

January 2024 Investment Views

Strategy:

A Year of Positive Surprises

Fixed Income:

A Tale of Two Pivots

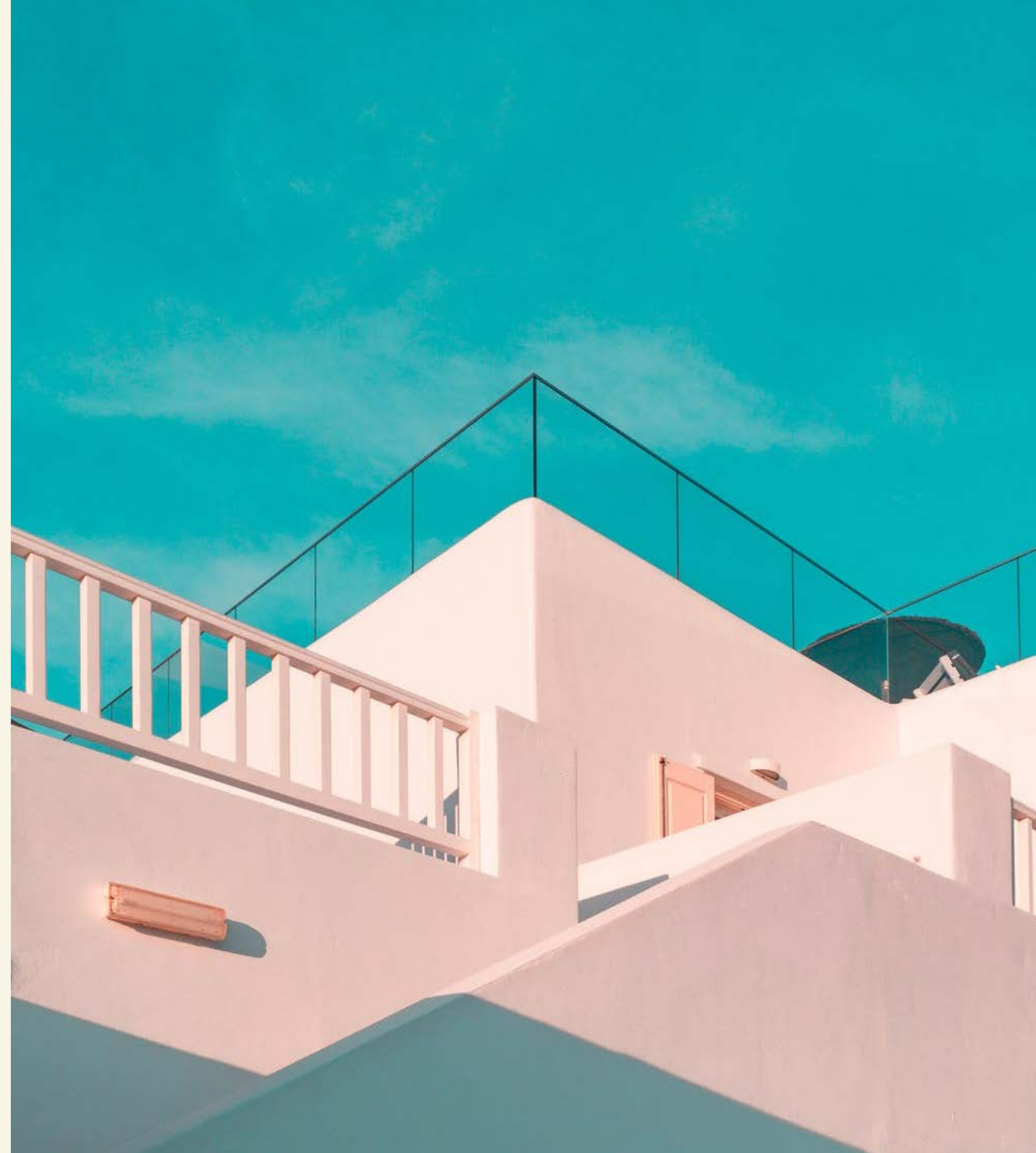
Equities:

Another Positive Quarter

A Year of Positive Surprises

- Markets welcome better inflation news
- Artificial Intelligence (AI) is advancing rapidly
- China's economic outlook remains challenging

The fourth quarter was a strong one for both bond and equity markets, rounding off an impressive year of returns. The MSCI World index returned 23.8% for the year in US dollar terms, with US equity markets leading the way returning 26.5%. After a challenging summer for bond markets, yields fell substantially (prices increased) in the last two months of the year. This recovery helped bonds avoid a third year of losses and returns ended up in mid-single digits for the full year.



Four main themes shaped last year; the resilience of many economies to higher interest rates, Artificial Intelligence (AI), falling inflation and the underwhelming re-opening of China's economy.

The year began with a lot of pessimism around the impact of inflation and higher interest rates on growth. These worries were amplified in the first quarter when there were stresses in the US regional bank sector. However, a very rapid and forceful response from the Federal Reserve alleviated concerns and the focus quickly turned to the topic of AI.

AI has existed in various forms for decades, but generative AI (technology that can produce various types of content, including text, imagery, audio and synthetic data) was thrust into the spotlight due to the success of OpenAI's hugely popular ChatGPT product. The speed with which ChatGPT became mainstream is quite remarkable.

There is some uncertainty, but the potential of AI is quite striking. Goldman Sachs estimates that broad improvements in workforce efficiency could add almost 1.5% to US labour productivity. As with any new technology, a key question in an investment context is how can it be applied and monetised in the real world. It is still early days, but semiconductor firms and data centres are already benefiting on the hardware side, while established businesses such as Microsoft and Adobe have embedded AI in their software. Companies across a wide array of industries have been exploring the new technology and it has been a recurrent theme on earnings calls in recent quarters.

Technological advances help to lower inflation over the long-term, but the more recent fall in global inflation has come from energy, food and goods prices. Inflation was widely expected to fall last year, and markets have taken comfort from recent readings coming in below expectations. Inflation for services has been more stubborn than for goods, as wages are a bigger component of the cost for service companies. However, a better balance between vacancies

1.5%

The percentage Goldman Sachs estimates that improvements in workforce efficiency could add to US labour productivity.

Inflation was widely expected to fall last year, and markets have taken comfort from recent readings coming in below expectations.



2%

The Federal Reserve core PCE (Personal Consumption Expenditures) target.

STRATEGY

and job seekers is helping to constrain wage growth. Over the last six months, core PCE (Personal Consumption Expenditures), the specific inflation rate that the Federal Reserve targets, has been running at an annualised pace below the 2% target. Lower inflation has been very helpful for both bonds and equities and explains much of the strong performance in the fourth quarter.

China's recovery from the pandemic has been underwhelming and Chinese equities lagged again in the fourth quarter. The property market continues to work through difficult debt issues, which has dampened consumer confidence. Business and investor confidence have also been hit by regulatory crackdowns, particularly in Technology, which is a significant weighting in the stock market. There are signs that economic growth is once again being prioritised by policymakers, but geopolitical risk will continue to hang over foreign direct investment and Chinese financial markets for the foreseeable future.

Investor sentiment coming into 2023 was cautious given elevated recession risk against a backdrop of elevated inflation and higher interest rates. As 2023 unfolded, we saw a number of influential Wall Street banks remove their forecast for a US recession. While the consensus expectation was only for a very mild recession, this was a symbolic shift. A combination of good news on both inflation and growth has been very powerful for markets, but inflation risks remain and the market has moved quickly to price in a lot of good news.

In the fourth quarter, we trimmed our equity allocation a little to reflect the risk that markets are pricing in more interest rates cuts than the data warrants. The good news is that bond yields remain more attractive than they have been for the decade prior to the pandemic and wide dispersion in equities creates opportunities at the industry/company level. Furthermore, Alternative Assets such as commodities and gold continue to provide attractive diversification benefits in this era of heightened geopolitical risk.

A Tale of Two Pivots

- Global bond markets experienced volatility in both directions
- The US Treasury and the Federal Reserve helped to ease financial conditions
- Geopolitical events failed to ignite energy prices as the US ramps up supply

The final quarter of 2023 proved to be volatile, with the weakness in global bond markets extending to the end of October when the US 10-year nominal Treasury yield reached a high of 4.99%. This sell-off was finally halted by action from the US Treasury. Treasury Secretary Janet Yellen amended the supply mix of US debt issuance, reducing longer maturity debt sales and increasing issuance of US Treasury bills. This “pivot” provided a reason for short-sellers to take gains on bearish bets, and an opportunity for investors with an appetite for ultra-safe yield to add to fixed income at real yields (adjusted for inflation) not seen since 2008.



FIXED INCOME

Risk assets wasted no time in rallying, with credit spreads (the premium that corporate borrowers pay to borrow) tightening. US high yield spreads tightened by 70bps (basis points), mirroring the price action in equity markets. The US dollar also weakened and inflation expectations fell as global energy prices continued to slide. The price of WTI oil fell 21% to \$72 a barrel in the fourth quarter, despite tension in the Middle East, supply cuts from OPEC, and winter approaching. US energy production, which now totals 13.3m barrels per day, its highest level ever, has not only given the US energy market independence (reducing the need for the strategic petroleum reserve), but given its European allies a degree of stability.

The month of November alone saw one of the fastest easing in financial conditions in history, surpassing the immediate aftermath of the Lehman Brothers crisis in 2008 and the pandemic in 2020. With this backdrop, expectations were for the Federal Reserve to maintain a moderately hawkish bias at the final policy meeting of 2023, especially considering that US inflation was elevated on a number of metrics. However, this did not happen and policymakers effectively endorsed recent moves in markets and, in doing so, signalled the end of the tightening cycle.

This pivot caught the market by surprise. The previous “dot plot” (policymakers’ estimates for interest rates) released at the September meeting showed expectations of around 50bps of cuts in 2024. Although recent data has been mixed, the economy is far from a recession. Unemployment remains below 4% and the easing of financial conditions have provided 60bps of indirect base rate cuts. As a result, the market has now gone one step further and fully priced in 150bps of cuts during 2024, which fuelled further gains in risk assets during the final weeks of the year.

13.3m

The number of barrels of oil per day US energy is producing, its highest level ever.

21%

The percentage WTI oil fell, to \$72 a barrel in the fourth quarter.

INVESTMENT VIEWS

With global supply chains re-tightening as container traffic is redirected around the Cape of Good Hope, rental inflation reaccelerating, and US services inflation still close to 4%, there is a risk that the Federal Reserve has declared victory on inflation too early. However, due to weaker trends in the US employment market in more recent months, the Federal Reserve is taking a calculated risk by showing a willingness to pivot before inflation has been sustainably brought back to target. With a US election due in 2024, policymakers may be pivoting early in an attempt to avoid the accusation of trying to influence the result (by moving rates in the run up to the election), although this would be a risk for them in terms of hard-won credibility on inflation.

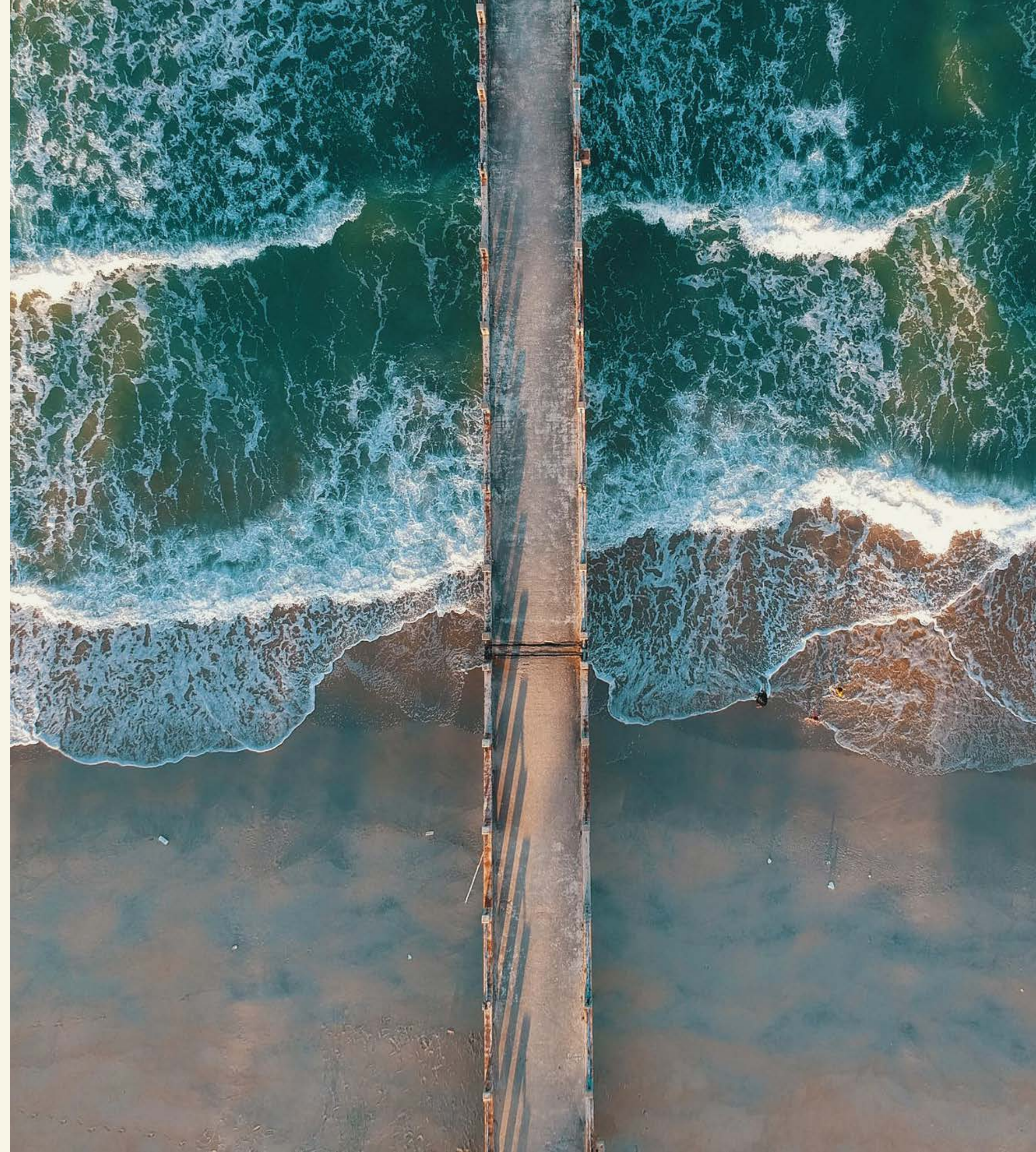
In addition to the duel pivots from the US Treasury and the Federal Reserve, US dollar global liquidity has expanded, helped by China and Japan. There has also been further liquidity easing as excess funds exit the Fed’s reverse repo facility. This helps the US Treasury fund itself via the increased US Treasury bill supply and enables the US banking system to hold onto excess reserves, which in turn can be extended as credit. With US\$700bn remaining in this facility, we have many months before this source of liquidity is exhausted.

Looking forward, given the rapid moves in bond markets, we are not inclined to add to duration exposure at these levels. Short-dated bonds can now only generate further capital gains if central banks reduce base rates in 2024 by more than the average 150bps that is priced into the Euro and US dollar curves. This is possible, but only likely in the event that a recession is realised. This outcome is not our base case at this time, so there may be a degree of weakness in fixed income markets in coming months. With the yield curve still inverted (short-dated bond yields are higher than long-dated bond yields) positive carry/income can be generated in cash or near cash instruments.

Another Positive Quarter

- Equities defy cautious expectations
- Technology is still in the driving seat
- Emerging Markets continue to lag

The fourth quarter was a strong period for equities as a 4.9% return in December followed an early “Santa rally” when the MSCI World Index gained 9.4% in November in US dollar terms. This brought the full year return to a very strong 24%, well ahead of Wall Street estimates made at the start of the year which were a muted 5%. Since 2000, the MSCI World Index has gained more than 20% per annum eight times, with the gains ranging from 20-33%. This occurred three times between 2000-2010 and then another three





54%

Information Technology (IT) returns dominated the year.

27%

The US focus on technology drove market returns.

EQUITIES

times between 2010-2020. So far it has occurred twice since 2020. This highlights the importance of owning equities through the cycle and is a reminder of how difficult it is to try to predict short-term market movements.

Information Technology (IT) dominated the year, with the sector returning 54% and the Communication Services sector, which includes names such as Alphabet (Google) and Meta (Facebook), returning 46%. Defensive sectors lagged significantly with Consumer Staples, Healthcare, and Utilities returning 3%, 4%, and 1% respectively. With long-term structural tailwinds in place and having underperformed during the year, the Healthcare sector appears to be attractively priced and well positioned for 2024. Another segment which underperformed and has similar long-term structural tailwinds are stocks linked to the energy transition.

Developed markets were the place to be last year, with the US focus on technology driving returns. The US market gained 27%, with Europe (ex the UK) also performing strongly and closing with a 22% return. Japan, which has become a more attractive investment proposition this year and which we are overweight, performed well and gained 20%. Other countries in the area however did not perform as well, with Asia Pacific (ex Japan) returning only 6% and Emerging Markets 10%. China underperformed meaningfully, with the Hang Seng Index down 5% and the Shanghai index down 9%, as increased regulation and a challenging property market overshadowed a reopening economy.

2023 has been a story about the “Magnificent Seven” versus the rest of the market. These seven stocks (Microsoft, Apple, Nvidia, Meta, Alphabet, Amazon and Tesla) have been responsible for the bulk of equity returns this year. This played out in the first half of the year, as a market capitalisation weighted index of these seven stocks outperformed the MSCI World Index by 38% in the first

EQUITIES

quarter and by 23% in the second quarter. This was driven partly by AI's "Big Bang" moment, but also by a flight to safety after the regional banking crisis. Most of these companies have healthy margins, large cash piles, generate significant cash flow and, maybe more importantly, have above average growth rates and are seen to be more resilient to a slowdown in the economy.

Looking forward, it appears that equity returns are being driven by what is taking place in the bond markets. With the Federal Reserve signalling three interest rate cuts and the markets pricing in six interest rate cuts for 2024, the question is how will equities perform if these interest rate cuts do not materialise. At the moment, expected lower real yields are supporting higher than average equity valuations. In 2023 we saw valuation multiples expand meaningfully. With unemployment low, excess savings still historically high, and company balance sheets healthy, the question is whether the Federal Reserve will be in a position to cut rates, or whether 2024 will see interest rates stay higher for longer. Equity markets have priced in a lot of good news, but in this exceptional post-pandemic cycle where technology is moving quickly and government policy has again become a more important factor for markets, there is plenty of support for a number of attractive underlying themes within equity markets.








23%

The amount the "Magnificent Seven" outperformed the MSCI World Index in the second quarter of 2023.

At the moment, expected lower real yields are supporting higher than average equity valuations.

Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	<div>EQUITIES (MODEST UNDERWEIGHT)\$</div>	<div>CASH (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)</div>
Fixed Income		<div>EMERGING MARKET DEBT INFLATION PROTECTION</div>
Equities Regional		<div>JAPAN EMERGING MARKETS</div>
Equities Sector	<div>CONSUMER DISCRETIONARY + UTILITIES</div>	<div>CONSUMER STAPLES HEALTHCARE</div>

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