2024 INVESTMENT OUTLOOK

JANUARY 2024

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

EXECUTIVE SUMMARY

We outline our core views on the global economy, geopolitics and financial markets below, examining each in this year's Investment Outlook.

Entrenched disinflation: The trend of falling inflation will become entrenched in 2024, with CPI inflation falling close to target in most developed markets by the end of the year. This will provide support to real income and spending growth in the near term, whilst offering space for lower interest rates, as central banks gradually recalibrate policy from their current restrictive stance.

US economic moderation: Having rejected the consensus expectation for recession in 2023, we expect the US economy to moderate in 2024, with growth slowing from the current six month run-rate of 3.5% per annum. This is primarily because of lagged headwinds from higher rates, cooling demand for labour, and the exhausted fiscal boost from 2020-21, all weighing on consumer activity. However, a recession, defined as 'broad based economic weakening', remains unlikely in our view, with real income growth providing crucial support. If it does happen, it will likely be mild and short-lived in comparison to history, considering the lack of structural imbalances.

Delicate European recovery: Economies in Europe (including the UK) have stagnated for most of the past two years, as painful inflation has combined with little economic growth. The good news is that most of the economic pressure has passed, and entrenched disinflation will provide a much-needed tailwind to consumer spending. However, headwinds from China's growth slowdown and restrictive fiscal policy will weigh on growth momentum.

China's structural slowdown: We urged caution towards China and broad emerging markets last year, despite post zero-covid enthusiasm, and remain sceptical that the world's second largest economy will re-emerge as a growth powerhouse anytime soon. China's economic challenges require many years of deleveraging and rebalancing, a path the authorities are willing to follow. Whilst we see evidence of stabilisation, a catalyst for resurgent growth momentum remains elusive.

Equities – staying constructive: Equity markets have closed the year on the front foot, with participation broadening beyond the dominance of the 'Magnificent 7[1]' technology giants. For globally diversified investors, this represents a welcome development following market declines in 2022 and a concentrated recovery for most of 2023. Central to our multi asset process is a focus on the potential real equity return over a full market cycle, which continues to support equity allocation.

Fixed Income – the return of diversification: With entrenched disinflation the expected macro backdrop, and recession risks not to be dismissed, the risk reward for core government bond investment is favourable. Our allocation has incrementally increased from near zero in 2021, and now offers both real return and key diversification properties for multi asset portfolios. Credit offers competitive all-in yields and remains a core allocation in fixed income portfolios, with a bias to investment grade.

Alternatives – an attractive blend of non-core asset classes: Having registered double digit gains last year, the outlook for insurance linked bonds remains particularly enticing with high underlying yields. Long / short equity and physical gold offer additional volatility anchors, delivering valuable returns this year. With the risk of market dislocation ever-present, we retain conviction in these uncorrelated alternative assets for 2024.

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[1] The Magnificent 7 are Apple, Amazon, Alphabet, Meta, Microsoft, Tesla and Nvidia.

INTRODUCTION

The global economy outperformed expectations in 2023, driven by resilient consumer spending and employment growth. This has been most evident in the US, where activity reaccelerated in the second and third quarters of the year, despite the regional banking crisis in March. Inflation has fallen sharply without the economic pain that was considered by many economists to be essential. Europe and the UK, whilst suffering a more acute cost of living squeeze, have also avoided the deep recession that was widely forecast last winter.

Despite being concentrated in a small number of stocks known as the 'Magnificent 7' for most of the year, equity markets have also surprised positively. Earnings expectations have stabilised, following an adjustment to higher interest rates in 2022, and in most cases, valuations have risen on economic optimism. High growth themes, for example AI-centric US technology and obesity drug producing pharmaceuticals, have gained significant attention amongst investors, propelling their stock prices higher. Following a softer spell over the summer, momentum has recovered during the fourth quarter, returning the S&P 500 to its all-time high from the end of 2021.

Bond markets have also turned a corner in recent weeks, following a peak to trough drawdown of c. 19% from July 2020 to October 2023. Rate hiking cycles are likely over, with falling inflation prompting investors to bet on rate cuts in 2024. The US 10 year Treasury yield has fallen from c. 5% in mid-October to 3.8% at year end, boosting returns for investors (chart 1[2]).

Chart 1: A buoyant end to 2023 for stocks and bonds

Yet the world is in a fragile state. The once buoyant China is struggling to transition to a structurally lower growth consumer led economy, suffering deflation, real estate deleveraging and high household savings. After an impressive display of economic resilience, the US economy faces a tougher task in the coming quarters, as the fiscal boost from 2020-21 evaporates and the lagged impact of monetary tightening catches up. Conflicting geopolitical priorities between major economic powers, notably China, Russia and the US, look set to collide with potential political change in 2024, representing a source of market and economic volatility.

Our focus is to balance these developments, challenges, opportunities and risks in a robust multi asset investment strategy, guided by centralised principles and processes. We outline our core views for 2024 on the global economy, geopolitics and financial markets below.

[2] *Source: Bloomberg, USD, Dec 2023. MSCI AC World Index represents global equities and Bloomberg Global Aggregate Float Adjusted USD Hedged, Index represents global bonds.*

Section 1. Assessing the Global Economy

1.1 Entrenched Disinflation

The trend of falling inflation will become entrenched in 2024, with CPI inflation falling close to target in most developed markets by the end of the year. This will provide support to real income and spending growth whilst offering space for lower interest rates, as central banks gradually recalibrate policy from their current restrictive stance.

> A disinflationary outlook has underpinned our investment strategy since mid-2022, providing the basis for continued engagement in equities and increasing allocation to government bonds.

The primary rationale for this view was that pandemic era imbalances that ignited inflation in 2021, namely an undersupplied labour market (chart 2[3]), excessive spending on goods relative to services (chart 3[4]), and supply chain bottlenecks (chart 4[5]), would dissipate. We see clear evidence of this view having played out today. In addition, the energy and commodities inflation shock in 2022 was also temporary in nature (chart 5[5]), driven by the Russia-Ukraine war. We illustrate these dynamics in the below charts:

Chart 2: The US labour market is rebalancing

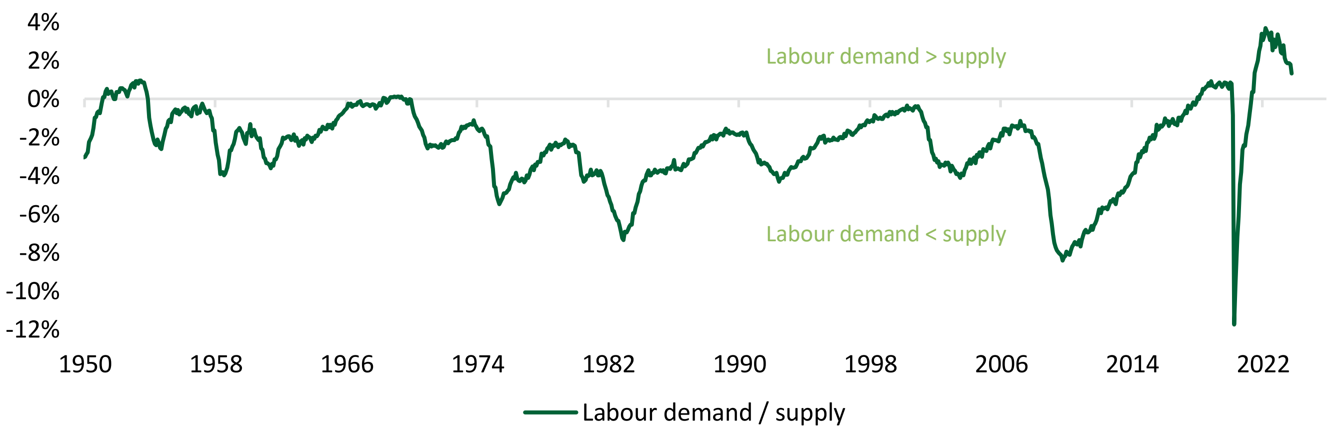


Chart 3: Goods spending dominance is over

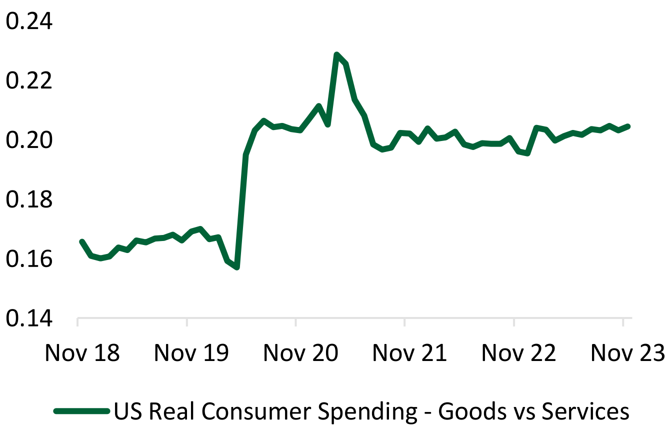
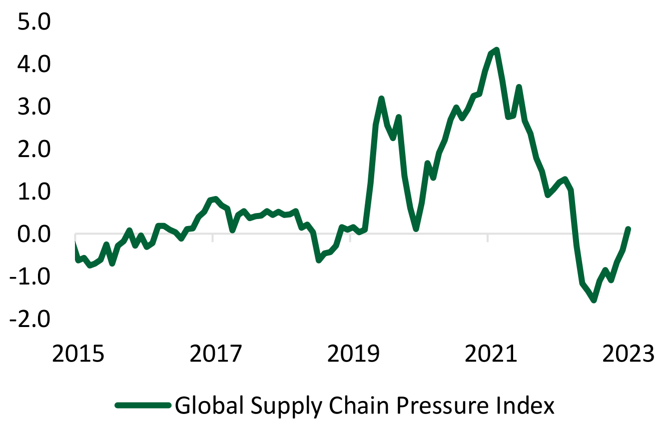


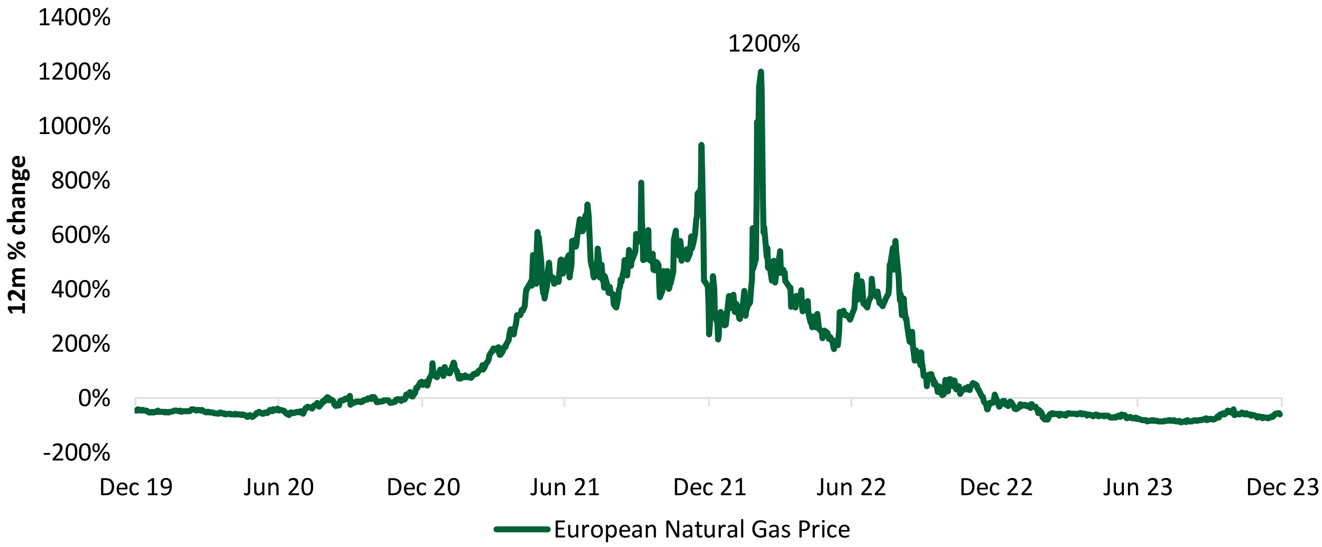
Chart 4: Supply chain pressures have normalised



[3] *Source: BCA Global Research, Dec 2023. Labour demand / supply is the difference between labour demand and labour supply, as percentage of labour supply.*

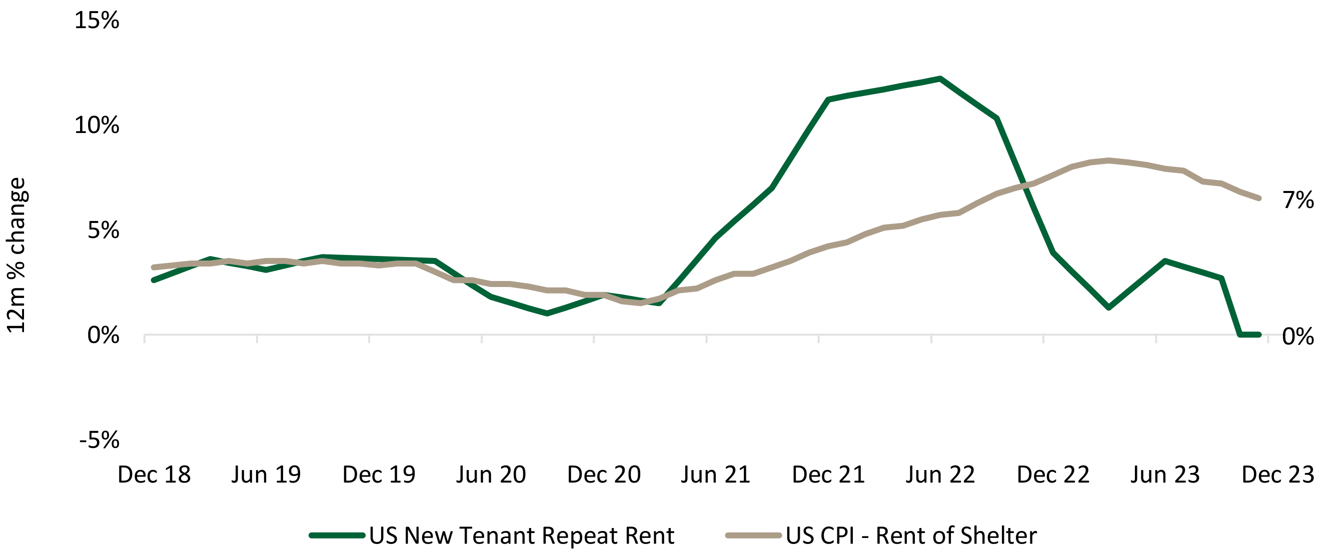
[4] *Source: Bloomberg, Dec 2023.*

Chart 5: Energy is detracting from inflation



Rent was also a major driver of inflation in recent years, driven by the post covid money supply surge and associated mini housing boom. In the US, rent constitutes c. 35% of headline CPI inflation, measuring both current underlying rent dynamics and adjustments to existing lease agreements over time. This makes the official data slow to reflect real-time market dynamics. A useful guide is to focus only on how rents are changing for new tenants (chart 6[5]). It is clear from this measure that the trajectory is for lower rent inflation, consistent with historical averages by the end of the year.

Chart 6: Rent inflation will soon catch up with reality



Inflation is notoriously backward looking, which means we need to consider what is driving inflation and where those variables are heading. In the absence of a major shock that reignites inflation expectations, the drivers of lower inflation are well entrenched for 2024.

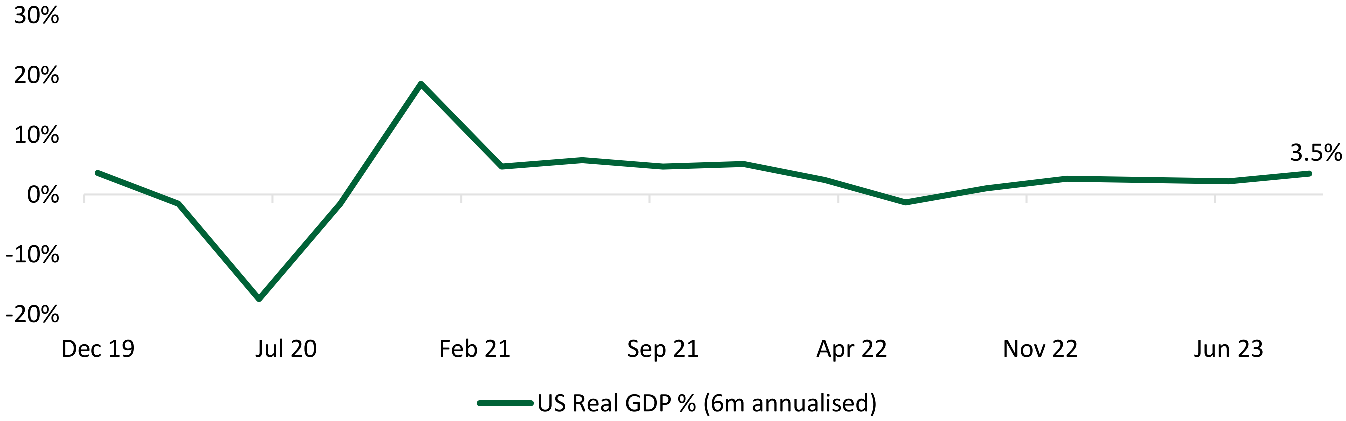
[5] *Source: Bloomberg, Dec 2023.*

1.2 US Growth Moderation

The resilience of the US economy in 2023 was largely attributed to robust consumer spending. Underestimated American consumerism proved vital, steering the economy through challenges such as a regional banking crisis and the sharpest rise in interest rates since the 1970s. Savings accumulated during the pandemic and a strong labour market further contributed to this resilience.

Having rejected the consensus expectation for recession in 2023, we expect the US economy to moderate in 2024, with growth slowing from the current six month run-rate of 3.5% per annum[6] (chart 7).

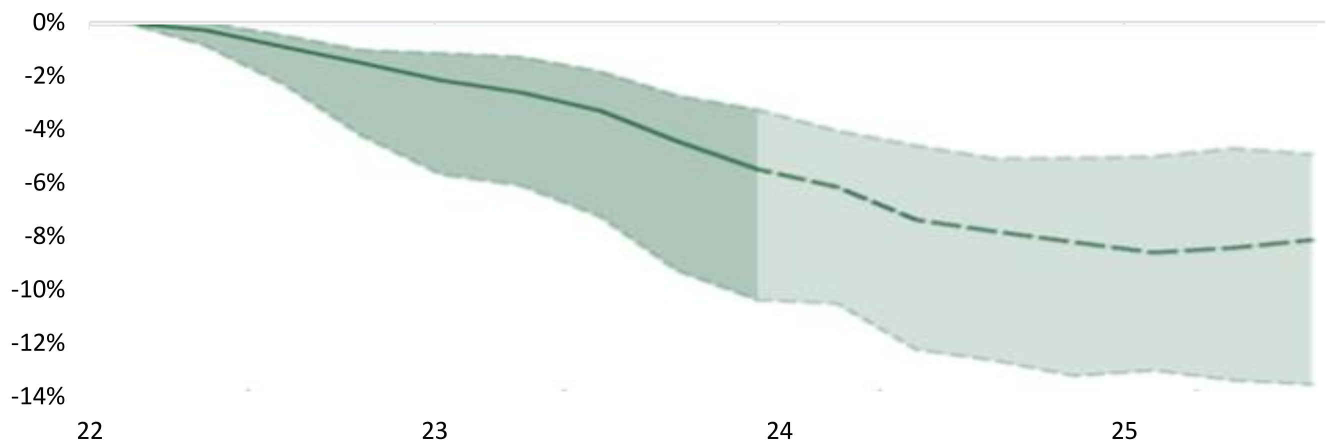
Chart 7: US GDP growth has been impressive



Importantly, higher interest rates take time to slow economic growth. As the Chicago Federal Reserve recently argued, *"the policy tightening that has already been implemented will exert further restraint in the quarters ahead, amounting to downward pressure of about 3 percentage points on the level of real gross domestic product (GDP)"* (chart 8). Whilst the consumer has been insulated from higher rates by pandemic era excess savings, most estimates suggest that they will be exhausted in 2024.

In addition, the tightening in bank lending standards that followed the regional banking crisis in March is weighing on business lending, and likely to lead to outright credit contraction this year. This typically coincides with broader economic weakness.

Chart 8: Cumulative impact on US Real GDP level from first rate hike [7]



[6] *Source: Bloomberg, September 2023.*
[7] *Source: BCA Research, Federal Reserve Bank of Chicago, September 2023.*

These factors might be enough to push the US economy into recession. We assign a 30% probability of that outcome over the next 12 months. However there remains good reason to expect a more moderate 'soft landing' with real GDP growth staying comfortably above zero for the year as a whole.

> The most important of these is the boost to real incomes that will flow from falling inflation. This 'cost of living tailwind' will provide crucial support to spending as the cycle matures, preventing a rise in precautionary saving that often precedes periods of recession.

Central banks are also unlikely to retain restrictive policy if inflation declines and growth moderates in the first half of the year, as we expect. Whilst interest rates have risen sharply, higher inflation has kept *real* rates (interest rate minus inflation rate) relatively manageable so far. However, as inflation continues its downward trajectory, real rates will continue to rise if central banks do not act.

Indeed, the Federal Reserve's guidance to the market has already pivoted to a more accommodative tone, with Chair Jerome Powell noting that they are "very much focused" on the risk of keeping rates too high for too long in December. Furthermore, the imbalances that deepened prior recessions, particularly in 2008-09, are not replicated today. Aggregate households and corporations deleveraged during the prior cycle, and extended the duration of their debt profile at historically low interest rates, reducing the risk of a painful debt refinancing cycle.

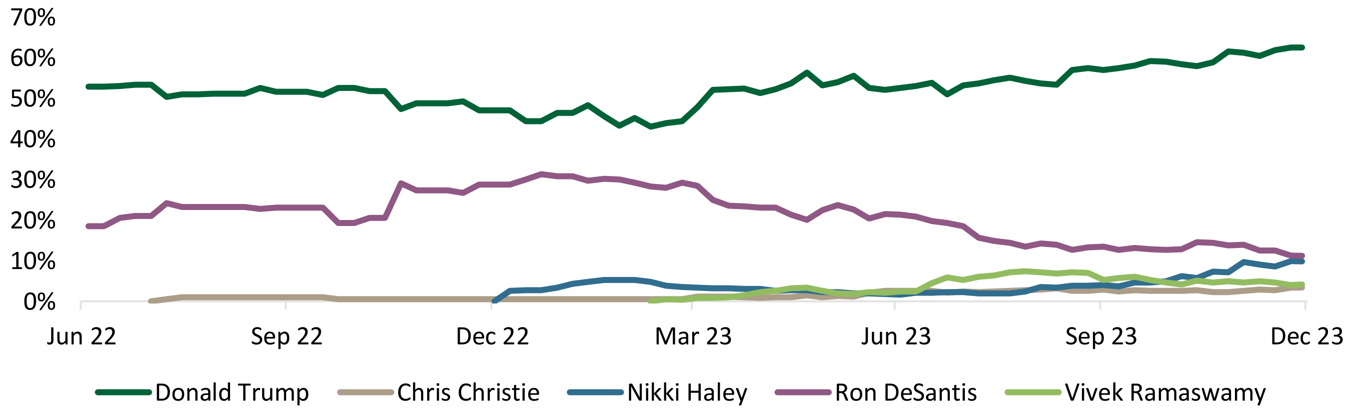
> The US economic cycle is maturing; concerns about rising inflation are giving way to slowing growth, which will justify a recalibration of interest rates to a less restrictive setting. We expect recent above-trend growth to slow, but calls for a deep contraction in activity remain wide of the mark.

1.3 Election Cycle Collides with Geopolitical Risk

The US Presidential election in 2024 represents a source of volatility against a backdrop of ongoing geopolitical tensions, particularly with China, Russia and in the Middle East. Whilst it is always the case that the outcome cannot be predicted, particularly 11 months in advance, the combination of global instability and domestic polarisation makes this year's election particularly uncertain and relevant for investors.

Much will depend on the state of the US economy in the second half of the year. If recession is avoided, and consumers are feeling the benefit of rising real incomes, the Democrats will benefit from a high probability of incumbent re-election. However, an economic softening by November 2024 is not far-fetched, as we describe above. This will embolden the Republican nominee, who at this juncture looks likely to be former President Trump (chart 9[8]).

Chart 9: Republican Nominee polls suggest a Trump vs Biden rematch



[8] *Source: Bloomberg, RealClearPolitics, Republican Nominee 2024 Polls December 2023.*

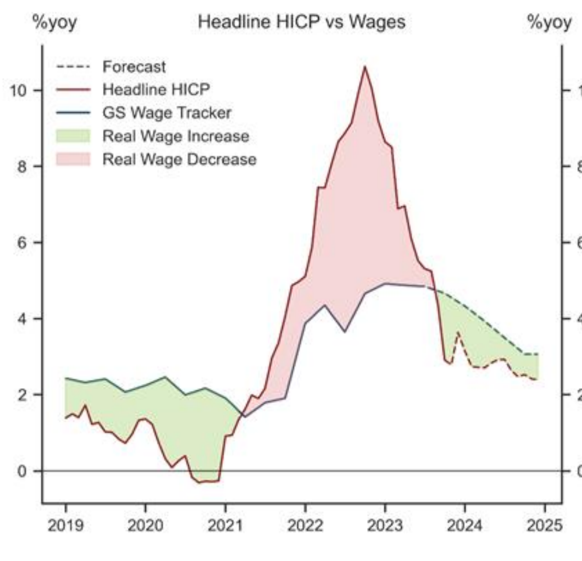
The implications of this contest are substantial. Importantly, the question of whether US foreign policymaking will be predominantly unilateral or multilateral in 2025-2029, with US commitment to NATO at stake, means that geopolitical tensions will remain high. With an incentive to undermine the likelihood of a Biden re-election, Russia may attempt to apply pressure through the energy market or escalation in Ukraine. The risk of miscalculation in the Middle East and with China is also high, with domestic polarisation in the US potentially being seized upon.

The trend of global instability is unlikely to reverse in 2024, with the US heading towards a highly polarised rematch between Presidents Biden and Trump. This means the risk of geopolitical escalation is uncomfortably high, demanding an investment strategy which embeds multiple diversifying assets and adopts a flexible approach.

1.4 Delicate European Recovery

Economies in Europe (including the UK) have stagnated for most of the past two years, as painful inflation has combined with little economic growth. The good news is that most of the economic pressure has passed, and entrenched disinflation will provide a much-needed tailwind to consumer spending. In a similar pattern to the US economy, the balance between wage growth and inflation is turning favourably for consumers (chart 10[9]). Despite caution in signalling victory too soon, the ECB and Bank of England will lean towards rate cuts before long. The manufacturing sector, which has been locked in a downturn for approximately 2 years, also seems to be stabilising, as evidenced by key leading indicators. This will provide support to the languishing German economy in particular.

Chart 10: Real wage growth will support European economies



However, these positive developments are likely to be offset by cooling labour markets and the combination of restrictive fiscal and monetary policy. The UK, for example, will continue to absorb a mortgage refinancing headwind at higher rates on average than in 2023. In addition, the fiscal consolidation will intensify in 2024, acting as a headwind of c. 1.6% of GDP in the coming year[10]. Despite an upcoming general election that could motivate tax giveaways, these are unlikely to come into effect before 2025, if at all.

Fiscal restraint is also evident in the Eurozone. Energy support measures will unwind this year, and the recent decision by the German constitutional court to block a redirection of unused pandemic funds exacerbates a tightening in government spending. With the sluggish manufacturing sector and China slowdown acting as strong headwinds over the past year, fiscal support to re-energise the Eurozone economy is unfortunately absent.

Economies in Europe and the UK will be supported by rising real incomes this year, as the impact of high inflation eases. However, with a lack of synchronised growth momentum across the region, we expect the recovery to be modest, curtailed by China's ongoing slowdown and restrictive policy.

[9] *Source: Goldman Sachs Research, Dec 2023. HICP Eurozone Inflation.*
[10] *Source: Pantheon Macroeconomics, Dec 2023.*

1.5 China's Structural Slowdown

We urged caution towards China and broad emerging markets last year, despite post zero-covid enthusiasm, and remain sceptical that the world's second largest economy will re-emerge as a growth driver anytime soon.

Despite the positive impact of economic reopening, the Chinese economy faces a myriad of structural challenges that constrain overall growth. Importantly, the Chinese authorities are willing to oversee a period of lacklustre growth in order to address those challenges. Policymakers are focused on restructuring the economy away from the debt heavy sectors that drove the prior boom, particularly real estate, and towards consumerism. This model is underpinned by President Xi's 'common prosperity' goals and the technology of the future – AI, electric vehicles and semiconductors.

In the meantime, fiscal stimulus is proving to be more measured and targeted than before, avoiding a full-blown property market collapse whilst also ensuring a focus on economic restructuring. A stabilisation in the manufacturing sector will provide a much-needed support, but the signs are clear that headline GDP growth is not a priority in China.

> China's economic challenges require many years of deleveraging and rebalancing, a path the authorities are willing to follow. Whilst we see evidence of stabilisation, we do not see support for a durable change of fortunes for investors.

Section 2. Multi Asset Investment Strategy

2.1 Equities – staying constructive

A strong end to a concentrated year

Equity markets have closed the year on the front foot, with participation broadening beyond the dominance of the 'Magnificent 7' technology giants. Useful indicators of momentum and market trend have shifted favourably, and despite a soft start to 2024, the body of financial and macro evidence gives a constructive message.

For globally diversified investors, this represents a welcome development following market declines in 2022 and a concentrated recovery for most of 2023 (chart 11[12]). Actively managed strategies typically allocate less to the largest companies in the index, with almost a quarter of the S&P 500 concentrated in just 5 stocks. A useful illustration is the performance of the equal weighted S&P 500 relative to the conventional market cap weighted index (chart 12[11]).

Chart 11:
7 companies have reigned supreme

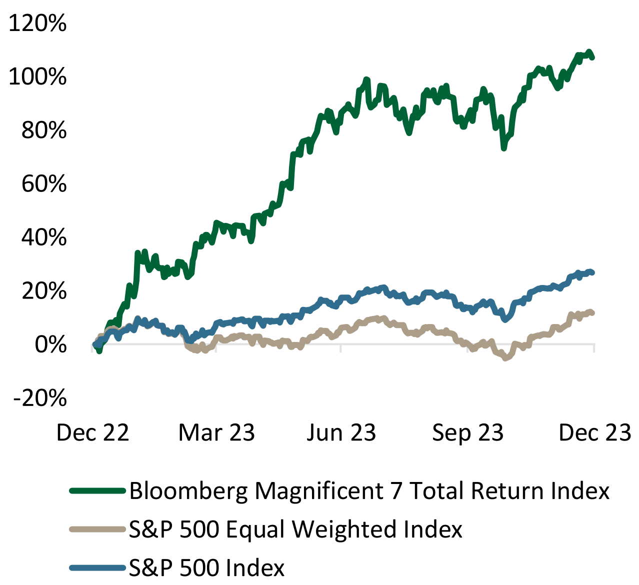
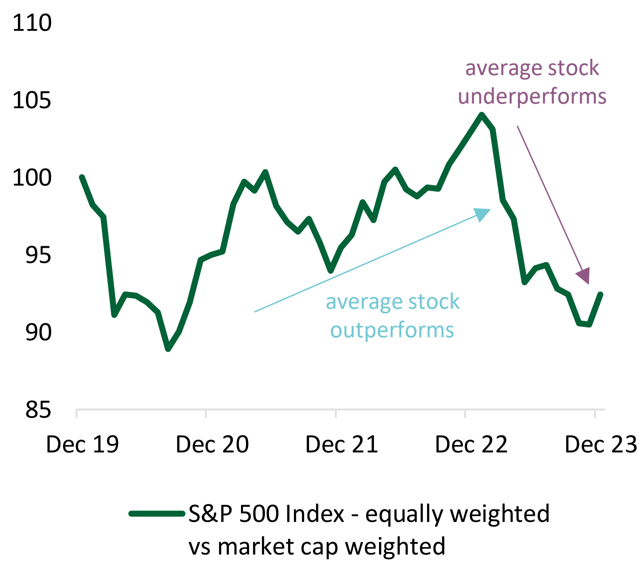


Chart 12:
Concentrated recovery works against diversification



> The credentials of disruptive technology businesses such as Alphabet, Microsoft and Nvidia remain enviable, with cash rich balance sheets and strong AI-linked revenue growth. Despite high expectations it is unlikely they will substantially lose investor appeal, particularly in the uncertain macro environment we describe.

A healthy allocation to 'passive' index trackers ensures participation in this market dynamic – one which we have gradually leaned into over recent years – complemented by differentiating active strategies. This approach brings balance, combines opportunities across sectors and company sizes, and ensures a prudent and diversified approach to equity investment.

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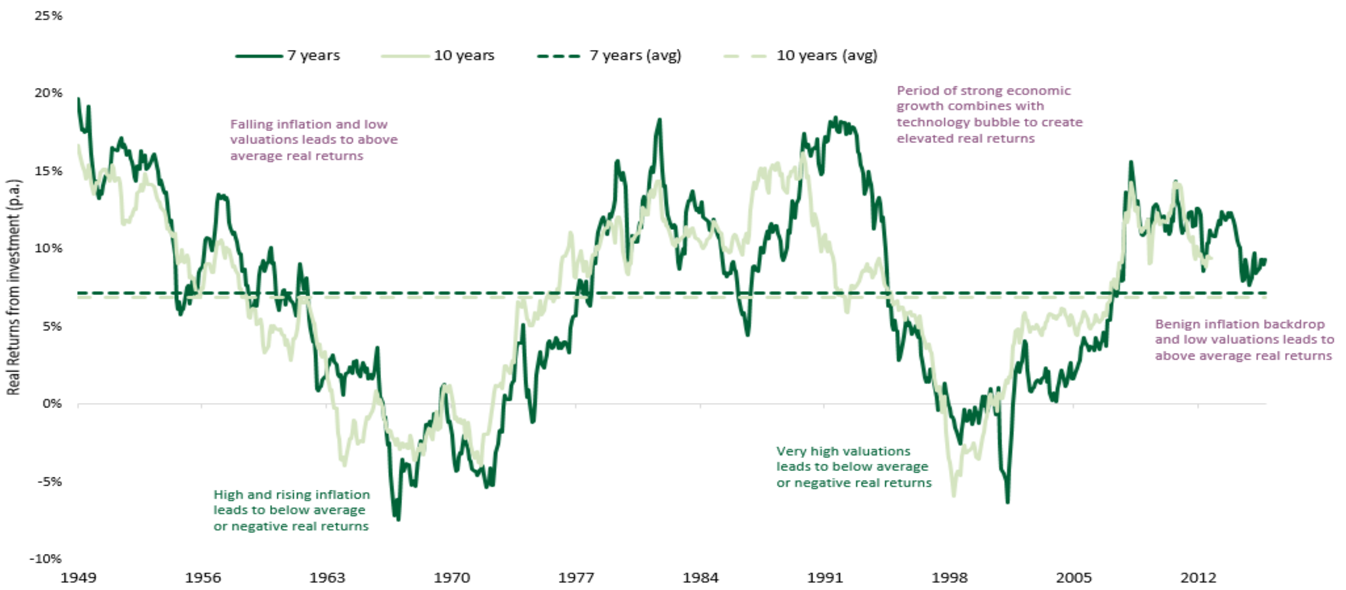
[11] *Source: Bloomberg, Dec 2023, USD.*

Focus on real equity returns over 7-10 years

Central to our multi asset process is a focus on the potential real equity return over a full market cycle, which continues to support equity allocation. On average, equities have historically beaten inflation over periods of 7-10 years, although variability has been significant. Notably, periods of high (and rising) inflation and high starting valuations have been reliably associated with negative real returns over this timeframe. (chart 13[12]).

Chart 13: Real equity returns can vary substantially – inflation regime and valuations are key



Such conditions do not appear to be present today. Whilst high expectations for AI-driven revenues in the technology sector has pushed their valuations to historically high levels, the market overall remains reasonably priced (chart 14[13]). Entrenched disinflation represents the overarching macro theme, supporting a continued recovery in real earnings growth following 2022 declines (chart 15[14]).

Chart 14: Valuations are not restrictively high

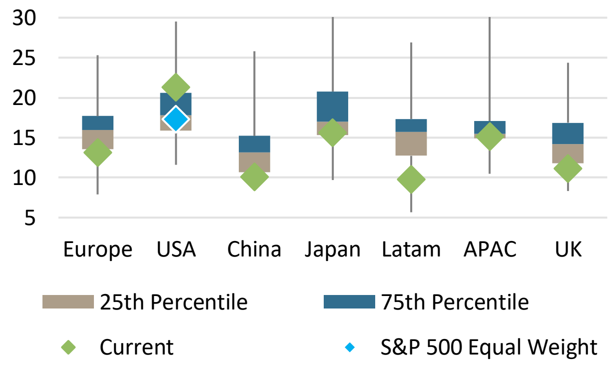
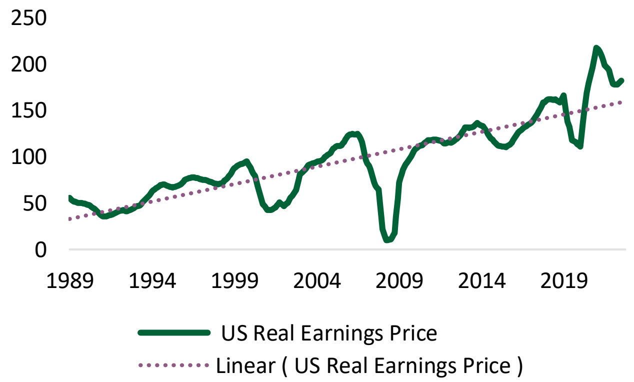


Chart 15: US Real Earnings Growth is recovering



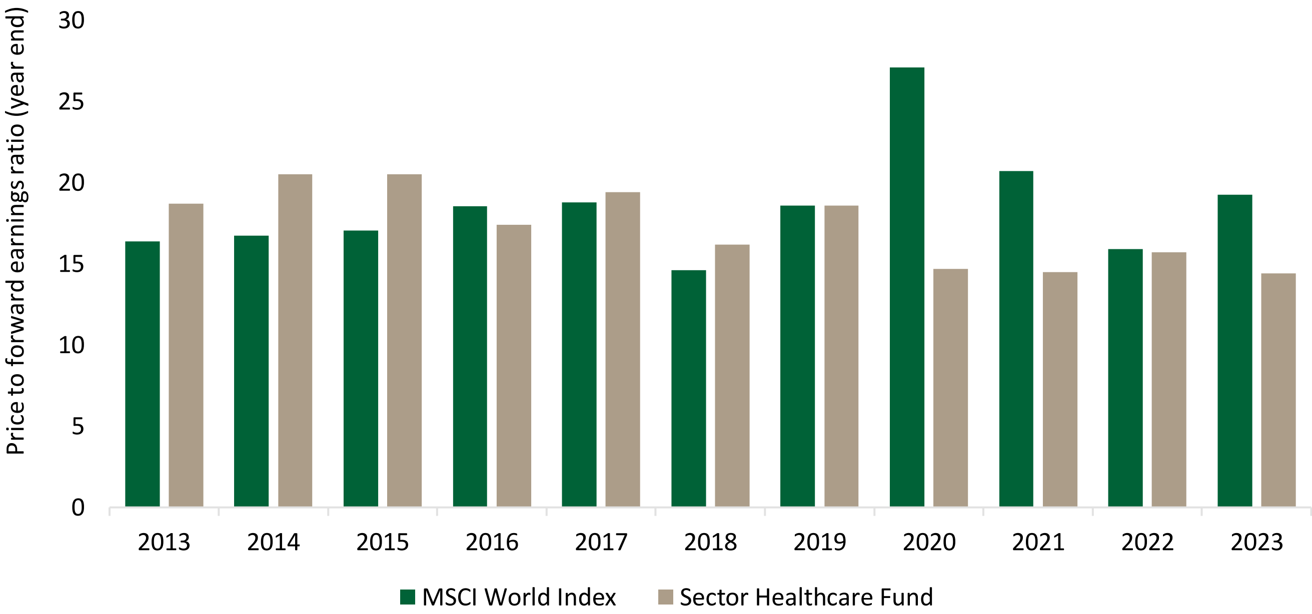
The combination of falling inflation, moderate valuations and recovering real earnings growth support continued engagement in a globally diversified equity strategy.

12 *Source: US Equities and inflation using Robert Shiller data, Yale Department of Economics, Sept 2023, USD.*
13 *Source: Bloomberg, Dec 2023, using semi-annual trailing P/E.*
14 *Source: US Equities and inflation using Robert Shiller data, Yale Department of Economics, Sept 2023, USD.*

Healthcare – a differentiated approach

Our global equity strategy leans into the Healthcare sector where we identify a strong fundamental case for attractive returns. As a traditionally defensive segment of the equity market, Healthcare performed well in 2022, benefiting from stable earnings as inflation accelerated, but retreated in 2023 as sentiment shifted to Technology. With the economic cycle maturing, valuations for Healthcare stocks appear attractive (chart 16[15]).

Chart 16: Good value can be found in the Healthcare sector



However, like the market overall, the Healthcare sector is diverse, with the performance of a small number of companies dwarfing the rest of the sector in 2023. Large pharmaceutical companies, Eli Lilly and Novo Nordisk, have experienced substantial valuation and share price appreciation, driven by revenue growth from obesity drugs, Ozempic and Wegovy.

Following 2023's performance, we anticipate a moderation in this theme. The obesity drug market is still in its infancy, with only 500,000 individuals being prescribed the drug in the US, and questions remain around the speed and scope of adoption. Payer coverage, pricing and manufacturing supply are likely to frame investor sentiment and the outlook for Novo and Eli Lilly, the two market leaders.

At this stage, whether obesity drugs will receive government support and be covered by insurance companies is unclear. Most US private health insurers refuse to cover such therapies, considering them as cosmetic solutions. For Novo Nordisk, whether or not Ozempic is listed on the next 15 drugs selected for Medicare negotiations will be decisive, due in February 2025. Eli Lilly will launch the Zepbound drug in 2024, with elevated sales expectations creating the risk of near-term disappointment.

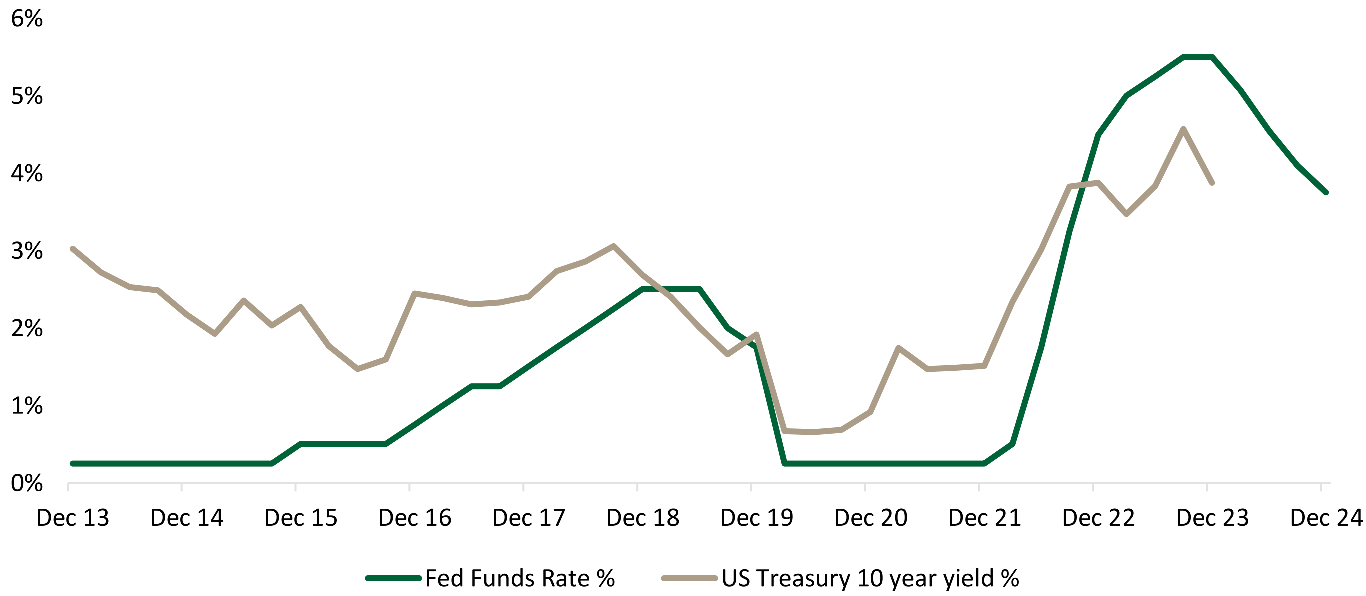
> The long-term outlook for this structural growth theme looks favourable, and is likely to provide a tailwind to the Healthcare sector overall. However, a differentiated approach is preferred, which captures quality and value opportunities across medical technology, healthcare services, biotechnology and the broader pharmaceutical industry. As the economic cycle matures, we retain strong conviction in this strategy.

[15] *Source: Bloomberg, Sector Healthcare, Dec 2023.*

2.2 Fixed Income – the return of diversification

With entrenched disinflation the expected macro backdrop, and recession risks not to be dismissed, the risk-reward for core government bond investment is favourable, despite a sharp fall in bond yields since September.

Chart 17: Interest rates are expected to fall from current levels



Our allocation has incrementally increased from near zero in 2021, and now offers both real return and key diversification properties for multi asset portfolios. Market pricing suggests that US interest rates will fall from 5.5% currently to 3.8% by the end of the year (chart 17[16]), supporting returns for bond investors at current levels. Credit also offers competitive all-in yields and remains a core allocation in fixed income portfolios, with a bias to quality investment grade through specialist active managers.

[16] *Source: Bloomberg, Dec 2023.*

2.3 Alternatives – an attractive blend of non-core asset classes

Investments in long / short equity, physical gold and insurance-linked bonds have collectively added valuable returns to portfolios in 2023. With the risk of market dislocation ever-present, we retain conviction in these uncorrelated alternative assets for 2024.

Having registered double-digit gains last year (chart 18[16]), the outlook for insurance-linked bonds is particularly enticing with high underlying yields (chart 19[17]). This investment accesses the global reinsurance market where a strong demand and pricing environment is creating the potential for further healthy gains. Certainly, the risk of short-term declines triggered by natural events is ever-present, as we witnessed with Hurricane Ian in 2022. However, the diversification of the underlying exposure and historically high spreads means that this risk is well compensated for, with strong recovery potential.

Chart 18: Strong Insurance-Linked Bond returns in 2023

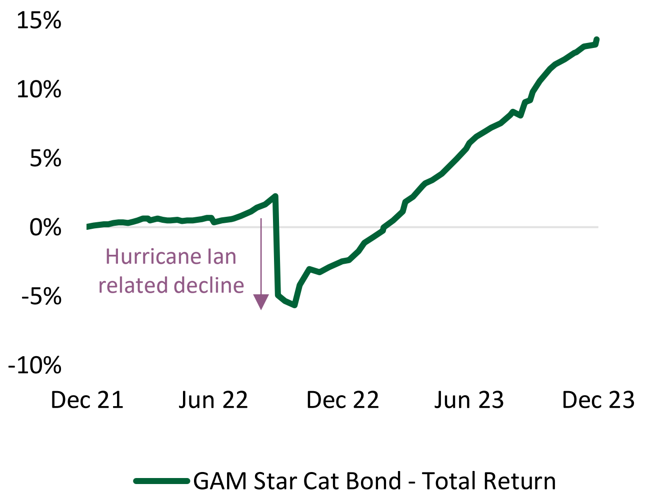
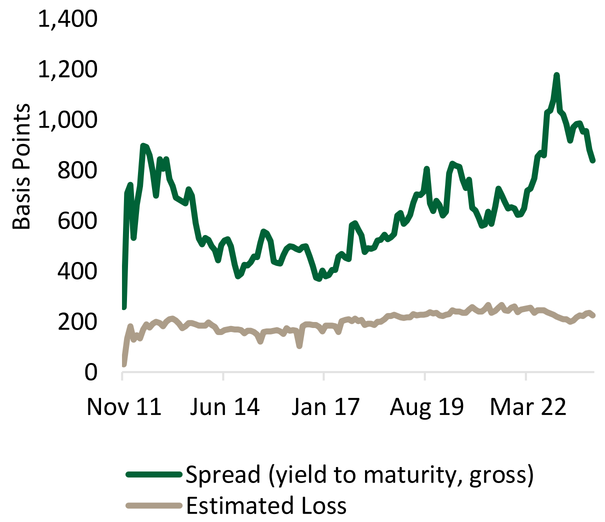


Chart 19: Attractive spreads support the outlook



Summary

As the economic cycle matures, we expect declining inflation and moderating growth to support lower interest rates. US outperformance is likely to persist, relative to an uneven recovery in Europe and persistent headwinds in China. Entrenched disinflation will lift real income growth and contain the likelihood of a deep US recession, which we estimate at c. 30% for the next 12 months. The risks to this view remain in focus, most notably geopolitical. Multiple elections this year, including the US Presidency, coincide with a fragile geopolitical landscape, raising the threat of an energy or supply chain shock. Such unforeseeable developments argue for a well-diversified, flexible and robust portfolio, which remain core investment principles.

We wish you a happy and prosperous 2024.

SFIM Chief Investment Officer Group
January 2024

[17] *Source: GAM, November 2023.*

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