Global Market Outlook

2024

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2024: The Final Act of an Inflation Story?

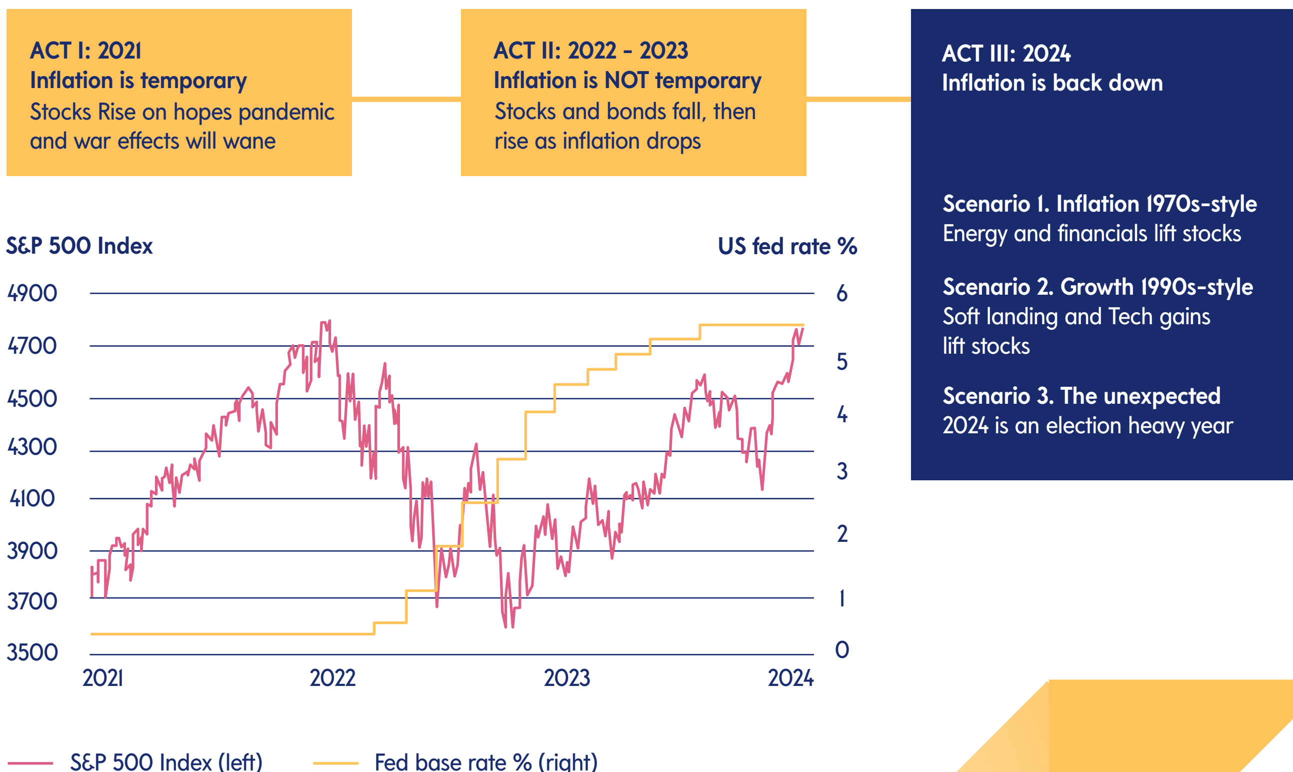
Ever since the pandemic outbreak in 2020 and Russia's invasion of Ukraine in 2022, financial markets have mostly been about whether inflation was temporary or not. As the economy's No. 1 public enemy (to many people), inflation is a crucial factor in fiscal and monetary policy decisions, as well as consumption and investment trends. This will not change in 2024.

The next 12 months, though, are expected to bring us the third and final act of the inflation shock story that has driven asset returns over the past three years: as seen in **Figure 1**, Equity prices rose in 2021, when central banks believed the inflation spike would be temporary.

This changed abruptly in 2022, when prices continued to rise and central banks responded with the fastest rate hiking cycle in history. Financial assets plunged. The trend continued in 2023, although it reversed as soon as inflation started to wane.

We believe inflation will remain within central banks' acceptable levels in 2024, offering an opportunity to investors. Where and when these opportunities can be found will depend on which scenario will unfold following the 2020-2023 inflation shock: a return to the 1970s recessions and inflation spikes, which led to an energy-driven stock rally? A 1990s rarely seen soft landing, as already claimed by US Treasury Secretary Janet Yellen? Or should we expect the unexpected given the long list of national elections this year, including the US.

Figure 1



Source: MIFL, Bloomberg. 5 Jan. 2024

Potential 2024 scenarios

Let's look at each scenario and then assess how each option may affect major asset classes.

1. Recession à la 1970s with an energy-led market

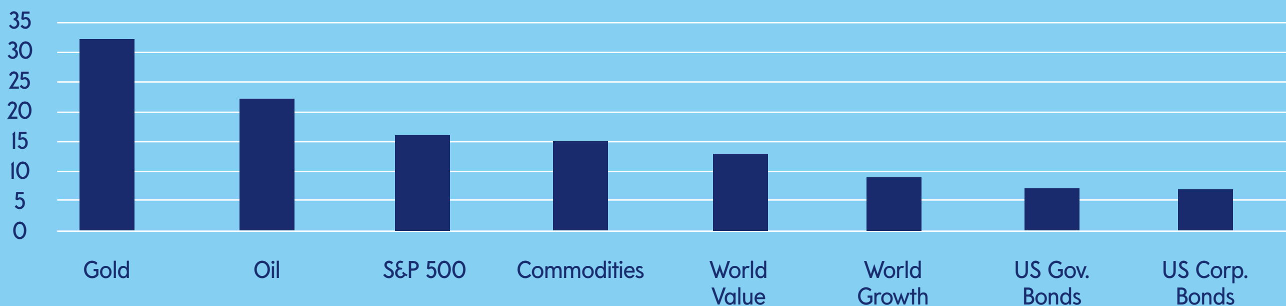
Despite the 1973 and 1979 oil shocks following the Yom Kippur Arab-Israeli wars, which led to sharp recessions, the 1975-1980 period led to equity gains driven by the Energy sector - as many as six of the world's ten largest companies were in oil, including Exxon, Standard Oil and Shell. As seen in **Figure 2**, traditional inflation-hedging commodities, such as gold, also rose, and as one would expect in slow-growth times, Global Value equities outperformed Growth. Some investors see echoes of this era today, given the protracted conflicts in the Middle East and Russia-Ukraine, which have led to major disruptions in oil, gas and commodity markets since 2020.

2. Growth à la 1990s soft landing

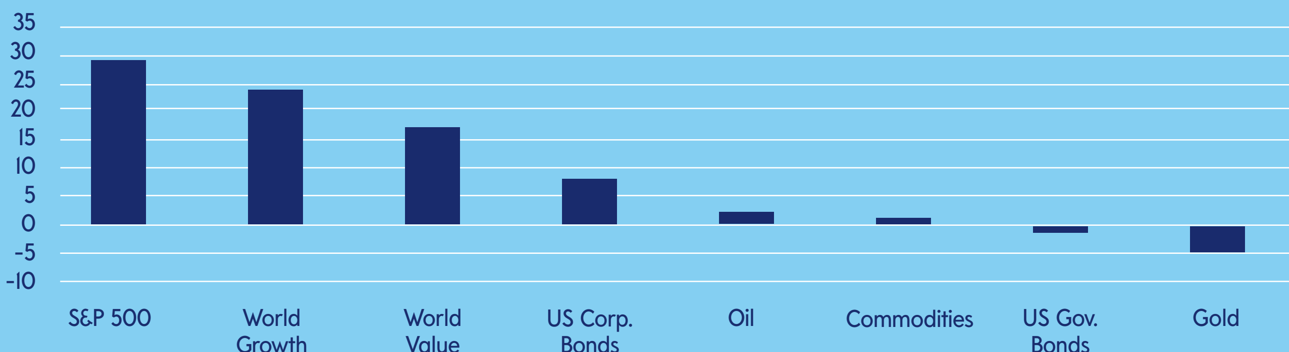
The rapid increase of interest rates and inflation over the past two years is expected to dampen growth, although many economists predict a soft landing for the global economy, with a projected Gross Domestic Product (GDP) growth rate of 2.6% - down from 2.9% in 2023 - but still far from recession territory. Such an outcome would be a rare policy win, as central banks have seldom brought inflation down without creating a recession; there is one recent precedent: in 1994, the US Federal Reserve (Fed) started a rate-rising cycle, as the economy started to expand on the back of a low-rate period, but the moves did not trigger a recession. Instead, the US experienced a period of rapid growth and low unemployment. Partially due to a globalising economy and the new Internet technology, the second half of the 1990s left us very strong Growth-led financial returns, as seen in **Figure 2**.

Figure 2: Both the 1970's (inflation) and 1990's (tech boom) led to market gains

1975 - 1980 Asset Returns % (Average Annual total return, in %)



1995 - 2000 Asset Returns % (Average Annual total return, in %)



Source: Bloomberg, S&P, MSCI, MIFL.

Many economists expect a similar outcome to start unfolding this year, given the parallelisms between the two periods: apart from similar steep rate hikes following a low-rate period, both decades share Technology as the leading growth driver: the Internet in the 1990s and expectations that Artificial Intelligence (AI) will soon do the same.

3. Election-led unexpected outcomes

Politics will take centre stage in 2024, given the number of national elections planned around the world, including Mexico, the UK and India. The November US election will prove crucial, especially if Donald Trump becomes a candidate and pushes ahead expansive fiscal policies in an already high-deficit country. We expect the months-long White House race to bring volatility, which active managers may turn into opportunity.

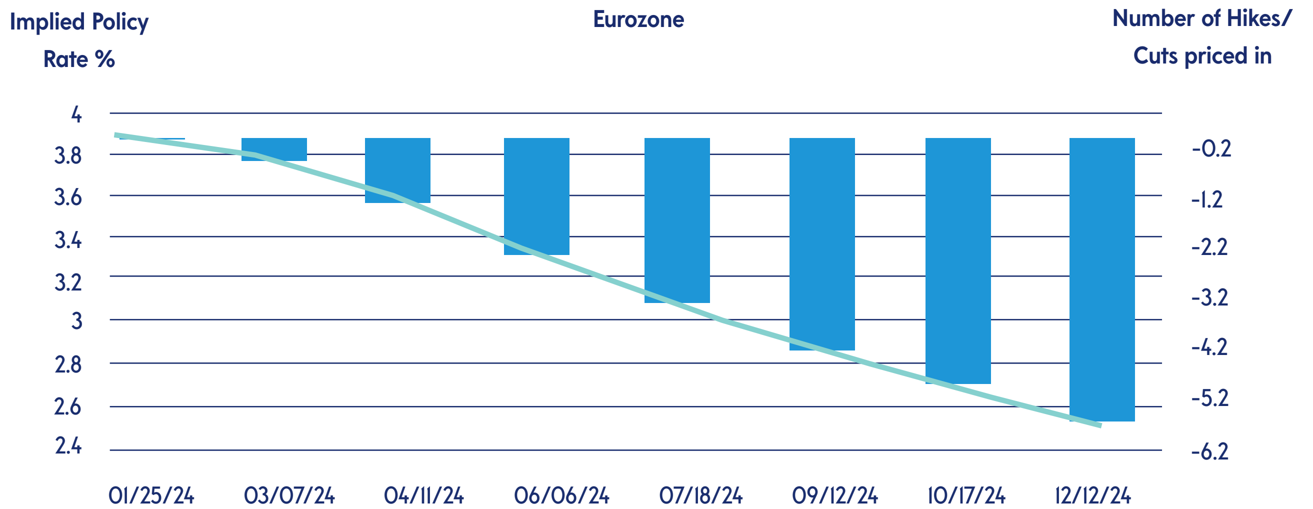
Which scenario should we expect?

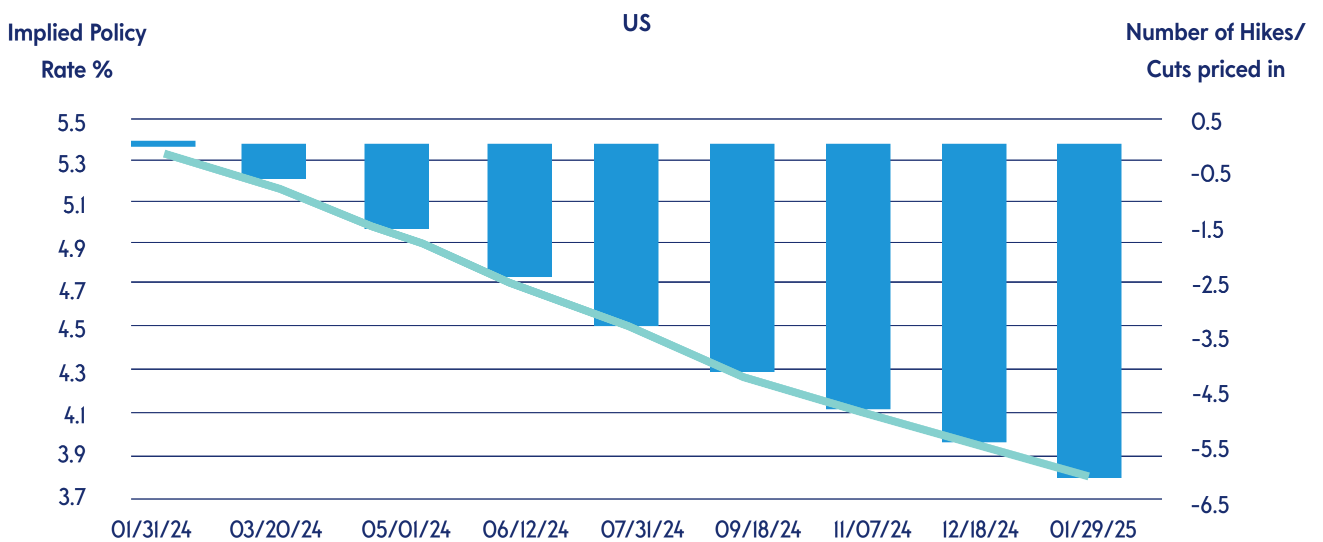
While the "1970s-recession or 1990s-growth" dilemma is still on the cards, and nobody has a crystal ball, most investors and economists agree that 2024 will deliver rate cuts around the world, as seen in **Figure 3**. With global inflation expected to fall further back toward 2% by the middle of the year, central banks should be encouraged to cut interest rates. However, we believe that the market is currently expecting aggressive interest rate cuts and that this may be too optimistic because inflation pressures have not been completely removed. Central banks may therefore be hesitant to cut interest rates too soon.

How will this backdrop impact major asset classes?

In principle, rate cuts are positive for most asset classes, as they tend to push up bond prices and reduce corporate costs, lifting earnings and hence, equity prices. Still, many more factors are expected to drive financial markets in 2024. We highlight the following:

Figure 3: Markets expect five rate cuts in Europe and the US - too optimistic?





Source: Bloomberg 9 Jan. 2024

Bonds: Navigating a changing landscape

Partial relief after two years of rising yields

A slowdown in growth and falling inflation in 2024 should alleviate the pressure on bond markets, especially in safer segments, such as developed sovereign bonds. Bond yields may fall back, especially in Europe and the UK, which are already close to or in recession. The US may not follow the same dynamic, given its stronger growth and higher budget deficit (of 6.3% of GDP).

Rate cuts

We expect the European Central Bank (ECB) to cut rates more than the market currently discounts, given the ailing state of the European economy. Germany, Europe's growth engine, is already in recession, hit by rising energy costs and lower demand from China. We believe this creates a favourable backdrop for European sovereign bonds, particularly at the front end of yield curves. Lower short-term rates would imply a broad-based steepening of European curves.

US yield curve moves might be different, given the different macro picture, the uncertainty around the election and the hard lessons learned in the 1970s, when inflation reached double-digits. This combination may make the Fed more reticent to cut rates too quickly.

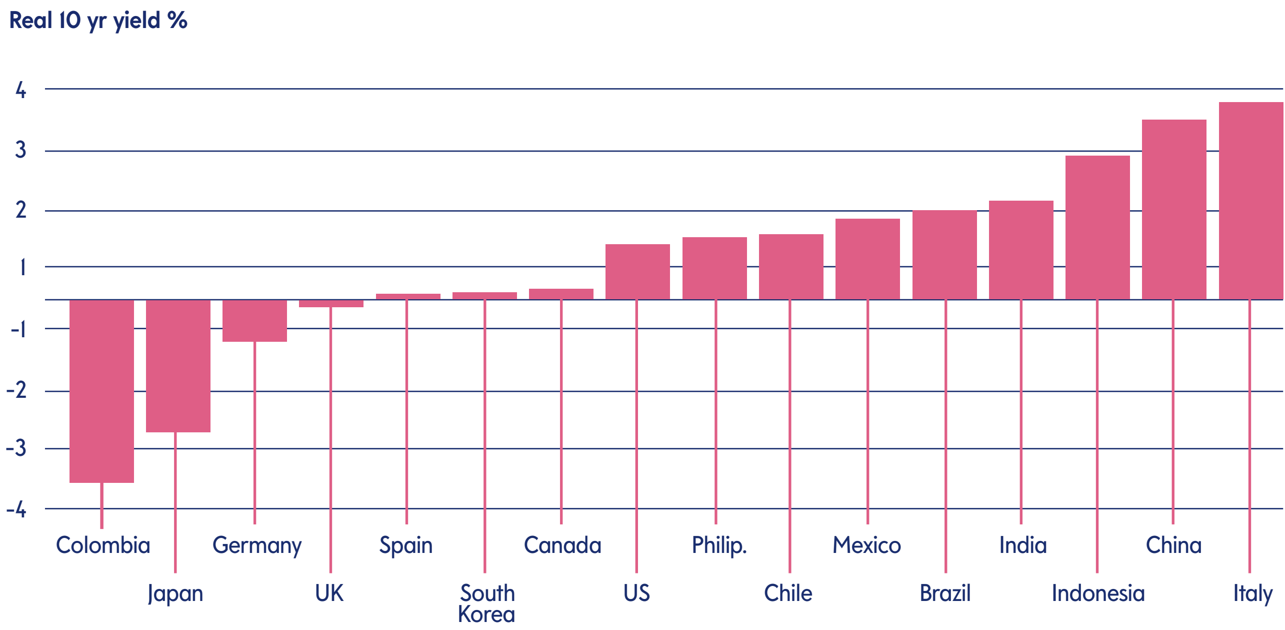
European bonds to outperform the US

Because of the softer macro backdrop, we expect European and UK fixed income assets to outperform their US counterparts. Likewise, countries with weaker economies should see bigger rate cuts. Canada and Sweden, for instance, are both facing housing market concerns.

Emerging Market debt

Some Emerging Markets (EMs) were the most proactive in hiking policy rates in 2022-23, leaving them ready to start cutting now - Brazil and Mexico have already done so. In Asia, however, the weaker outlook for China weighs on the entire region. We are more constructive in Latin America, where energy-producing countries, such as Colombia, Mexico and Brazil, are less vulnerable to oil price spikes. Similarly, we have a positive view of oil-producing Indonesia, which has a moderate budget deficit of 3.7% of GDP and is growing at a strong 5% pace. Overall, and barring a sharp rise in the US dollar this year, EMs might be set up for a strong 2024. As seen in **Figure 4**, the asset class is already delivering higher real yields than most developed markets.

Figure 4: Emerging markets offer higher real yields



Source: Bloomberg 8 Jan. 2024

Defensive on Corporate bonds

The slow-growth backdrop makes us defensive on Credit overall, particularly High Yield (HY), given its lower credit rating. However, a moderate slowdown may not unduly affect the highest quality areas of the market, making us favour the more defensive Utilities and Staples sectors. Despite this cautious HY view, we do not expect a significant default wave, as the so-called funding maturity wall does not hit until 2025. That said, a generalised spread widening is somewhat likely, also given the present tight levels.

Equities: earnings expected to stay strong despite slower growth

Strong earnings forecasts

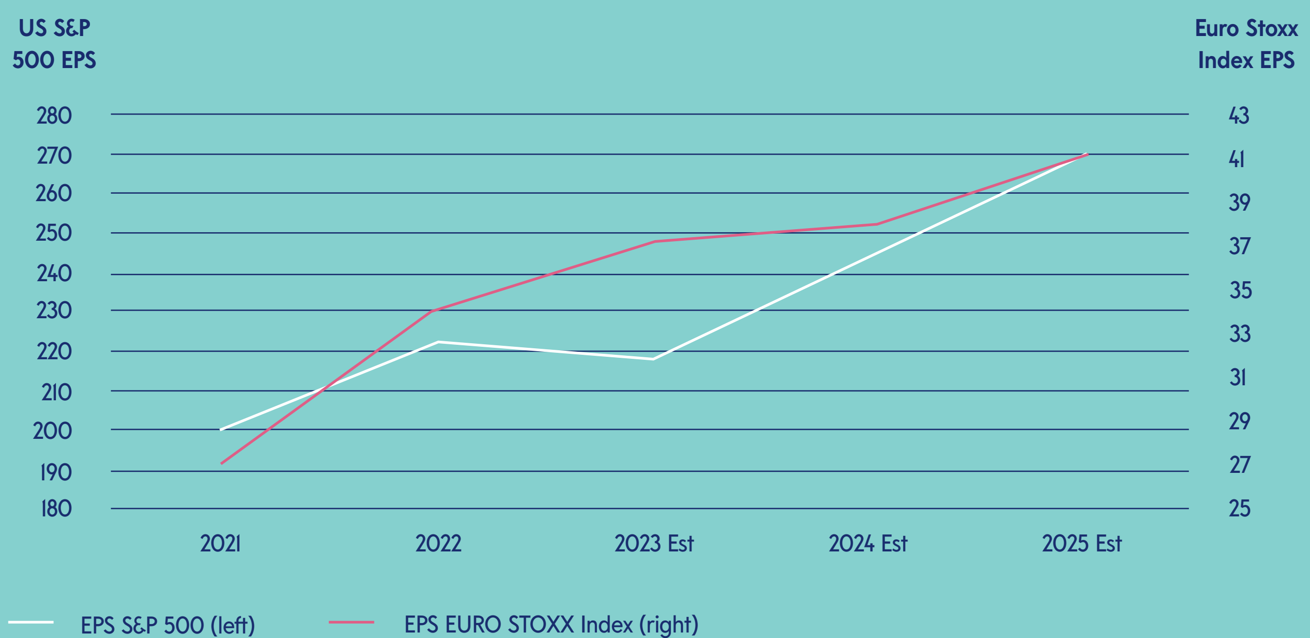
Current Earnings per Share growth estimates are strong, at above 10%, as seen in **Figure 5**. However, given the strong returns in 2023, we expect gains to be harder to come by in 2024. At almost 17 times earnings, global equity valuations are modestly expensive, pushed higher by US Technology stocks, especially those in the AI sector. Outside Technology, a more sanguine outlook is priced in.

The year of active management

Slower growth and higher valuations should limit the Equity rally we saw at the end of last year. However, if a global recession is averted, a further Equity rise may be supported by resilient consumers and by growth sectors such as Technology and Healthcare: we should not underestimate the growth potential of AI and the positive effects of the new obesity drugs on health care costs and consumer habits.

Apart from stock-picking, active equity managers are expected to find opportunities in this election year: as many as 40 countries are voting in 2024, bringing 41% of the world's population and 42% of its gross domestic product to the polls, according to Bloomberg.

Figure 5: Strong earnings forecasts may continue to support Equity markets



Source: Bloomberg 9 Jan. 2024

Tech Fatigue?

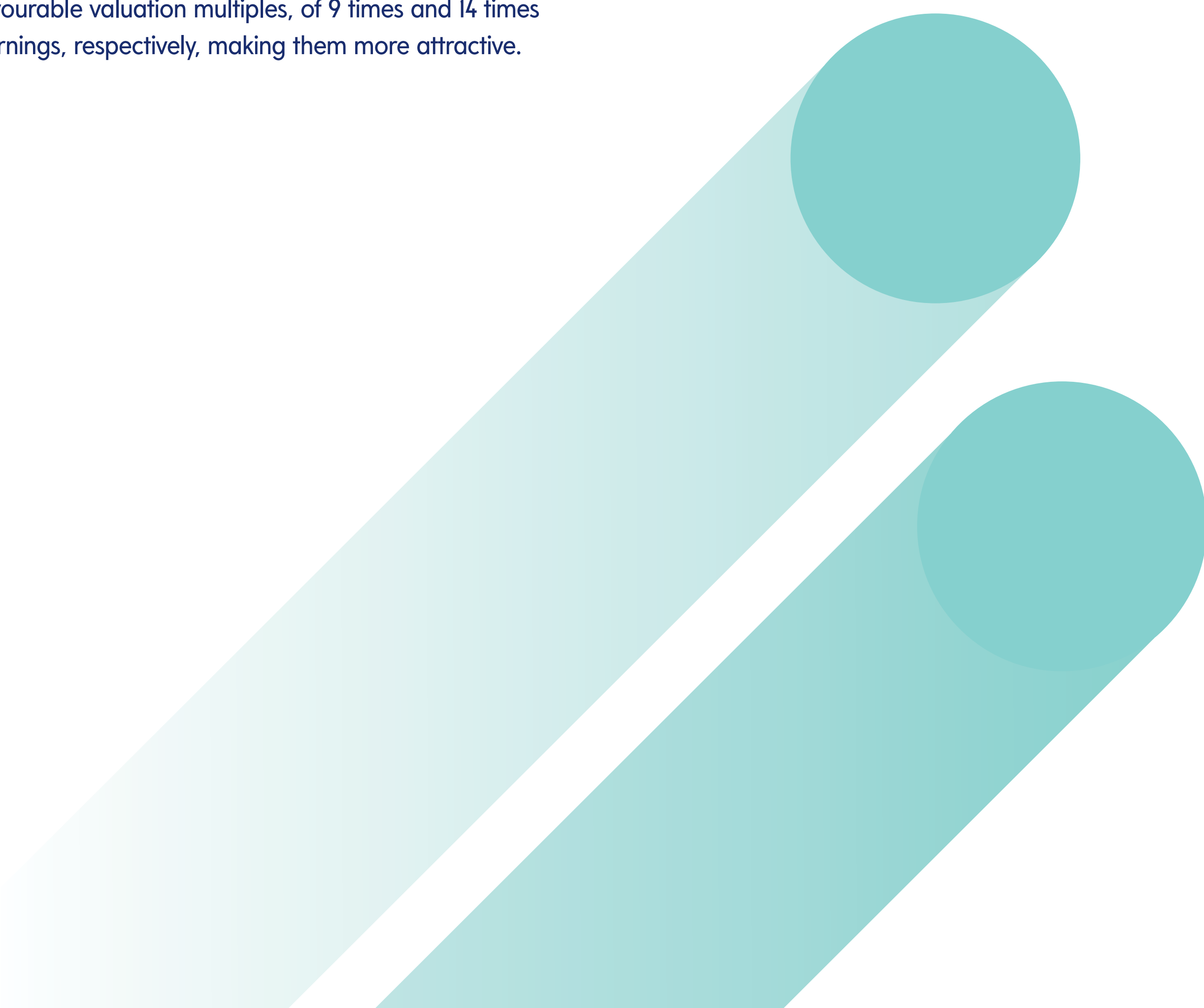
Apart from elections and recessions, the big trade for 2024 may lay on whether investors continue to double down on Technology and AI, or whether they will rotate into less expensive parts of the market. We believe Technology is a secular trend that will play out over many years, although in the short term, it might re-rate should a recession surface in 2024, leading investors to take profits and seek defensive sectors like Healthcare, Pharmaceuticals, Consumer Staples and Utilities.

The China question

The world's second-largest economy could be a catalyst for global equities if it can reboot its struggling economy. This would favour European exporters, including German car-makers, French luxury product businesses and British service providers. Both European and Chinese equities are currently trading at more favourable valuation multiples, of 9 times and 14 times earnings, respectively, making them more attractive.

Quality bias until the growth outlook becomes clearer

From a style perspective, and as we believe we are late in the economic cycle, our preference is for Quality stocks with strong pricing power. If central banks can engineer a soft landing, we would favour non-US equities, Value and Small and Mid-cap stocks that have lagged over this cycle and are trading at historically low relative valuations.



Conclusion

Given the ongoing economic and geopolitical uncertainties, money managers will have to adapt to the changing economic and market conditions. This will be especially crucial in the many countries where a national election this year can significantly change fiscal and trading policies.

Additionally, as we see protracted geopolitical challenges, including two unresolved wars, our main advice to investors is to use the cheapest and most effective risk-reduction tool in financial markets: Diversification. As seen in **Figure 6**, last year's losers often become next year's winners, and vice versa, meaning that a balanced and mixed portfolio of holdings is often the best way to reduce risk and capture potential gains.

Historically, financial markets have been primarily focused on generating income -through dividends in equities and coupons in bonds. For those who favour a back-to-basics, lower-risk approach, there are plenty of so-called 'dividend aristocrats' providing attractive, regular distributions, while fixed income yields are, for the first time in almost two decades, back to the high levels that investors traditionally demand.

This return to normality - if there is such a thing - implies a closure of the inflation-shock story that has shaken financial markets since the COVID-19 pandemic. This is expected to reduce sharp and volatile policy moves, bringing a better alignment between asset prices and their fundamentals - ultimately providing more opportunity for managers and investors.

Figure 6: Asset Class Returns; 2015-2023

2015	2016	2017	2018	2021	2022	2023
"Japan Equity, 10%"	"Oil, 45%"	"EM Equity, 31%"	"Global Agg Bonds, - 1%"	"Oil, 34%"	"UK Equity, 7%"	"Japan Equity, 29%"
"European Equity, 8%"	"UK Equity, 19%"	"US Equity, 21%"	"Gold, - 2%"	"US Equity, 31%"	"Oil, 7%"	"US Equity, 26%"
"60/40, 5%"	"Global HY Bonds, 14%"	"Japan Equity, 20%"	"EM HC Bonds, - 2%"	"Global Equity, 27%"	"Gold, 0%"	"Global Equity, 23%"
"Global Equity, 2%"	"US Equity, 11%"	"Global Equity, 18%"	"Global Corp Bonds, - 3%"	"European Equity, 26%"	"Japan Equity, - 4%"	"European Equity, 16%"
"EM HC Bonds, 1%"	"EM HC Bonds, 10%"	"European Equity, 14%"	"Global HY Bonds, - 4%"	"60/40, 21%"	"Global HY Bonds, - 13%"	"Global HY Bonds, 14%"
"US Equity, 1%"	"EM Equity, 10%"	"Gold, 14%"	"US Equity, - 5%"	"Japan Equity, 18%"	"European Equity, - 13%"	"60/40, 13%"
"UK Equity, - 2%"	"Global Equity, 9%"	"Oil, 12%"	"Global Equity, - 7%"	"Gold, 18%"	"60/40, - 14%"	"Gold, 13%"
"Global HY Bonds, - 3%"	"Gold, 8%"	"UK Equity, 12%"	"60/40, - 8%"	"EM Equity, 18%"	"EM HC Bonds, - 15%"	"EM Equity, 10%"
"Global Agg Bonds, - 3%"	"60/40, 5%"	"60/40, 11%"	"UK Equity, - 9%"	"UK Equity, 16%"	"EM Equity, - 16%"	"Global Corp Bonds, 9%"
"Global Corp Bonds, - 4%"	"Global Corp Bonds, 4%"	"Global HY Bonds, 10%"	"EM Equity, - 10%"	"EM HC Bonds, 13%"	"Global Equity, - 16%"	"EM HC Bonds, 9%"
"EM Equity, - 6%"	"European Equity, 2%"	"Global Corp Bonds, 9%"	"European Equity, - 11%"	"Global HY Bonds, 13%"	"Global Agg Bonds, - 16%"	"UK Equity, 8%"
"Gold, - 10%"	"Global Agg Bonds, 2%"	"EM HC Bonds, 8%"	"Japan Equity, - 15%"	"Global Corp Bonds, 11%"	"Global Corp Bonds, - 17%"	"Global Agg Bonds, 6%"
"Oil, - 30%"	"Japan Equity, - 1%"	"Global Agg Bonds, 7%"	"Oil, - 25%"	"Global Agg Bonds, 7%"	"US Equity, - 20%"	"Oil, - 11%"

Source: MIFL, Bloomberg 2023

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