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Investment Management

2024 - The Road Ahead for Markets

JANUARY 2024

Introduction

As we enter 2024 the economic backdrop is evolving. Inflation and interest rates, which have dominated market focus and shaped the economic cycle over the past two years, are coming down.

Economic growth is likely to be a key focal point, with growth in the US likely to be lower, whilst in other developed markets it will be pedestrian.

A slower growth environment, coupled with inflation that is likely to fall back to pre-Covid levels, paves the way for central banks to begin the process of easing monetary policy, which remains at its tightest since 2008.

A slower growth environment paves the way for central banks to cut rates.

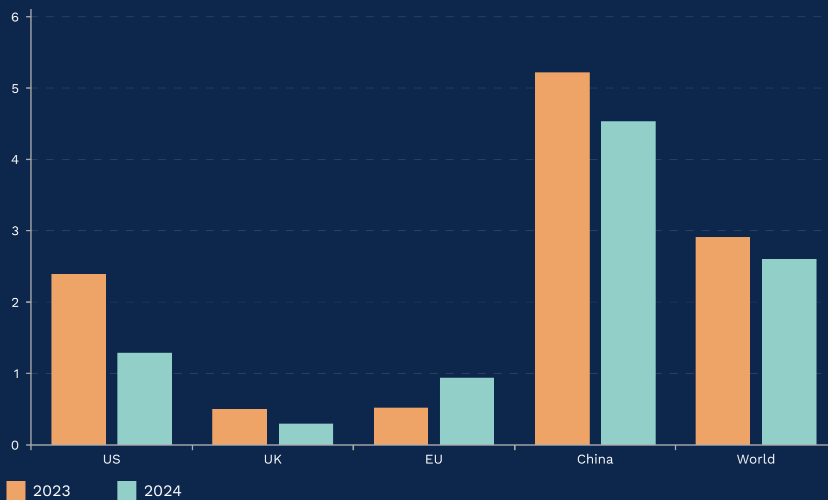
On balance, it would appear that the soft landing the Federal Reserve (Fed) was aiming for is on track to be achieved, albeit risks remain to that view, and a recession cannot be ruled out. It will also be a year characterised by politics, with elections due in a number of countries, including the Presidential election in the US, and a likely General Election in the UK.

Markets started to price in a soft landing scenario towards the end of 2023. This backdrop represents a reasonably constructive framework for both bonds and equities, albeit both look extended in the near-term, and attention needs to be given to valuations. We expect a move up in longer duration yields which might present an opportunity to reposition some of our exposure, whilst within equities we expect market breadth to continue to broaden out, lending itself to well diversified equity allocations.

An Easier Descent for Economic Activity

/ REAL GDP FORECASTS (%)

Growth is forecast to be lower in 2024 across most areas, compared to 2023.



Source: Bloomberg Consensus forecasts, 28 December 2023

The world's largest economy, the US, has exhibited remarkable resilience in 2023, growing above trend despite interest rates being at their highest level in 15 years, and bucking expectations of a recession. A key support here has come from the US consumer, where spending has been resilient, and confidence high, thanks in part to a robust labour market. Rising wages have also acted as key linchpin to the US consumer, with real disposable incomes rising recently as wage inflation exceeded consumer price inflation.

As we move into the new year there are signs of cooling in the labour markets, which warrants attention, but in the absence of a sharp move up in unemployment or a collapse in job openings the consumer is likely to remain in reasonable health, although growth will likely slow. Falling inflation may also help consumer sentiment. In addition further support for consumers and corporates, via lower interest rates (covered below), will also aid the economy. Nevertheless, whilst a recession may be avoided, growth will be lower and below trend.

China, the world's second-largest economy, has experienced a slower recovery than expected after the economy re-opened just over 12 months ago. Concerns around the real estate market have continued to weigh on both consumer confidence and the broader economy, raising worries that the economy faces a property bust and deflationary cycle akin to that suffered by Japan over 30 years ago.

2024 is likely to be a year in which a combination of fiscal and monetary policy support is provided to the Chinese economy, allowing it to continue its recovery post-Covid lockdowns. This will act as a stimulus to those countries and regions sensitive to China growth – such as Asia Pacific, Japan and Europe.

Both the UK and Eurozone economies have experienced weak economic growth of late, and the most likely scenario in 2024 is a continuation of this trend, albeit with some recovery. Similar to the US, a positive likely lies with growth in real disposable incomes, and in the case of Europe a recovery in manufacturing industries.

In the UK, there is also the possibility of some form of fiscal stimulus ahead of the General Election, with the Chancellor potentially having headroom to unveil some measures at the next budget on 06 March 2024. Nevertheless, in both Europe and the UK growth is likely to remain quite low, and the risk of recession elevated.

Whilst a soft landing for the global economy would appear to be the central scenario – and is arguably consensus in the market - risks of a recession remain elevated and above historic averages. Growth will also likely be lower in 2024 than 2023, as can be seen in consensus economic forecasts.

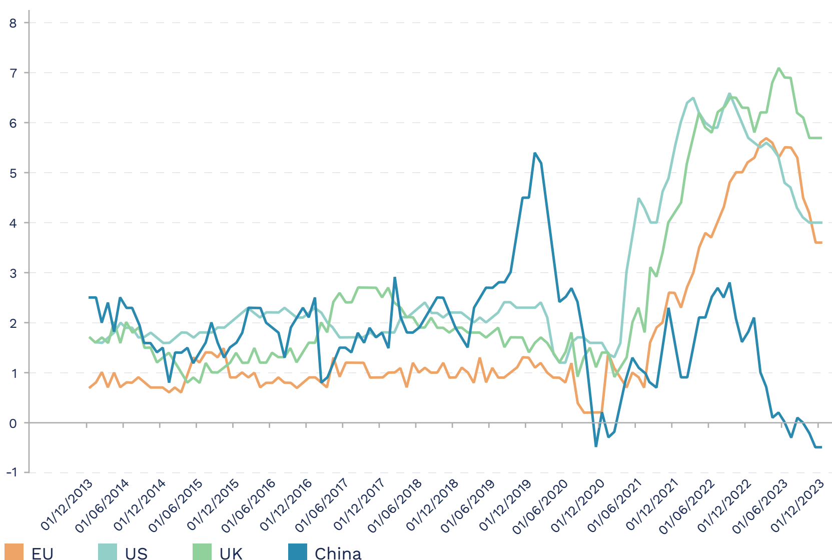
Interest rates do operate with a lag, of around 12 to 18 months, and the impact of rate hikes over the past two years will only now be filtering through economies. As such, we expect economic data in the first few months of the year to provide sufficient evidence and confidence as to whether the all-clear can be given.

Inflation Will Continue Its Descent

Inflation will continue its downward move in coming months in most developed markets, as the effects of supply chain issues and pent-up demand (for services) continues to fade and normalise.

/ CORE CPI (% YOY)

Inflation will continue its downward trend in 2024.



Source: Bloomberg, 28 December 2023

This will allow inflation to return towards, if not below, the vicinity of central bank mandated targets some time this year. That said, it is likely to be bumpy at points, and is partly dependent on slowing economic conditions.

It should be kept in mind that China remains on the cusp of deflation, whilst declining food and energy prices will continue to supress price indices. Looking slighter further ahead, we do foresee global inflation running at a slightly higher level than over the past 30 to 40 years, for a host of reasons, including de-globalisation and investment in energy transition and climate change mitigation infrastructure and technology.

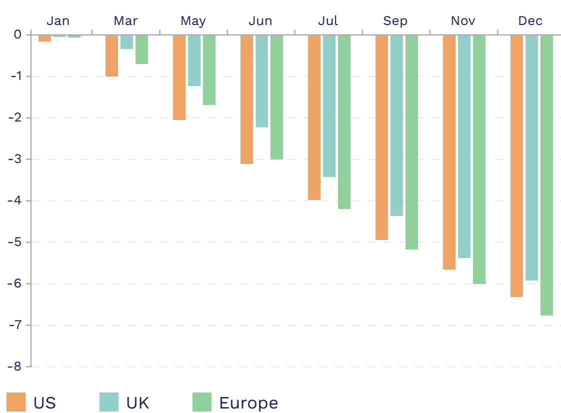
As such, policy makers focus has started to shift. Over the past couple of years, the focus has been on inflation, and the need to return it to target. It has also been a key driver of market volatility. With that job effectively done, and inflation back to more manageable levels policymaker attention can turn to labour markets, and economic growth. With the latter weakening, and real interest rates at very high and constrictive levels, we remain of the view that we have seen the peak in interest rates.

Central Banks Will Begin a Shift Towards Monetary Easing

With the peak in interest rates in, it is now becoming very likely that interest rates in most countries – the exception being Japan – will come down during 2024.

TOTAL RATE CUTS PRICED IN FOR 2024

Outlook for rate cuts in 2024 have accelerated in the last quarter of 2023.



Source: Bloomberg, 28 December 2023

The Fed's most recent dot plot indicated that the committee expects to cut interest rates three times during the course of the year. It is likely that the Bank of England and the European Central Bank will also cut rates this year – sooner than anticipated.

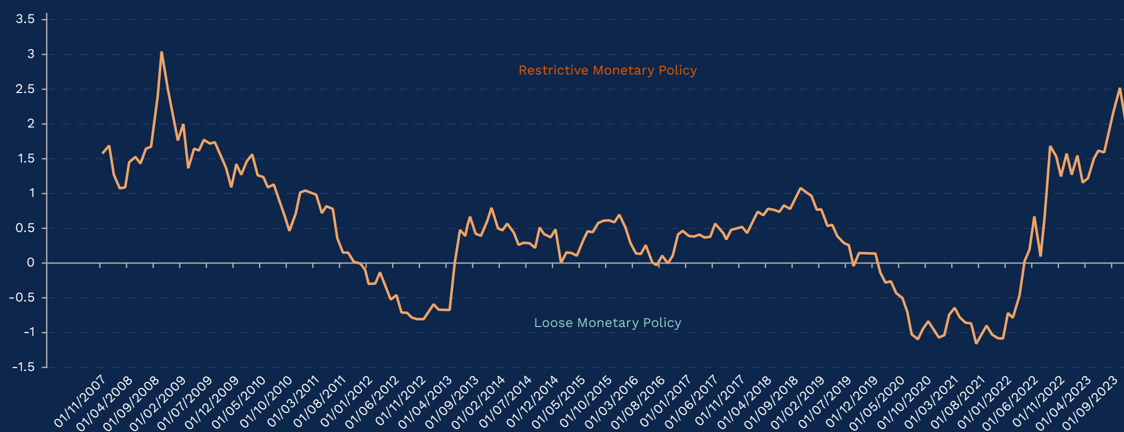
The decisions to cut will be dependent on inflation continuing its descent, and also policy makers desire to avoid a hard landing. With real rates the most constrictive they have been in over 15 years, and economic growth slowing, central banks have room to move, albeit they will be mindful of the lessons of the 1970s, and wary of declaring victory on inflation too soon.

Nevertheless, the degree of cuts expected in 2024 in our view looks excessive, and may have gone too far in the near-term. In the US, the market is pricing six cuts during the year (compared to three from the Fed's own projections), taking rates back below 4%. Five cuts are priced in for the UK and just under seven from the European Central Bank.

Whilst this degree of cuts can not be ruled out, it looks unlikely based on current economic conditions and forecasts, and we would not rule out some of these cuts ultimately getting priced out. We would expect cuts to bring down real rates, but these are likely to remain restrictive (keeping real rates positive), as opposed to accommodative or expansionary (taking real rates negative), implying that nominal interest rates will remain higher than inflation.

US 10 YEAR REAL YIELD

Real interests in the US are at their highest levels since 2008.



Source: Bloomberg, 28 December 2023

Potentially a Year of Political Turbulence and Change

Geopolitical tensions and risks around both the Ukraine and Middle East conflicts remain in play as we move into 2024, with limited signs of an end to the conflict in the former.

Both are significant humanitarian tragedies. For now, both conflicts remain regional affairs, which have not dragged other parties into the conflict, and are reasonably contained regarding their impact on global economic fundamentals. That said, the longer they persist, the greater the burden on fiscal balances for those providing military aid and support. A peaceful resolution to either conflict would be a positive for risk sentiment generally, but whether this can be achieved is difficult to predict.

2024 will be a year of elections, starting with Taiwan in January, followed by India, South Africa, and Europe in early summer. Closer to home, a general election in the UK is due by January 2025, although it is possible that it gets called ahead of that, and possibly as early as May. Based on current polling a change in government looks likely, with the Conservatives lagging labour consistently by around 20 points in recent polls, although the possibility of a hung parliament cannot be ruled out.

Significant focus and attention will be paid to the US Presidential election in November 2024, and it could be more consequential for investors. At present it looks likely that President Biden will be running against Donald Trump who remains the primary front runner for the Republicans in polling (despite two states banning him from their presidential ballot).

If Donald Trump secures a second term, it is likely that fiscal support will remain accommodative, with tax cuts due to expire in 2025 extended, and other policies to boost growth could be forthcoming. However, globally it may prompt concerns of a return to trade wars and also questions over the US's ongoing support for the Ukraine and Israel. We expect the eventual outcome of the race will only become clearer in the summer, and may be a source of market volatility during the year.

Based on current polling, a change in government looks likely.

Tempering Expectations for Corporate Earnings Growth

Slowing global growth is likely to present a challenging environment for corporates to deliver strong earnings growth, particularly with margins already at very high levels.

Lower inflation may compromise the ability of certain sectors being able to deliver meaningful revenue growth, although operating costs could benefit from lower input costs (such as energy) and borrowing costs.

Globally, corporates are expected to grow earnings by 8.0% in 2024 (based on Bloomberg consensus forecasts), above global Gross Domestic Product nominal growth of 6.9%. If growth was to fall below this, earnings estimates could be at risk of downward adjustments, which could weigh on valuations in the more expensive parts of global equity markets.

Dollar To Take a Step Back

Returning to growth expectations for the year ahead, it is likely to be a period where the positive-growth differential the US has enjoyed versus developed markets peers over the past two years, starts to narrow.

US DOLLAR SPOT INDEX

Further US Dollar weakness could follow.

Source: Bloomberg, 28 December 2023

We expect that this will have some influence on currency markets, particularly if interest rates differentials also narrow between countries and regions.

Connecting this with the US Dollar smile theory, which suggest that the US strengthens when the US economy is performing either very strongly or weakly, but underperforms when economic fundamentals roll over, we may be entering an environment conducive to a weaker US Dollar, relative to other currencies, some of which has been playing out in the fourth quarter of 2023.

We have a positive view on UK and Emerging Market equities.

Ramifications for Capital Markets

A soft landing scenario, coupled with declining inflation and interest rates would represent a constructive backdrop for both equity and fixed income markets.

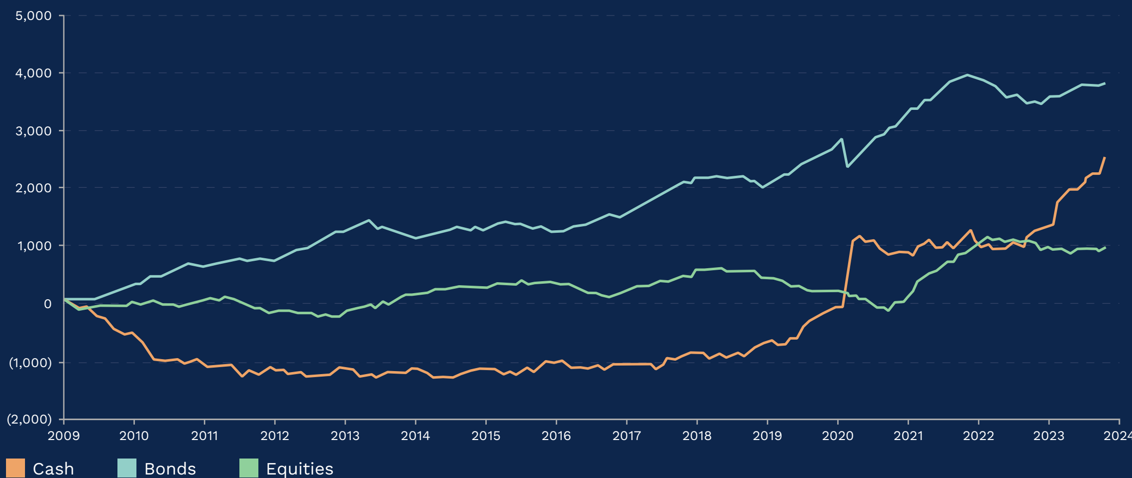
This has proved to be the case in the final two months of 2023, with both asset classes rallying strongly. As such, there is an element of the market already adjusting and pricing in this particular outcome and backdrop, as well as the reduced probability of a recession. That said, further flows into both equities and fixed income could be forthcoming if funds that have flowed into money market funds over the past 12 to 18 months start to seek a new home should interest rates come down (increasing the relative attractiveness of both bonds and equities).

In the near-term, equities have had a strong run in the latter part of 2023, with US equities trading close to all-time highs, and therefore may be due a pause or some retracement, lending itself to a cautious stance in the very near-term. That said, valuations do not appear excessive in many markets, and we have a positive view on UK and Emerging Market equities, with the former trading very cheaply. The US is the one market where valuations are somewhat more challenging, although the picture does improve if you strip out the valuations of the seven largest technology companies, and we have a negative stance towards this region at present.

Market breadth has been showing signs of improvement over the past couple of months, and we expect this to continue as we move through 2024, allowing those regions and sectors which have lagged, to catch up. A soft landing is likely to see focus return to certain cyclical areas of markets, including small caps, which we have recently allocated to. Equity markets outside of the US also traditionally do well during weaker dollar periods. Finally, slower growth may see investors pay up for companies which can deliver high rates of growth – technology being an example here, albeit attention should also be paid to valuations. We expect it to be a year where active management of equity exposure will be key.

GLOBAL FUND FLOWS (CUMULATIVE SINCE 2009, $ BILLIONS)

There have been significant fund flows into money market funds in 2023, and if a recession is avoided these funds may rotate back into equities and / or bonds.



Source: Goldman Sachs

FORWARD PRICE/EARNING MULTIPLES

Most equity markets trade in the middle of their forward price-earnings multiple ranges for the past decade (stripping out the COVID-19 period).

Source: Bloomberg, 28 December 2023

In fixed income markets, shorter dated government and corporate bonds continue to look attractive on valuation grounds, and act as a cornerstone for multi-asset portfolios. As with equities, this asset class has also seen a repricing in late 2023, with yields on longer-duration bonds falling. Consistent with our view that rate cut expectations have likely gone too far, we do anticipate that some of this yield move will unwind, presenting an opportunity to consider increasing duration within our fixed income investments. Meanwhile the reset that we have seen in yields over the past 18 months should ensure that this asset class provides favourable hedging characteristics if we do see a recession.

10 YEAR BOND YIELDS

Bond yields remain attractive on absolute grounds.

Source: Bloomberg, 28 December 2023

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