January 2024

MONTHLY HOUSE VIEWS

2024 OUTLOOK

Macro

Overall, global growth in 2023 proved more resilient than had been expected after the previous year's equity bear market, with consensus estimates ri,,sing from 2.1% to 2.9% over the year. On closer inspection, the outperformance was mainly contributed by the US – China's post-lockdown recovery has underwhelmed while activity in the Eurozone has been sluggish. Part of the explanation has been US fiscal policy – stimulus cheques boosted household savings during the pandemic and are now being spent, while the 2023 federal budget deficit is estimated to have reached -6.2% of GDP, a level more associated with recessions than with cyclical upswings. However, the economy could weaken in H2 – estimates suggest that consumers will have spent the bulk of their excess savings by mid-2024 while rising rates and Treasury yields mean that the cost of servicing US debt will rise to 2.7% of GDP this year, the highest since 1997.

Central Banks

The publication by the Federal Reserve (Fed) of its summary of projections in December showed that decision-makers expect to make three 25bp rate cuts in 2024, confirming market hopes that we'd seen the last rate hikes for this cycle. This marked a clear switch away from the Fed's previous insistence that rates would stay "higher-for-longer". However, traders have since revised their expectations and now anticipate six cuts next year according to Bloomberg's calculator, which seems rather excessive given the resilience demonstrated by the US economy. Similarly, they expect between six and seven cuts from the European Central Bank (ECB) despite its insistence that there's "more work to be done" to bring inflation under control. The only major central bank which may tighten policy this year is the Bank of Japan (BoJ) where inflation has been above target since April 2022.

Markets

November's "everything rally" continued in December with further gains for equities, sovereign bonds and investment grade (IG) and high yield (HY) credit. The MSCI World index of global equities rose 4.8% while the Bloomberg Global Aggregate bond index gained 4.2% and US IG and HY rose 5.0% and 3.7% respectively. Like the previous month, the only asset class to lose ground was commodities, pulled lower by more weakness in energy although both industrial and precious metals gained ground over the month. As is often the case when risk appetite is high, the US dollar index sold off, shedding -2.1% its second straight monthly fall.

Bottom Line

We decided to keep our overall asset allocation unchanged again this month with equity allocations towards the top of the neutral band. We expect some further upside in equities over the next few months before investors begin to fret about recession risks. Our favourite region remains the US which we prefer over Europe, which we prefer in turn over Asia. After the sharp falls in long-dated yields in November and December, we expect a rise in yields in coming weeks as traders adjust their over-optimistic rate-cut forecasts. This should give us an opportunity to continue our regular purchases in US duration (i.e., sensitivity to changes in rates) via an ETF of 7-10 year maturity Treasuries.

Summary House Views

OUR ASSET ALLOCATION

The tables below present the latest conclusions of our Global Investment Committee.

Equities	We maintain equity allocations towards the upper end of the Neutral band and continue to recommend investors strike a balance between Value and Growth. We prefer the US to Europe, and Europe to Asia.	Neutral
United States	We have adjusted our US allocation to achieve a better balance between Growth and Value. Quality and Growth stocks have dominated recent market performance, but their valuations are getting stretched.	Overweight
Eurozone	The bear story for Eurozone equity markets is well-known. However, the markets are still cheap, still under-owned and in an uptrend.	Neutral
UK	The normalisation of relations with the European Union is good news for UK exporters, but the government's switch to austerity has done little to address the UK's growth deficit.	Underweight
Switzerland	The Swiss market is dominated by high-quality, defensive stocks, which should help cushion any downside, while inflationary pressures remain well below those suffered by its neighbours.	Neutral
Japan	The new central bank governor has finally commenced some modest policy tightening aimed at stabilising the yen, which could underline the attractiveness of Japanese equities.	Neutral
Emerging (EM)	The reopening of the Chinese economy has underwhelmed investors. For now, advanced economy equities in the US and Europe have more upside potential.	Neutral

Fixed Income	Today's environment of high inflation, elevated policy rates, quantitative tightening and inverted yield curves will continue to prove challenging for fixed income investors.	Underweight
Sovereigns	The sharp rise in policy rates and inverted yield curve have created attractive opportunities in short-dated bonds. Nonetheless, the risk of economic downturn justified our decision to rebuild exposure to duration.	Underweight
Duration	With real yields finally back in positive territory, we have rebuilt exposure to duration. This both reduced our underweight compared to the market and provides a hedge against macro weakness and a Fed pivot.	Underweight
Inflation-linked	Inflation-protected securities tend to have very high duration, making then extremely sensitive to small shifts in inflation expectations.	Neutral
Investment Grade	The sharp rise in policy rates and inverted yield curve have created some buying opportunities in short-dated EUR-denominated high-quality corporate bonds. We remain Underweight nonetheless.	Underweight
High Yield	Credit spreads have tightened to unattractive levels, especially if growth weakens which could blow headwinds against risk assets like high yield bonds, given the potential for a deterioration in credit quality.	Underweight
Emerging debt (in € and $)	The best opportunities lie in Latin America where central banks have hiked rates far enough to take yields above inflation. However, political risk requires careful monitoring.	Neutral

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Commodities	With reopening in China likely to gradually boost demand for raw materials, we maintain our modestly Overweight allocation to commodities.	Overweight
Energy	With OPEC+ cutting output and oil majors reluctant to invest in new production capacity, crude oil supply is constrained. However, fears of economic slowdown in the west keep prices rangebound.	Neutral
Industrial metals	The key driver for industrial metal prices will be Chinese demand as the economy picks up. We also continue to highlight the attractions of transition metals like copper and nickel.	Neutral
Precious metals	Central bank demand for gold remains strong and bullion continues to provide useful diversification benefits in terms of portfolio construction.	Overweight

Currencies	After a bullish surge from July to September, the dollar index has corrected steadily and is now down for the year to date.	
EUR/USD	The conviction that the European Central Bank has finished its rate hike cycle may remove one of the single currency's supports.	Neutral
GBP/USD	Although the growth outlook still looks bleak given the UK's structural weaknesses, sterling remains heavily under-valued.	Neutral
EUR/GBP	Both currencies face strikes and political challenges, and the advantage conferred by the Eurozone's better budget discipline is offset by sterling's higher rates.	Neutral
USD/JPY	The shift in official statements about yen weakness suggests that the authorities may intervene to prevent further dollar strength.	Neutral
EUR/CHF	The Swiss National Bank will keep a close eye on ECB rate hike plans – CHF strength has been to the SNB's strategy to keep inflation under control, which appears to have worked for now.	Neutral
Emerging	EM currencies hit a new multi-decade low against the US dollar in early October and have since attempted to begin to build a base.	Underweight

↗ Upgrade ↘ Downgrade ⊕ Overweight ⊜ Neutral ⊖ Underweight

Economic Outlook

2024 OUTLOOK

The economic recession which was widely forecast after 2022's equity bear market did not materialise last year. Indeed, the US economy accelerated to an annualised growth rate of 4.9% in Q3, up from 2.1% in Q2, and the Atlanta Federal Reserve's GDPNow tracker estimates that Q4 will have reached 2.5%, well above the potential growth rate. What does 2024 hold in store?

The momentum from last year's second half is likely to carry over into early 2024. Job growth is still robust – December saw 216,000 new jobs created versus a consensus estimate of 175,000 – and the unemployment rate at 3.7% is still close to last April's 3.4%, a 54-year low. Moreover, November's retail sales – which include the Black Friday start to the holiday shopping season – rose by a better-than-expected 4.1% year-on-year (YoY), boosted no doubt by excess household savings.

However, the second half of 2024 looks more challenging for the US economy. First of all, the lagged effect of the sharp hikes in rates between March 2022 and July last year will be felt increasingly felt by borrowers as old fixed-rate loans are replaced by new borrowing at higher rates. In addition, banks are becoming more worried about credit quality and have been steadily tightening lending standards – according to the latest loan-officer survey, 33.9% of respondents are still tightening terms for loans. Second, business confidence has been consistently weak in recent months. The Institute of Supply Management's December surveys showed confidence among manufacturers in contraction territory for the 14th consecutive month while service businesses said that employment conditions had plummeted to the lowest level since the pandemic panic in spring 2020. And third, it should be noted that consumer spending has been boosted by credit-card borrowing – which currently stands at $1.03 trillion, close to all-time highs and up from $736bn in April 2021 – and by pandemic-era stimulus cheques and unemployment benefits. Household cash balances shot up from $0.9tn to $4.8tn between Q3 2019 and Q3 2022. However, at the current rate of household spending, it is estimated that most of the excess savings will have been exhausted by this summer.

The Eurozone economy is already very close to a technical recession, which is defined as two consecutive quarterly declines in GDP. Q3 2023 saw GDP dip by -0.1% across the region, after growth of only 0.1% in both the first and second quarters, and Q4 looks little better. The composite purchasing manager index (PMI) surveys, which cover both manufacturing and services, has been mired in contraction territory since last June. Moreover, 2024 is unlikely to see much improvement. Like in the US, lending standards have been tightened in recent quarters which is bad news for borrowers, given the higher reliance on bank credit in Europe than in the US. Moreover, the European Central Bank's deposit rate currently sits at 4.0%, the highest level since the single currency was launched at the turn of the century. All in all, the consensus expectation is for GDP growth of only 1.3% this year according to Bloomberg.

China was 2023's big disappointment for economists, who had forecast a mini-boom in activity as the country emerged from the stringent "zero-Covid" policy which was abandoned by President Xi in December 2022. However, the hoped-for recovery proved underwhelming, and 2023 GDP growth forecasts have been revised lower from a high of 5.7% to 5.2%. Recent activity data has been slightly more encouraging – over the twelve months to November, industrial production is up 6.6% while retail sales have bounced 10.1%. But the consensus growth forecast for this year is well below the averages of 7.8% in the 2010s and 10.2% in the 2000s.

Recent declines in headline inflation have fostered hopes that prices will soon be back in line with central banks' inflation objective, which is typically 2.0% for ex-energy and food or core prices. In the US, the headline consumer price index (CPI) is down from a recent peak of 9.1% YoY to 3.4% in December, while core inflation has receded from 6.6% YoY to 3.9%. The difference between the two is largely due to energy prices which have fallen -14.3% from their highs. However, it may well be that the easiest part of this disinflation is behind us. Looking ahead, wage pressures may begin to bite into profit margins and force companies to increase selling prices. In December for example, growth in average hourly earnings edged higher to 4.1% YoY, which is well below the 5.6% inflation rate consumers expect over the next twelve months according to the Conference Board's December survey – further demands for higher wages are likely. Moreover, the avowed aim of western governments to reduce over-reliance on world-wide supply chains, especially with China, via policies of "onshoring", "nearshoring" or "friendshoring", is likely to lead to higher manufacturing costs. In addition, freight transportation costs and delays have shot higher in recent days as shipping companies scramble to reroute container traffic away from the piracy risks in the Red Sea and toward the Cape of Good Hope.

Bottom Line

In summary, although we expect late-2023's momentum to carry over to the first part of this year, we do see storm clouds gathering ahead of a second-half slowdown in activity. And if, as we expect, inflation fails to return rapidly to 2%, central banks could find themselves facing a toxic combination of sluggish growth and sticky inflation.

EQUITIES

The upward momentum in global equity markets continued after November's outsized 9.2% rally with the MSCI World index of global equities gaining 4.8% in December with the index ending the year just 2.5% shy of its January 2022 all-time high. European equities outperformed the US for the third time in four months – Europe's STOXX600 index jumped 5.4% while the US S&P500 index gained 4.4%. Both indices outperformed emerging markets which rose 3.7% overall. At the regional level, Latin America led the way for the second straight month with a 7.7% jump, followed by Eastern Europe which gained 6.7%. LatAm's strength came despite a -49.0% plunge in Argentina after new president Javier Millei devalued the peso by -57.1% against the US dollar. Asia continued to lag, gaining only 3.1% in December, penalised by a -2.6% drop in Chinese stocks (all data in dollar terms).

US . Participation in the Q4 rally remained broad-based – the proportion of stocks trading above their 200-day moving average (DMA) soared from only 25.0% in late October to 78.5% at year-end, the highest level since mid-2021. Moreover, the strength was consistent across factors – MSCI's US Value index led the way with a 5.3% jump followed by Quality and Growth which gained 4.7% and 3.9% respectively. The only sector not to participate was energy which shed -0.4% in December, hardly surprising given the -7.0% drop in Brent crude prices and the -10.3% plunge in US natural gas. Real estate, one of this year's laggards, topped the leader board in December with a 7.8% advance, bolstered by a massive drop in yields as traders revised their 2024 rate-cut expectations from -114bp to -158bp over the month. Further illustration of the broad-based participation can be gleaned by comparing the Magnificent Seven index, which includes the very largest tech and internet platform leaders, and the Russell 2000 small-cap index – the former underperformed the S&P500 with a 3.9% advance while the latter soared 12.1%

The Q4 surge in prices has pushed US valuations considerably higher, from 19.1x trailing earnings at end October to 22.3x at year-end. The pace of the advance in prices was not matched by upward revisions in earnings expectations for the next twelve months, which have only risen 1.3% since end-October according to Bloomberg. Moreover, the valuation premium over European stocks rose sharply over the period, from 8.0 points to 9.6 points. And as illustrated in our December House Views, this premium has little to do with the market-dominant positions of the Magnificent Seven stocks – US financials and utilities, for example, trade at premia of 99.6% and 76.3% respectively while US information technology stocks are at a premium of only 36.3% over their European brethren. The same holds true for factor indices - according to MSCI, US Growth stocks trade at a 49.6% premium to Europe and US Value 79.8% higher. We continue to call for a blend of Growth and Value stocks in portfolios.

Europe . The bear case for European equities is well known. Economic growth is sluggish at best – activity slipped at a -0.4% annualised rate in Q3 and, as highlighted on page 4, the PMI business confidence surveys have been stuck in contraction territory since early summer. As a result, corporate earnings have disappointed – according to Bloomberg, earnings for the MSCI Europe index fell -3.9% last year and are only expected to inch 0.2% higher in 2024. Moreover, investors have been steady sellers of European equity funds in recent quarters – until EPFR announced modest inflows to European equity funds in the very last week of 2023, there had been 41 consecutive weeks of steady outflows. And finally, the geopolitical backdrop remains worrisome – the war in Ukraine has reached stalemate while the conflict in the near east looks like spilling over to the broader region with knock-on effects on supply chains and inflation from Houthi attacks on cargo ships in the Red Sea. Any yet, Eurozone equity markets performed satisfactorily last year – three of the four main markets, Germany, Italy and Spain, matched or beat the S&P500 in price return terms, measured in euros.

In valuation terms, European equities continue to look cheap compared to history and to other markets, notably the US. Moreover, European stocks are likely to pay investors a handsome 3.8% dividend yield in 2024, well above the current 3.3% yield on euro investment grade corporate bonds and the expected 1.5% yield on the MSCI US index.

Asia . Within emerging markets, Eastern Europe led the way last year with a 42.1% surge for the MSCI regional index, with Hungary and Poland outperforming. Latin America followed with a 25.1% jump, led by regional heavyweights Mexico and Brazil, which soared 36.3% and 33.1% respectively. The laggard, as mentioned above, was Asia which gained only 5.6%. Performance was depressed by China, which represents 26.4% of the regional index and which plunged -13.3% last year. The other Asian heavyweight, India which is 16.7% of the index, compensated with a 19.3% surge in 2023.

Factors . December saw global Value stocks outperform Growth, by 5.2% to 4.4%, for the first month in three. However, the performance differential over the whole year remains enormous at 8.7% and 35.9% respectively. The same holds true for valuations – Growth trades at 25.5x forward earnings versus 13.3% for Value. We continue to call for a balance between factors in portfolios.

Bottom Line

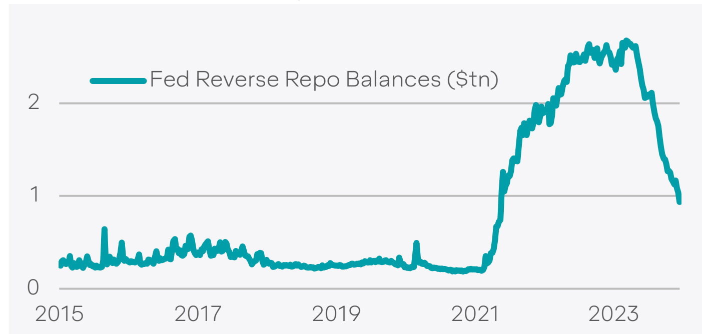
At the start of 2024, we have decided to keep our overall equity allocation unchanged at the upper end of the Neutral band. We prefer US equities to Europe, and Europe to Asia. If we are right in expecting a slowdown in H2, investors should expect more volatility in 2024 after what we expect to be a decent start to the year.

FIXED INCOME

At the end of October, Bloomberg's Global Aggregate bond index was down -3.4% for the year-to-date (YTD) and seemed to be headed for an unprecedented third consecutive down year. However, November and December's "everything rally" saw back-to-back gains of 5.0% and 4.2% respectively, enabling the index to close the year up 5.7%. The bond rally was driven by a combination of declines in long-dated bond yields (as traders bet on economic weakness and falling inflation pushing central banks to pivot to easing) and of tightening credit spreads (as traders bet that economic strength would allow credit quality to improve). Investors should note the inconsistency of betting simultaneously on growth and recession.

US . After peaking at 5.0% in mid-October, US ten-year (10y) bond yields plummeted by 112bp to end the year well below 4.0%. This meant that long-dated bond prices rallied strongly (as bond prices rise, their yields fall) – by end-December, the 7-10 year US Treasury index had surged 9.3% from its mid-October low for the year. The move was given impetus by some rather benign inflation readings – month-on-month headline inflation was only 0.0% and 0.1% in October and November – and by the dovish pivot at the Fed's mid-December policy meeting. After leaving rates unchanged for the third consecutive meeting, the central bank announced that further hikes were "not the base case anymore" and published updated projections showing a total of 75bp of easing in 2024.

The sharp fall in long-dated yields accentuated the inversion of the yield curve (this is when 10y bonds yield less than 3m bills, an exception to the normal relationship between the two). After tightening from -190bp in May to -50bp in mid-October, the yield spread widened again to -145bp at year end. However, bond traders may have pushed prices too far too fast. First, the market expects more than six -25bp rate cuts rather than the three suggested by the Fed, which may prove too optimistic. Second, as suggested on page 4, inflation may prove stickier than has been widely assumed. Third, despite shrinking its asset holdings by -$95bn per month since late 2022, the Fed's balance sheet is still $3.5 trillion (tn) larger than before the pandemic, which suggests more selling to come. Finally, money market funds' reverse repurchase agreements with the Fed have

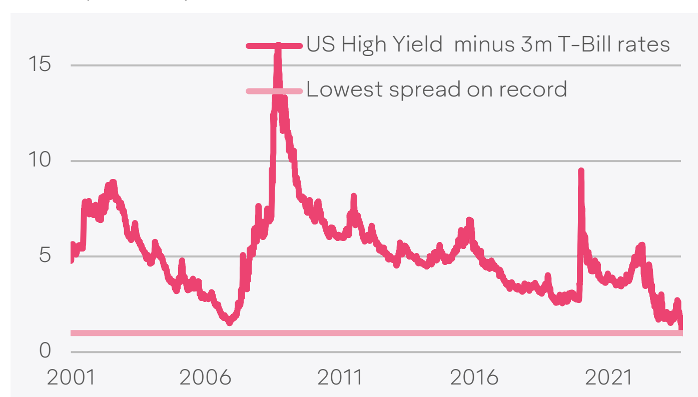


Source: Bloomberg

shrunk by over -$1.5tn since last May as fund managers have switched towards Treasury bills to capture the attractive yields on offer, which has absorbed much of the massive increase in Treasury issuance. However, this process will be largely complete by mid-2024 at which point the shrinking liquidity driven by the Fed's "quantitative tightening" could start to downward pressure on bond prices given the need to finance the administration's massive deficits.

Europe . German 10y Bund yields followed the same path as in the US, collapsing from almost 3.0% to under 2.0% over Q3. This accentuated the inversion of the 3m10y yield curve which reached -152bp at year end, the steepest level on record. The rally in long-dated bonds comes despite a somewhat hawkish message from the ECB at its December meeting – president Lagarde insisted that there had been no discussion whatsoever about rate cuts. Moreover, the governing council decided to wind down the reinvestment of maturing bonds in its pandemic emergency purchase programme from June onwards, which will reduce demand for eurozone sovereign bonds. Nonetheless, traders increased their bets on rate cuts this year, from three -25bp cuts in late October to over six by year-end. Any unwinding of these bets would surely put some upward pressure on 10y yields.

Credit . The "everything rally" in the last two months of the year pulled credit spreads (the difference in yields between corporate and sovereign bonds) tighter across the board. Investment grade (IG) spreads fell by -34bp in dollars and -20bp in euros while high yield (HY) spreads – which are more sensitive to swings in equity markets – plunged by -114bp in USD and -90bp in EUR. However, the levels reached look somewhat unattractive – IG and HY spreads in dollars stand -33bp and -170bp respectively below their twenty-year averages. There is a bit more value in euros where the HY spread is only -98bp below its average and the IG spread is actually 15bp above its own. Nonetheless, any second-half economic slowdown is likely to put some upward pressure on corporate spreads.



Source: Bloomberg

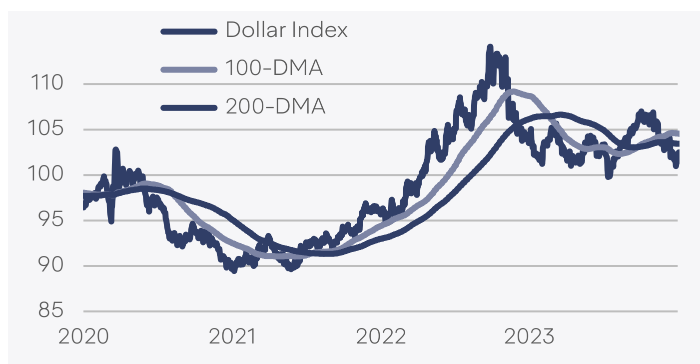
Bottom Line

Although we remain defensive overall in our fixed income allocations, with a clear focus on high quality credit, the position we built steadily in rate-sensitive bonds came into its own in November and December as long-dated bonds rallied hard.

CURRENCIES

The rangebound dollar index dropped -2.1%, both for December and for the year as a whole, as traders ramped up rate cut bets.

USD . As traders adjusted their expectations for US rates lower over the last couple of months, the dollar index (which measures its value against its main trading partners among advanced economies) dropped -5.0% over November and December. If, as we expect, traders become more circumspect about the pace of rate cuts in the weeks to come, the index could recover somewhat. However, the offset between relatively high interest rates in dollars and the worsening twin deficits in the US could keep the dollar index rangebound for some time to come.



Source: Bloomberg

EUR . The ECB sounded a much more hawkish note than the Fed at its December meeting which helped the euro to a significant rally against the US dollar over the fourth quarter (+4.4%). However, the continued resilience of the US economy and some stickiness in its inflation mean that the Fed may cut less and later than expected, which should help the greenback rally against the single currency in early 2024. Thereafter, we expect rangebound trading for the euro against the dollar.

JPY . So far, the Bank of Japan (BoJ) has stuck to its negative interest rate policy, the last major central bank to do so, which has kept the currency weak against the dollar. Indeed, despite a Q4 rally, the yen shed -7.0% last year, its third consecutive large annual fall against the greenback. Looking ahead, the BoJ may be emboldened to normalise policy now that inflation has been above its 2.0% target for 21 consecutive months. A shift to positive rates should strengthen the yen, especially if it coincides with Fed rate cuts.

CNY . Unlike Japan, China is battling with a bout of deflation – consumer prices fell -0.5% YoY in November – and the People's Bank of China (PBoC) has been engaged in very gradual policy easing. Given the sluggishness of the recovery from the zero-Covid lockdowns and the overhang of bad real estate loans, further easing is likely. Nevertheless, the renminbi strengthened 3.0% against the dollar over November and December. Looking ahead, the CNY is unlikely to stage a rally until the economy is on a sounder footing.

COMMODITIES

Global spot commodity prices slumped -3.6% lower in December, dragged lower by persistent weakness in energy prices.

Energy . After a 32.7% surge from their mid-June low to the late-September high for the year, Brent crude prices have corrected sharply, dropping -19.2% over the fourth quarter. As highlighted last month, this prompted the OPEC+ cartel to announce in late November that members had agreed to make additional voluntary cuts to output. Saudi Arabia, the dominant Middle East player, committed to extend its -1 million barrels per day (mb/d) cut until March while Russia said it would increase its export reduction from -0.3 mb/d to -0.5 mb/d. In addition, the other cartel members have undertaken to announce cuts to their output of -0.5 mb/d in aggregate.

However, this announcement failed to stem price weakness as non-cartel producers ramp up output and as demand growth slows. According to the International Energy Agency (IEA) December report, OPEC+ market share has fallen to just 51%, the lowest level since the cartel was expanded to include Russia and allies in 2016. At the same time, US output has soared since end 2022 from 12.1mb/d to 13.3mb/d, the highest level on record, while Brazilian and Guyanese output has also hit new heights. Moreover, the IEA slashed its Q4 demand estimate "drastically" by 0.4 million barrels per day (mb/d) citing higher interest rates and stagnant economic activity in Europe among the reasons. The outlook for prices is slightly better this year with the IEA revising oil demand up by 0.13mb/d compared to previous estimates, but much will depend on whether OPEC+ can keep its discipline.

Gold . Gold prices rose 1.3% in December taking calendar 2023 gains to 13.1%, with gold hitting an all-time high at $2,077 per ounce in late December. In part, the strength in Q4 was driven by dollar weakness – gold is traded in dollars and tends to strengthen when the greenback falls. And in part, it was driven by falling bond yields – the opportunity cost of holding gold, a non-interest-bearing asset, falls when rates decline. Moreover, investors have continued to redeem holdings in gold-backed ETFs to the tune of -$14.7bn over the whole year, the equivalent of some -244.4 tonnes. The only region to see net inflows last year was Asia where investors added around $1.3bn to portfolios, the equivalent of 19.1 t.

On the other hand, demand for gold from emerging world central banks and consumers in China and India remains robust. With little growth forecast in mining output, the longer-term picture for gold prices remains bright.

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