices, as a whole, suffered a sharp correction in 2022: -6.7% for the CAC 40 (reinvested dividends) and around -18% for the S&P 500. In fixed-income markets, the *Bloomberg Euro Aggregate Corporate* and *Treasury* indices fell by 13.7% and 18.5% respectively. The crypto-asset market experienced a "crypto winter" with the collapse of TerraLuna in May 2022, or again the failure of the FTX platform in November 2022. In early 2023, however, a sharp rebound was recorded, with the CAC 40 reaching its all-time peak last April at more than 7500 points. The correction has therefore, in the end, been rather limited until now, although markets proved nervous and reacted sharply to adverse events which recently revealed significant vulnerabilities in a high-interest-rate environment.

First in the United Kingdom, where defined-benefit pension funds' use of leverage, via Liability Driven Investment (LDI) strategies, led to a massive sell-off in government bond markets and required strong and targeted intervention by the Bank of England to prevent the contagion of financial instability. More recently, the failure of US regional banks, faced with huge withdrawals of deposits, provided an illustration of the materialisation of liquidity risk. This event also highlighted the question of asset valuations in a higher-interest--rate universe and revealed the existence of significant unrealised losses in debt security portfolios, due to their accounting treatment at amortised cost. The entities most exposed to leverage effects and liquidity risk therefore appear most vulnerable to rising interest rates.

The interest-rate shock has therefore apparently not fully materialised and further episodes of corrections, like that seen in bank stocks, could recur. The ability of financial market participants to adapt to the new environment appears of prime importance, especially since monetary normalisation has apparently not come to an end.

At this stage, the declines in assets under management of French funds observed in 2022 are mostly the consequence of a market effect, with redemptions remaining marginal, even for bond funds. Money market funds even profited from the rise in interest rates, which had the effect of increasing their returns and net subscriptions from the end of 2022. However, the vulnerabilities experienced by the commercial real estate sector call for some vigilance. This sector, invested in significantly by investment funds, with total assets under management of €1,270 billion for funds domiciled in the euro zone at end-March 2023, saw a sharp contraction in transaction volumes and prices. Also, the substantial use of debt leverage by this category of funds makes them extremely vulnerable to rising interest rates. At the start of 2023, moreover, the European Systemic Risk

Council issued recommendations designed to improve the monitoring of systemic risks resulting from the commercial real estate market and promote the resilience of bank and non-bank entities exposed to this sector.

The rise in interest rates also increases credit risk, adversely affects the sustainability of debt and affects refinancing ability.

Faced with high debt ratios, the rise in interest rates adversely affects borrowers' debt servicing ability. As regards governments, the budgetary and fiscal effort to limit the impact of the Covid-19 crisis and then the energy crisis kept debt at high levels. Moreover, interest rates became positive in May 2022, significantly increasing the burden of this debt. In the corporate bond segment, liquidity conditions deteriorated significantly and volatility has increased sharply since the spring of 2022, reaching levels similar to those in 2008. In the high-yield bond segment in particular, yields reached as much as 7% in Europe and 8.5% in the United States, which could point to possible refinancing problems for the most risky firms. This pressure on financing costs could eventually lead to a significant increase in defaults: the S&P rating agency, for example, estimates that the default rate of companies rated as speculative could reach 3.6% in Europe by March 2024 (versus 2.8% in March 2023).

There is also extremely high pressure on financing costs for the private equity sector which makes extensive use of leverage. Since mid-2022, this sector, whose assets are estimated at around $7,616 billion globally, shows signs of a drop in activity marked by a reduction in fundraising, investments, and divestment transactions. While the slump in activity seems less acute in Europe than in the United States, the fall in fundraising could be protracted, jeopardising the refinancing ability of this sector against the backdrop of expectations of a rise in the default rate of companies of speculative credit quality.

Rising interest rates favour time deposits and regulated passbook savings accounts. After contracting in the second half of 2022, retail investors' activity in the stock market increased slightly in early 2023.

Inflationary pressures and rising interest rates reduced the gross financial wealth of French households by €260.9 billion in one year to €5,785 billion at end-2022, but the savings rate has risen again recently, reflecting renewed precautionary saving. As a result of rising interest rates, regulated savings accounts and, what is new, time deposit accounts have appeared as the main beneficiaries of the reallocations carried out at the expense of demand deposits. In life insurance, market rate arbitrage accelerated the net outflows from euro funds to the benefit of fund units. However, the total amounts invested in 2022, approximately €25 billion versus €84 billion allocated to deposits/liquid assets, reflect a still moderate appetite for risky assets. Retail investors' activity in the stock market, meanwhile, contracted in the second half of 2022 before picking up again in early 2023. This increase in activity is accompanied by a reduction in the age of investors, who also show a growing interest in crypto-assets.

Lastly, structural risks (cyber, financing of the energy transition) remain high

Geopolitical tensions are high in several regions of the world, which may increase the risk of cyber attacks, now motivated by ideology as well as by criminal intent. While the figures show proven losses of approximately €2 billion for French companies and government entities, they could, in practice, be far higher due to the reputational risk resulting from these attacks.

Finally, borrowing requirements for the energy transition have favoured a boom in sustainability issuance in recent years, but have also created uncertainty regarding the sustainability of some of the assets financed. The initiative concerning the new European standard for green bonds constitutes, in this sense, a real step forward, just like the entry into force of the Corporate Sustainability Reporting Directive (CSRD) and its detailed reporting standards for companies, effective from 2024. And yet, borrowing requirements remain substantial and the high-interest-rate environment could check the development of these products, making these investments harder to finance because less attractive.

Summary of risks:

	Description of the risks	Level at mid- 2023	Outlook for 2024
Financial stability	1. Increased risk premiums, weakening indebted firms; Crystallisation of corrections when valuations struggle to reflect changes in the fundamentals Geopolitical risks remain significant High valuation levels despite risk premiums which have risen Risks due to persistent inflation		↗
	2. Adaptation to the new interest-rate environment and lack of monetary policy coordination Impact on all the actors in the financial system: - first materialisation with failures of US regional banks - impact on the real estate sector (commercial real estate in particular) and private equity Risk of desynchronisation of monetary policies between the United States and Europe due to the difference in nature of the inflationary shocks affecting them		↗
	3. Credit risk, refinancing risk, sustainability of the debt service burden Increase in both private and public debt as a result of the Covid-19 crisis and the impacts of the Ukrainian crisis (tariff caps) Increase in financing costs First signs of increased corporate defaults delayed by public stimulus policies		↗
Market organisation and functioning	4. Volatility, sudden fluctuations in liquidity conditions, large-scale moves by investors from one asset class to another Markets resilient in 2022-early 2023 but nervous and reactive to adverse events End of stimulus by the authorities (central banks, supervisors, etc.) Pace and duration of monetary policy normalisation		↗
	5. Functioning of market and post-trade infrastructures Cyber risk remains high Lull in commodity markets reducing pressure on margin levels Migration of volumes to OTC trading		→
Financing of the economy	6. Profitability of financial institutions faced with an environment calling into question their business model Resilience of funds in 2022 and net inflows in 2023 Rise in interest rates entailing a risk of corporate defaults Real estate risk - signs indicating a turnaround in the real estate market, especially commercial real estate		→
	7. Difficult access by companies, especially SMEs, to financing Financing ensured in 2022 with substitution by bank credit Difficulties in guiding investors to capital products		↗
	8. Difficulties in obtaining financing for the energy transition Difficulties in obtaining equity financing for long-term investments (climate transition) despite proven net new money inflows Difficulties exacerbated by rising interest rates		↗
	9. Lack of protection of retail investors in the event of poor information about the risks associated with certain investments or certain distribution channels Further waves of scams Boundary becoming blurred between gaming and investment		→

IN BLUE: main new information that changes the assessment

	Lower	↘
	Stable	→
	Higher	↗