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FORUM FINANCE

1994

OUTLOOK 2024

DECEMBER 2023

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Outlook 2024: Executive Summary

The year 2024 will be marked by the continued normalization of monetary policy around the world, heightened geopolitical tensions and uncertainty about the decline in inflation.

Rising interest rates and bond yields have fundamentally changed the basis for all investment decisions. This paradigm shift will favour bond investors, who will benefit from higher expected returns, but will further weaken highly indebted actors, especially governments.

Although interest rates have peaked, structural inflationary pressures, such as rising protectionism or the energy transition, will certainly increase the risk of higher inflation than we have seen in recent decades.

As we enter 2024, undoubtedly a year of transformative change, investors' agility will be an asset in seizing the opportunities that volatile markets will offer in the quest not only for wealth preservation but also for real growth.

Economic Outlook

Slower growth ahead but still slightly above potential

US growth to outperform developed peers

China growth upgraded to 4.6% in 2024

Headline inflation falls in all G10 economies except Japan

Core inflation has also fallen, but at a slower pace

Developed central banks have reached the end of their hiking cycle

Monetary policy normalization underway in Japan

Best Investment Opportunities

High nominal and real yields provide a means of locking in cash flows

Front end of curve attractive due to flat yield curve beyond 3 years

Interest rate cuts make cash less appealing

Emerging market corporate debt offers attractive carry

Yields of around 8% for high yield are rare and followed by double-digit returns

European equities set to outperform US equities

Small caps or equal-weighted index trading at significant discount to large caps

Favourable risk/reward profile for Chinese equities

Key Risks

Rising inflation could delay central bank rate cuts

US consumer spending slows sharply

China’s economic woes persist

Unchecked geopolitical tensions and conflicts

A brief review of 2023

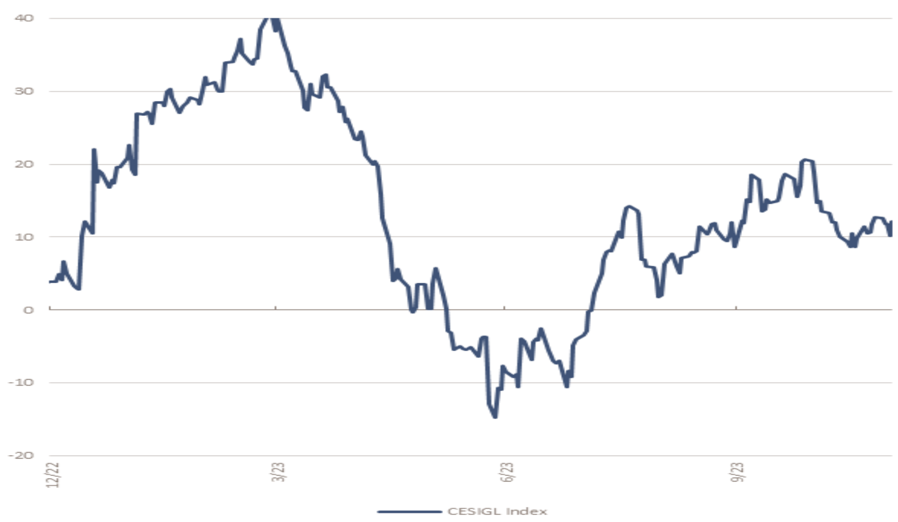
The transition to a world of higher interest rates than we have been accustomed to since the Global Financial Crisis (GFC) and the Covid-19 pandemic has continued. This paradigm shift has and will have a profound impact on economies and the investment landscape.

Higher interest rates will reduce the ability of households and businesses to borrow, but most importantly they will increase the interest burden on governments whose budget deficits have risen in recent years to levels that are difficult to sustain without greater fiscal orthodoxy.

Over the past two years to October, global bond markets have re-priced the transition to higher interest rates, a painful process that has left bond investors with heavy losses

Despite tighter monetary conditions, global economic growth, led by the US, has been far more resilient, recovering slowly from the disruptions caused by the pandemic and beating the odds, including the most optimistic expectations for the year.

Exhibit 1: Global Economic Surprise Index



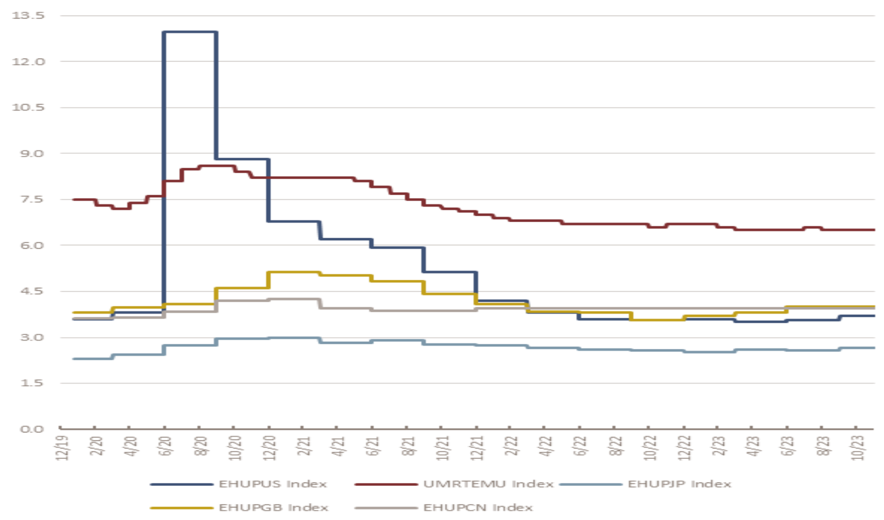
Source: Bloomberg

These positive surprises, particularly in the first quarter of 2023 (Exhibit 1), came despite major disruptions from wars (in Ukraine and more recently in Gaza), an unprecedented global tightening cycle to fight inflation and banking stress following the collapse of Silicon Valley Bank (SVB).

In the advanced economies, the US has surprised on the upside, while activity in the euro area has been revised downwards; even if euro area output has indeed recovered, it remains below pre-pandemic levels, reflecting greater dependence on imported energy prices and the adverse terms-of-trade shock caused by the war in Ukraine.

Part of the divergence between the major economies in terms of output and consumption is due to the labour market.

Exhibit 2: Unemployment Rate (%)



Source: Bloomberg

EHUPUS Index*: US Unemployment Rate (%) –* ***UMRTEMU Index****: Eurostat Unemployment Eurozone SA –* ***EHUPJP Index****: Japan Unemployment Rate (%) –* ***EHUPGB Index****: UK Unemployment Rate (%) –* ***EHUPCN Index****: China Unemployment Rate (%)*

Resilient global economy in 2023 with divergences

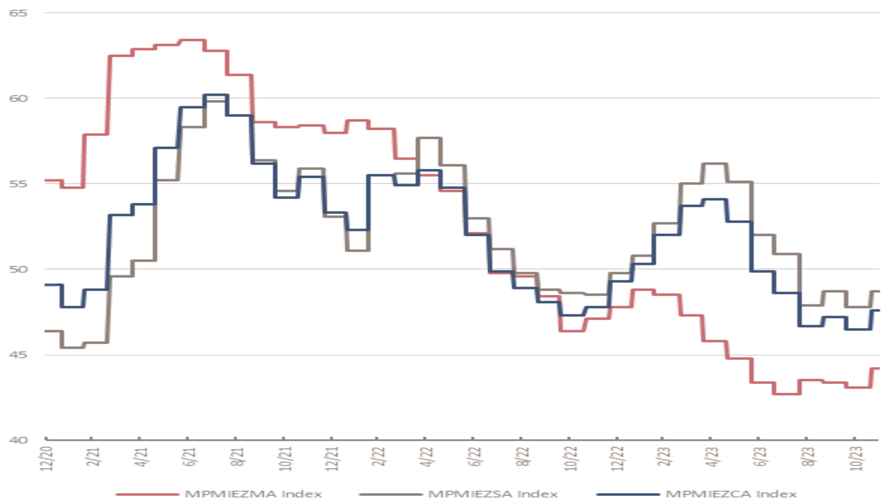
United States: Economic Strength

The strong performance of the US economy, with real GDP growth of 5.2% in the third quarter, above its pre-crisis path, has been driven by private consumption and investment. Household confidence, underpinned by the tightness of the US labour market, has supported real disposable income as well as excess savings from pandemic-related transfers. Finally, the US is more insulated from the rise in energy prices.

Eurozone: Recession and Challenges

The eurozone economy contracted by 0.1% in the third quarter and is expected to contract again at the end of 2023, confirming a recession. Eurozone industrial production contracted more than expected in October, falling by 6.6% year-on-year, while surveys of the composite purchasing managers' index, particularly the manufacturing component, are in contraction territory for the whole of 2023.

Exhibit 3: Eurozone Purchasing Managers' Index (PMI)



Source: Bloomberg
MPMIEZMA Index: Eurozone Manufacturing PMI SA – **MPMIEZSA Index**: Eurozone Services PMI SA – **MPMIEZCA Index**: Eurozone Composite PMI SA

Japan: Return to Nominal GDP Growth

The Japanese economy is returning to nominal GDP growth thanks to rising prices and wages. After a very strong start to the year, Japan's economy contracted faster than estimated in the third quarter as households faced growing headwinds from real wages, which fell 2.3% y/y in October for the 19th consecutive month, and spending was hit by higher inflation, which discouraged shoppers.

Emerging Markets: Resilience and Setbacks

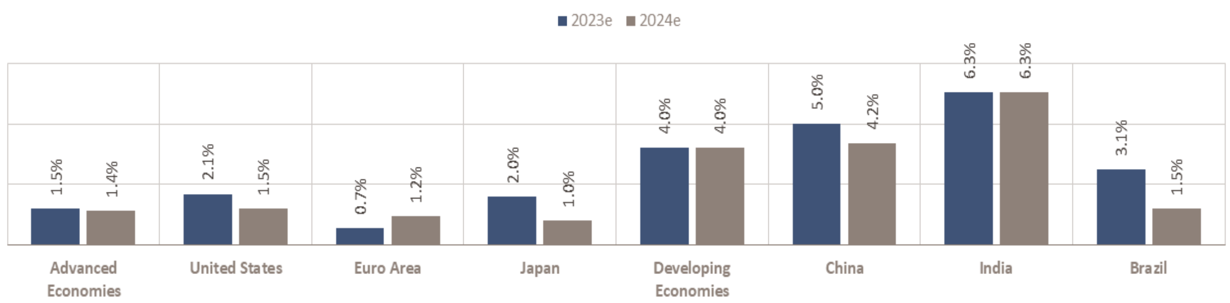
Many emerging market economies also proved resilient and surprised on the upside, with the notable exception of China. Constructive expectations for Chinese growth following the lifting of pandemic restrictions were quickly dashed by uncertainties over the youth labour market and a weak property market, leading to a lack of confidence among Chinese households and international investors alike. China's growth slowed from 8.9% in Q1 2023 to 4.0% in Q2 2023 and will deliver "close to" 5.5% GDP growth in 2023. Although lower than much of the past decade, China's GDP growth in 2023 is better than the 3% in 2022. Property and equities are the two main sources of household wealth, and downward price adjustments are hurting confidence across the Chinese economy.

Outlook for 2024

Global Growth Outlook: Should we fear a recession in 2024 ?

According to the International Monetary Fund's latest projections, global output will slow from 3.5% in 2022 to 3.0% in 2023 and 2.9% in 2024 on an annual basis, slightly above global potential growth. With growth expected to be 4.0% in emerging markets (EM) and 1.5% in developed markets (DM), the recovery in the growth premium, the difference between EM and DM economic growth, will continue in 2024 and is expected to reach its highest level in five years. The widening gap in projected year-on-year real GDP growth should make emerging markets more attractive to global capital flows.

Exhibit 4: Real GDP Growth Forecast (YoY, %)



Source: International Monetary Fund – World Economic Outlook – October 2023

Despite all the positive news on growth and inflation over the course of 2023, the median forecaster puts the probability of a recession in the next 12 months at around 50%, in line with some leading indicators suggesting that recession risks remain elevated in the US and Europe.

US growth is once again expected to outperform its DM peers and is now projected to reach 1.5% in 2024, in line with the potential growth of the US economy. The first reason is that lower headline inflation and a still robust labour market should contribute to real disposable income, while in the euro area and the UK it will be the fall in energy prices that will ease the squeeze on household incomes. The second source of growth optimism relates to the reduced impact of tighter financial conditions on the economy's growth rate. The third source is the expectation of a turnaround in manufacturing activity, largely due to the end of the destocking cycle and the impact of a disappointing rebound in China. Finally, central banks may not need to push the economy into recession to bring inflation back to their 2% target.

Even if the period of rising interest rates seems to be behind us, the European economy will feel the full impact of this monetary tightening in 2024. The monetary transmission mechanism will continue to have a profound impact on the euro area economy in 2024. Broad money supply is still contracting at an annual rate only seen in 2009. Bank lending rates to households and firms have risen rapidly and the euro has appreciated against the currencies of major trading partners since late summer.

The weaker economic environment has not yet translated into a weaker labour market, while investment continues to be supported by the supply-side issues in 2021-2022. These factors have offset the impact of tighter monetary conditions, but they will not contribute to the same extent in 2024. The first signs of some serious signs of weakness in the labour market will eventually be reflected in a higher unemployment rate.

The Japanese economy is expected to grow between 1.0 and 1.5% in 2024, down from 2% in 2023, before accelerating again in 2025. The seemingly uninspiring pace of growth is still above the potential growth rate of around 0.9%. Private consumption is expected to pick up, supported by wage growth and tax rebates.

China: Growth expected at 4.6% in 2024

China's economy has been losing steam since the second quarter of 2023 and faces numerous headwinds including rising local government debt, an ailing housing market and tepid demand both at home and abroad.

However, according to the IMF, China's economy will grow by 5.4% in 2023, up from an earlier forecast of 5.0%. Ongoing weakness in the property sector and subdued global demand is expected to limit GDP growth to 4.6% in 2024, still better than the 4.2% forecast made in October. The revised growth reflects recently announced new policy support.

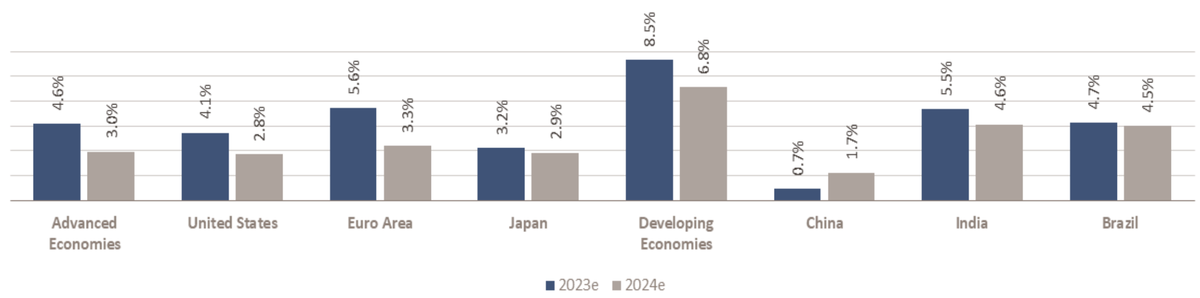
These include accelerating the exit of unprofitable property developers, removing barriers to house price adjustment, and increasing central government funding for housing completions. The increase in government spending will support economic activity in 2024, particularly the authorities' recent move to support the property sector.

In a rare adjustment, China raised its 2023 budget deficit target to 3.8% of gross domestic product (GDP) from the original 3.0%, after unveiling a plan to issue 1 trillion yuan ($139.23 billion) of government bonds to support the economic recovery. Fiscal and monetary room for manoeuvre is still ample, thanks to low consumer price inflation and a central government debt level that is not too high and enviable compared to that of the United States.

Global Inflation Outlook: Declining Steadily

Headline and core inflation are falling in all G10 economies except Japan, a trend that is expected to continue until 2024. According to the International Monetary Fund's latest projections, global inflation will fall steadily from 8.7% in 2022 to 6.9% in 2023 and 5.8% in 2024. Core inflation has also fallen, but at a slower pace. Central banks have thus achieved more than three-quarters of the adjustment needed to bring inflation back to their targets.

Exhibit 5: Consumer Price Index (CPI) forecast (YoY, %)



Source: International Monetary Fund – World Economic Outlook – October 2023

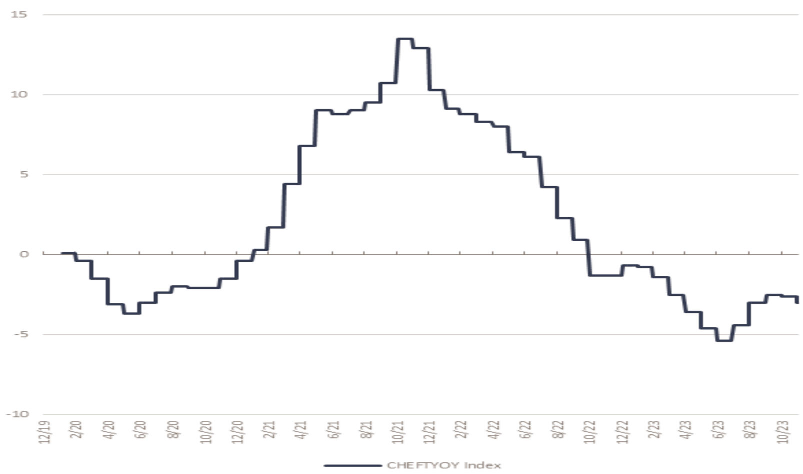
Based on our independent assessment of the components of the CPI, we are confident that US inflation will continue to decline from the current 3% to a level consistent with the Fed's 2% objective by the end of 2024. The reasons for our optimism are, firstly, the leading indicators of the shelter CPI, which point to further easing in the inflation component, and, secondly, the services component excluding shelter and energy services, whose main component is the labour market, which is finally showing signs of easing.

Euro area inflation has fallen sharply over the course of 2023. After peaking at 10.6% year-on-year in October 2022, it has fallen to 2.4% around a year later. The fact that inflation has peaked is clearly positive news, but the limited fiscal stimulus, high energy prices and interest rate hikes have pushed the euro area economy to the brink of recession. At its December meeting, the ECB lowered its inflation forecast for 2024 from 3.2% to 2.7%, but stressed that disinflation will not be achieved in a straight line and that inflation is likely to pick up in the near term.

After years of chronic deflation, Japan finally moves into an inflationary environment. In 2023, the inflation surges, largely driven by higher commodity prices and ultra-loose monetary policy. Looking ahead to 2024, demand-side factors such as wage growth and private consumption will play a more important role. Core CPI is expected to remain above 2.0% in 2024, which should eventually lead to tighter monetary conditions.

China has recently slipped into deflation, becoming an outlier in the post-pandemic recovery process. The consumer price index (CPI) fell by 0.5% on an annual basis in November. This is the biggest fall in three years. China has been struggling with weak prices for some time due to a struggling property market and weak consumption. This deflationary spiral is dragging down the economy as consumers and businesses stop buying or investing in anticipation of lower prices in the future. The Producer Price Index (PPI), which reflects the prices of commodities and raw materials, fell 3% in November, the 14th consecutive month of decline.

Exhibit 6: China Producer Price Index (YoY)



Source: Bloomberg
CHEFTYOY Index: China PPI YoY

However, it is important to emphasize that the recent weak CPI figures were partly due to the collapse in pork prices. The so-called core CPI, which strips out volatile items such as food and energy, rose by 0.6% year-on-year in November, as in the previous month.

Monetary Policy Outlook: Shift to Rate Cuts

After an unprecedented period of rapid and forceful monetary tightening, the major central banks in the developed world, except for Japan, have stopped raising interest rates, but they seem prepared to keep rates higher for longer. If interest rates have peaked, the question is whether central banks can win their battle against inflation without triggering a recession.

The dilemma for central banks, at least in most developed economies, is to balance the level of policy rates between conditions that are too restrictive, leading to a painful landing for the economy, or too expansionary, which could provoke a return of inflation requiring further monetary tightening.

In the US, the Fed has reached the end of its hiking cycle as the disinflationary trend materialises, but strong economic momentum will reduce the urgency to cut rates and could delay the first rate cut until 4Q2024. However, a clear trend towards further disinflation in the coming months or quarters would create a favourable environment for the Fed to gradually lower policy rates, even in the absence of a recession, to keep monetary conditions and real interest rates at their current level (around 2.2%).

In the eurozone and the UK, the combination of weaker growth momentum and tighter financial conditions has allowed the European Central Bank (ECB) and the Bank of England (BoE) to pause at current levels before pivoting towards easing in Q3 2024, possibly even earlier.

Exhibit 7: Financial Conditions Index

Source: Bloomberg

GSUSFCI Index: GS US Financial Conditions Index – **GSEAFCI Index:** GS Euro area Financial Conditions Index

Through the prism of the PMI indices, European economic growth is worrying. The growth situation, coupled with a significant drop in inflation, could lead the ECB to cut its key rates before the Fed.

The Swiss National Bank (SNB) left its key interest rate unchanged at 1.75% in December, acknowledging that inflationary pressures have eased. The new inflation forecasts are lower than in September due to reduced inflationary pressure from abroad. The SNB removed some of the language around selling foreign currency. This shift leaves the bank with the flexibility to sell CHF in the market and is less interested in a stronger currency.

Policy normalization is underway in Japan. The BoJ is expected to raise its overnight policy rate currently at minus 0.1%, to 0% in 2Q2024, possibly followed by a 25bp hike in July. A soft yield curve control (YCC) is likely to be maintained until mid-2025. The normalization of both monetary and fiscal policy is risky, especially after the transition from zero to growth. Any premature tightening would jeopardize this regime transition, while an uncontrolled rise in prices would push up interest rates, undermining the Bank of Japan's finances and potentially the overall stability of the Japanese financial system.

In emerging markets, inflation has started to fall, but the battle against inflation has not yet been decisively won. For the time being, the disinflation process will be more gradual than in the first half of 2023. This slower disinflation process will leave inflation levels above central bank targets in many countries, so even though some EM central banks have started to ease policy, and this trend could broaden, policy rates could remain above neutral in several countries throughout 2024.

At the same time, fiscal policy is more neutral than in the developed world, although the differences are substantial. Finally, the Fed's policy of easing in 2024 is supportive for emerging markets. China's central bank governor confirmed that the People's Bank of China (PBOC) will remain accommodative to support the economy through interest rate cuts and cash injections.

Valuation: Inflation and interest rates as the biggest catalysts

Global equity markets were up 16.9% in local currency terms at the end of November. This relatively strong performance was achieved after significant drawdowns in April and October. While interest rates may moderate on the back of lower inflationary pressures, the complex geopolitical landscape remains a potential threat to global supply chains and energy supplies.

Cash equivalent investments have delivered relatively strong returns as central banks have tightened more than initially expected. Even if short-term yields remain attractive, the expected rate cuts and hence the changes in the shape of the yield curve will reduce the attractiveness of holding cash as it represents an opportunity cost.

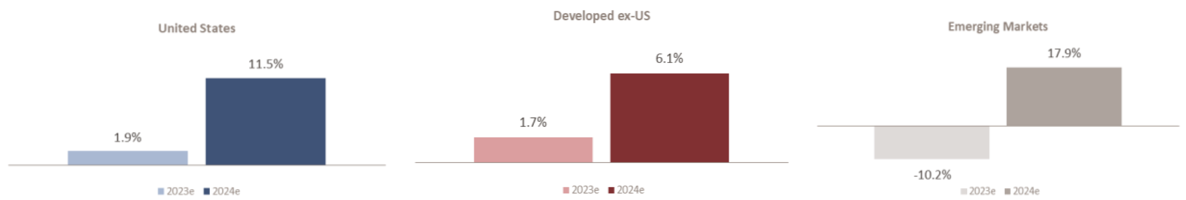
High nominal yields and attractive real yields offer bond investors the opportunity to lock in long-term cash flow streams. A relatively flat yield structure across maturities makes the front end of the curve particularly attractive, but we recognize that the potential normalization of the curve will require sufficient interest rate sensitivity, namely duration, as it will eventually become a positive contributor to total return. As a result, medium-dated government bonds and investment-grade corporates should benefit enormously in a soft-landing scenario, while offering drawdown mitigation in the event of a deeper economic slowdown.

The investment-grade corporate sector benefits from strong balance sheets and low refinancing needs. Therefore, in a slower growth environment, investors in high-quality corporate bonds should expect total returns close to initial yields. Current yields are attractive and if government bond yields fall due to a more pronounced economic slowdown, the favourable relative duration of the investment grade sector compared to high yield bonds will generate capital gains that will offset the widening of credit spreads.

Historically, the high yield sector has performed well in a steady growth environment. Even if spreads widen in response to deeper recessionary risks, the carry will support total return. Refinancing risk is certainly more prevalent than in the investment-grade universe, but the maturity wall of 2025-2026 maturity wall will not be a major concern for the market before the second half of next year.

After a negative 2022, driven by the start of monetary tightening by the Fed, equity markets rallied strongly in 2023, but with significant differences in performance between and within regions. 2024 is also likely to be a challenging year. Questions over household spending as excess savings are spent, rising geopolitical tensions and a heavy electoral agenda, will undoubtedly lead to a bout of volatility.

Exhibit 8: Estimated Annual Earnings Growth



Source: Bloomberg, Factset

US Equities: Valuation limits upside

At these levels, there are good reasons to be cautious. Even if the current market reflects a weaker economic environment for 2024, e.g. US real GDP growth of 1.5%, it offers limited room for multiple expansion from current levels.

On the earnings front, consensus 2024 EPS stands at $245, representing an increase of around 11% y/y, and $273 (also +11%) for 2025. The market is currently trading at a forward P/E multiple of 19x, while the equal-weight index is trading at the 74th percentile since 1976. The valuation premium of the large-cap index over the equal-weight index is 27%, well above historical averages.

Outside the US mega-caps, however, valuations look less stretched relative to history, while the equity risk premium (ERP) is in line with previous periods of higher interest rates.

At 5.5%, the three-month Treasury bill is in line with the earnings yield on the S&P500. The Magnificent 7 have faster expected sales growth, higher margins, a higher reinvestment ratio and trade at a relative valuation in line with historical averages, e.g. 0.9x relative PEG ratio. However, we remain cautiously optimistic on this sub-segment of the market as the risk/reward is not particularly attractive given the high expectations.

European Equities: Set to outperform the US

The pass-through of higher interest rates has been much faster than in the US, which has hurt consumer confidence. However, European equity markets remain attractively valued relative to other equity markets and relative to bonds.

Current valuations remain supportive for European equities. At 12.5x forward earnings, they trade below their long-term average and at a substantial 23% discount to the All-Country World Index. Consensus earnings growth is at 6% in 2024 and 9% in 2025, despite anaemic growth and negative sentiment on macro dynamics, but it is worth noting that over 40% of earnings come from faster growing regions.

Some of the main headwinds that European equities could face are weaker growth momentum than in the US and the high sensitivity of European economies to external shocks and the weight of export-led growth, especially to China.

Japanese equities: Valuation still well below average

Japanese indices have reached their highest levels since 1990. The pick-up in inflation has given companies the opportunity to raise prices, which has the potential to boost sales and hence earnings. Wage negotiations next year are likely to result in wage increases, which could encourage consumers to spend more. This positive effect on household demand will be accompanied by government spending and favourable expectations for exports, stimulated by the weak yen and the trend towards "friend-shoring".

Another positive driver for Japanese equities has been the Tokyo Stock Exchange's (TSE) governance reforms aimed at improving management practices, which have certainly acted as a catalyst for investors. In the wake of these reforms, Japanese equities attracted more than USD 53 billion of foreign investment flows from April to June and benefited from Warren Buffett's constructive comments on Japanese equities.

Investment convictions for 2024

#1 – Emerging Market Corporate Debt (Hard Currency): Attractive Carry and Spreads

Global interest rates are likely to have peaked in October, as both the global economy and inflation slow moderately, allowing central banks to eventually shift to a more dovish stance, with the first rate cuts now expected for 1Q in the US, many emerging market central banks have already started to cut rates and are therefore at an advanced stage of monetary normalization compared to the developed world. The Fed's recent comments have created a buying opportunity for emerging market debt. We therefore include emerging market debt corporate debt among our top convictions within fixed income for 2024.

Emerging market issuers will benefit from lower US Treasury yields, while spreads should remain at current levels or tighten slightly if the soft-landing scenario prevails. If the investment grade sector is the main beneficiary of falling rates, the default risk of high yield issuers would be largely reduced. As a result, EM credit offers attractive yield levels with spreads above their historical average.

#2 – High Yield: High Total Return and Slightly Tighter Spreads

Our base case is for a modest slowdown in economic activity in the first half of next year, but at this stage we rule out a full-blown recession in the US. While bond yields have improved significantly, spreads have tightened and remain close to historical averages.

This upward adjustment in yields - yield-to-worst of 7.84% for US high yield (1) - has not only improved investors' potential total return, risk-free rate plus spread, but also their ability to absorb negative shocks. Yields around 8% are relatively rare. Historically, when yields have reached these levels, the subsequent 12-month total return has been positive, with double-digit returns on average.

Credit metrics will inevitably suffer as more expensive debt replaces older debt, but interest coverage ratios remain well above historical levels. Total defaults are expected to be between 4.0% and 4.5% in 2024 for high yield, in line with the long-term average.

The end of the tightening cycle and expectations of interest rate cuts next year have led us to rebalance the interest rate component of our bond holdings. However, given the almost flat yield curve beyond three years, we prefer medium-dated bonds from higher-rated issuers.

[1] Bloomberg US High Yield as of December 18, 2023

#3 – Small Cap or Equal-Weighted Equities: Bet on market breath

Over the past 25 years, small caps in developed markets have outperformed large caps, but in 2023 through November they lagged 12%, one of the worst periods for the equal-weighted indices in 20 years.

We believe they will revert to their historical behaviour and deliver attractive returns given their starting valuation relative to large caps (P/E in the 3rd percentile over the past 20 years); while small caps generally have weaker balance sheets than large caps, the current valuation discount provides a significant cushion going forward. In the US, the valuation of the market-cap-weighted index is valued at 19.4x forward P/E versus 15.7x for the equal-weighted index.

In addition, small caps tend to perform strongly in the early stages of a new economic cycle. With interest rates having certainly peaked and even expected to fall in 2024, sectors such as real estate, industrials and materials, which are well represented in small-cap indices, should therefore drive performance. Finally, the disinflationary trend should support improvements in fundamentals such as margins and even earnings per share.

#4 – China: Favourable risk and reward profile

The slowdown in economic activity, the slump in the property sector with its negative impact on household confidence, and the tensions between the US and China have pushed Chinese equity valuations close to historic lows.

While all these uncertainties have partly justified the downgrading of Chinese equities, it has probably gone too far. Indeed, recent data has shown some signs of stabilization. Despite the disruption to Chinese economic activity in 2023, the consensus view remains that China will achieve real GDP growth of 5.2% in 2023 and 4.5% in 2024.

We have been reassured by recent policy measures, albeit still too timid, to address the financial stress in the real estate sector and the potential room for manoeuvre provided by the Fed's monetary policy pivot, which will allow the PBOC to increase monetary stimulus without risking excessive pressure on the Chinese renminbi.

The decline in equities in 2023, -9.7% versus +16.6% for global equities in US dollar terms, has brought valuations back to the depressed levels seen at the end of 2022. From a valuation perspective, the Chinese market is currently trading at a discount of more than 40% compared to the US market.

Asset Class Views

Asset Class			As of 30/11	Views for H1 2024
Fixed Income	Government	US	=	=/+
		EU	=	=/+
		UK	=	=
		CH	=	-
	Corporate	US IG	=/+	+
		EU IG	=/+	+
		US HY	+	+
		EU HY	+	+
	Emerging Market Debt	HC	-/=	-/=
		LC	=	=
		IG – HY	+	+
Asset Class			**As of 30/11**	**Views for H1 2024**
Equity		US Large	-/=	-/=
		US Small	=/+	=/+
		Europe Large	=/+	=/+
		Europe Small	=/+	+
		Switzerland Large	=	=
		Switzerland Small	=/+	+
		UK	=	=
		Japan	=	-
		China	-/=	+
		India	=	=
		Other EM	=	=

Commodities	=/-	=/-
Currencies (USD vs. G10)	=	=/-

(-) Negative, (=) Neutral, (+) Positive

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