

The Way We See It

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2024 Outlook - Smooth Sailing with Plenty of Tailwinds?

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A brief report which serves to review the past year and to offer our outlook for 2024.

Brief Thoughts on the Year of 2023

It turns out to be a much better year for global risk assets than the consensus led us to believe at the start of the year. GOJI held a more positive view than the consensus, but even our expectations were exceeded.

The generative AI Revolution sparked a spectacular rally in the top IT stocks in the U.S., thus lifting the Nasdaq, Semiconductor Chips and Standard and Poor indices to near all time high levels. This was further boosted by hopes of rate cuts by the US Fed and other major central banks in 2024.

At the time of writing (December 15th), global equities rose by an estimated 22.7%¹ in total returns and USD terms. Global bonds, which was under pressure with another year of large negative returns, ended up in a positive territory, 4.7%². Led by the U.S., Developed Markets performed substantially better than their Emerging counterparts. The latter was, once again, dragged down by the disappointing growth bounce in China. The Emerging bloc's weak currency trend against the strong U.S. dollar worsened their performance in USD terms.

1. MSCI World YTD as of 15/12/2023.

2. Bloomberg Global Aggregate YTD as of 15/12/2023.

Economic growth trends around the world offer a very mixed picture: the U.S. significantly surprised on the upside (particularly in the 2nd half, thanks to strong household and government spending). Japan and India also recorded solid real economic growth. The reverse occurred in Europe and China. The slump in domestic demand and inadequate fiscal and monetary easings in China not only impacted negatively the latter's domestic growth, but also European exports (as China has been one of their largest and growing buyer of goods and services).

Inflation trends are uniformly positive for risk assets: all countries benefit from a large fall in energy and other commodity prices. In addition, the normalisation of supply chain blockages helped to boost the supply of simple to sophisticated goods and services, as well as migrant labour.

In the month of December, the US Fed and other major central banks in the world appeared to have put their rate hiking cycle on hold, as both headline and core inflation trends have been decelerating. Investors were quick to react to this positive development, by pricing in enthusiastically large rate cuts in 2024.

Geopolitical tensions worsened during the year: Russia and Ukraine continued to fight, a situation which was made worse by the eruption of war in the Middle East, following the attack on and retaliation by Israel against Hamas and other Arab terrorist groups. Furthermore, the deterioration of semiconductor chips trade between the U.S. and allied versus China escalated, threatening the already-fragile political relations between the U.S. and China. Nonetheless, global risk assets appeared to take these unsettling news in their stride, and kept on rising.

Consensus Outlook for 2024

The consensus is bullish. Either moderately or very bullish.

Let us briefly look at the reasons why the majority of investors are feeling upbeat regarding risk markets next year:

U.S., Japan and India recorded solid economic growth; Europe and China saw the reverse.

US Fed and other CBs put rate hiking cycle on hold.

1. From a **macroeconomic perspective**, the word “Goldilocks” is frequently used to describe the world economy in 2024.

Firstly, global economic growth is expected to show a moderate pick up in activity, particularly insofar as the currently-sluggish European and Chinese economies are concerned. The U.S. economy is forecast to continue to grow at a relatively healthy pace, albeit more slowly than in 2023 (high rates and reduced lending capability to bite with a lag, currently-strong growth in government and consumer spending to slow).

Secondly, inflationary pressures are forecast to continue to abate, thus strengthening the case for central banks to cut rates (as positive real rates hurt borrowers).

Thirdly, the consensus appears quite complacent about the health of the commercial banking and financial systems, as well as the balance sheet status of households and corporates.

In other words, despite the aggressive tightening of monetary policy in G20 over the past 18 months, the consensus believes that there won't be any material financial accident in 2024. A somewhat heroic assumption, in our view!

Last but not least, the combination of a strong USD and very high interest rates in the U.S. and Europe do not seem to affect the U.S. debt liabilities position held by emerging countries (the Chinese property and Argentinian debt issues are probably the exceptions).

In brief, a **“not too hot, not too cold”** global economy is expected by the consensus, which would thus allow G20 central banks to cut rates and boost future growth. Indeed a wonderful Goldilocks scenario!

2. From an **Investment perspective**, the above Goldilocks macroeconomic backdrop encourages the consensus to feel confident that next year's markets will be just as bullish as the

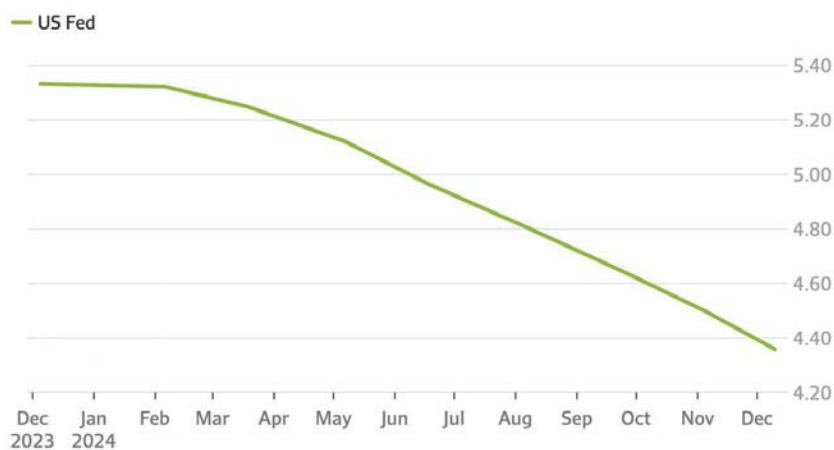
Market consensus points to a Goldilocks scenario.

recent uptrend witnessed since the end of October to date.

As interest rates are expected to be cut by G20 central banks anytime from now, right through to 2025, the consensus believes that everyone in the markets should have been and will continue to be emboldened to move out of their mountain of cash to hoover up stocks, and lock in high long-dated bond yields. The weakening of the U.S. dollar, caused by the more dovish Fed, has also encouraged investors to buy non-USD assets. These include crypto, precious metals, non-USD currencies/bonds/stocks and other assets. A broadening of the US equity and bond rally to the rest of the world is indeed a great signal.

What are the current implied expectations of the leading US Fed Fund rate in 2024? Let's have a look at the attached table (data as at 15/12/2023):

Rate Expectations (%)



Source: Refinitiv

The above table shows that fixed income investors are pricing in a total amount of rate cuts of 150bps in 2024, double the 75bps which is derived from averaging the individual Fed members' forecasts.

This reflects a very optimistic market discounting scenario! Moreover, if the Fed is not reducing its cash rate as much as the market currently hopes for, the USD will bounce back. This would impact

Dovish Fed leads to USD weakening; investors buy into non-USD asset classes.

Fixed income investors are pricing in a 150bps rate cut.

negatively on the weak-USD beneficiaries (please refer to above).

The implied bullishness in the fixed income market has been immediately reflected in higher equity prices and a visible contraction in the U.S. equity risk premium. The current P/E of the global leading equity barometer, the S&P 500, is estimated to be 21.6X, and the forward P/E at 19.3X (+11.8% EPS growth for 2024 forecast by market). This is quite expensive compared to the 10-year P/E average of 17.5X of the leading index. The question for the consensus is how one achieves 11.8% EPS growth with a marked-down real GDP growth of +1.4% in the US and a decelerating producer price index?

Lastly, the high uncertainty regarding the national elections in the US next year could impact on the required equity risk premium of US financial assets.

3. From a **geopolitical perspective**, uncertainties regarding the war in Russia and the Middle East remain. The Asia Pacific region could also witness rising tensions between China and the U.S., and its neighbouring countries. Investors do not appear to assign much risk premium for a potential blow up of the above troubled zones.

The Way We See It

- GOJI Outlook and Investment Strategy for 2024

First and importantly, one should note that the consensus' outlook set at the beginning of the year has been proven wrong almost every year! The reason appears to be based on the fact that their forecasts in the coming year seem to be simply extrapolated from the current trends over the last few months of the past year.

Given that the past few months' macroeconomic and markets' performance trends have pleasantly surprised on the market-friendly side, the consensus appears to have extrapolated them to continue in 2024 (the past few months have been a great period for both equities and bonds)! Hence, next year is projected by the consensus to continue to be a good, if not great, period for risk assets!

How to achieve high EPS growth with a low GDP growth & slowing PPI?

Consensus outlooks are often wrong for a good reason - extrapolated from recent trend.

Thus, the question: **How could the consensus be wrong-footed in 2024?** Will risk assets do worse or even better than market expectations?

Let us briefly discuss various scenarios which could go against the consensus' views:

1. From a **macroeconomic perspective**, will the consensus' "Goldilocks" base case occur?

The Goldilocks scenario assumes a gradual fall in headline and core inflation rates towards the target rate of 2%, and moderate GDP growth of about 1.4% p.a. in the US, 4-5% p.a. in China, and, for the world, 2.7-2.9% p.a. This favourable backdrop will certainly encourage G7 central banks to start to cut rates.

Questions which immediately arise include:

- Why will US growth slow down to 1.4% while fiscal spending is enormous (budget deficit at 6% of GDP), unemployment rate remains below 4%, long term rates (mortgages and corporate borrowing) have fallen, consumers and corporates are confident about the future, increased election year spending, and expectations of a series of rate cuts are imminent?
- Why would wages and core inflation continue their downward deceleration path when there remain shortages in skills and services labour, and that the very volatile energy prices can rebound anytime?
- What if the Chinese (hence European) economy recovers more than forecast, a result of lagged fiscal and monetary expansion ? This would put pressures on goods prices again.

In summary, **in GOJI's opinion**, the "not too hot, not too cold" macroeconomic setting seems more like a dream rather than reality ! **It is more likely that the U.S. and world economy will be stronger than expected**, and so inflation and

GOJI - U.S. and world economy will likely be stronger than expected; inflation and interest rates may rise from here.

interest rates will probably also be rising from current low levels.

2. From an **Investment perspective**, assuming that the Goldilocks scenario doesn't eventuate as hoped for, what would be the more plausible investment landscape for 2024?

Following the latest FOMC meeting, both the Fed chairman and a number of influential Fed members have tried to inject caution in the current rate cuts euphoria. They clearly explained that the 75bps rate cut announced by Jay Powell post the meeting is not an official policy: it is simply an input which is derived from the dot plot which, in turn, involves collecting and averaging all the members' own end of 2024 rate forecasts. Investors went a step further by discounting not just 75bps, but 150bps of rate cuts by December 2024.

Thus the question is - what if the Fed ends up holding current high rates (or raise rates again?) for longer, based on GOJI's stronger growth base case scenario? If so, rates will definitely rise again, thus impacting adversely all fixed income markets, with the long end being more affected.

Equity markets, anticipating a much easier monetary policy, will undoubtedly be disappointed. This is especially so as valuations are expensive and all investors have been loading up with stocks since November. As a result, taking a 12-month view, we believe that the U.S. equity market is currently trading close to its peak level (probably some 5-7% away). Using the leading global equity market index as a benchmark, the S&P 500 is likely to trade within a band of 4000 to 5100 (current : 4760).

Within the global equity universe, **it is likely that investors will modestly re-balance in favour China and Emerging Markets**, based on liquidity, valuation and investor positioning differentials.

3. Lastly, **geopolitical** uncertainties are unlikely to be solved anytime soon. The current wars in Russia

GOJI - likely to see modest rebalance in favour China and EM.

and the Middle East are expected to increase in intensity as peace talks have been ineffective. Tensions in the Asia Pacific region could bubble up and explode. We believe that a geopolitical risk premium with regard to the valuation of equities has to be added.

Investors' Positioning and Sentiment

At this time last year, investors were fretting about potential adverse consequences of a restrictive monetary policy implemented by the Fed and other G7 central banks on the US and global economy, and their financial markets.

How the past 12 months dramatically changed this picture - Currently, all investors, ranging from institutions to small investors, black-box quant-driven to humans, long-term investors to one-day punters, are now joining each other to celebrate the 2023 Christmas and the 2024 New Year in style: from their bottom levels in late October, we witnessed in awe a raging bull market in US equities and a recovery in US bonds, rising by about 16.2% and 6.7% respectively.

Thus, the question:

Will investors continue to pour money in equities and bonds in 2024?

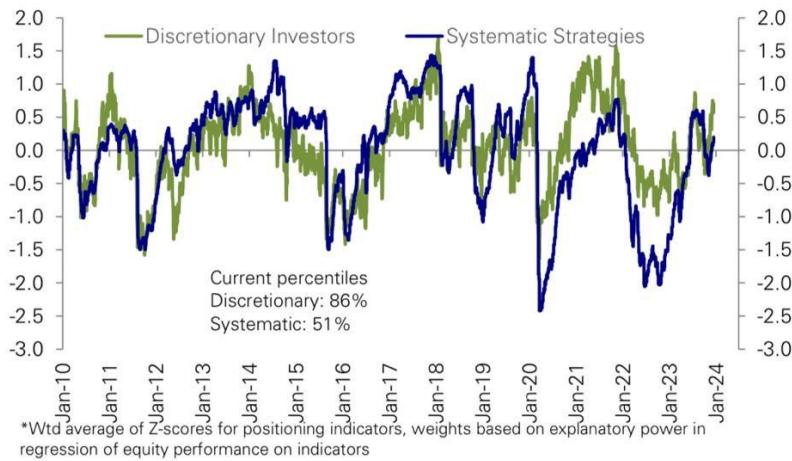
Let's take a quick look at how they are positioned at present.

Equities Positioning by Investors

One's first reaction to the above question is to reply "Yes, of course, in an Goldilocks scenario, everyone will want to buy more equities in 2024!". However, before we go along with the consensus, let's have a look at how Discretionary (fundamental long-term investors) and Systematics (quant-driven shorter-term investors) are currently positioned in equities:

[See chart on overpage]

Discretionary vs Systematic Equity Positioning

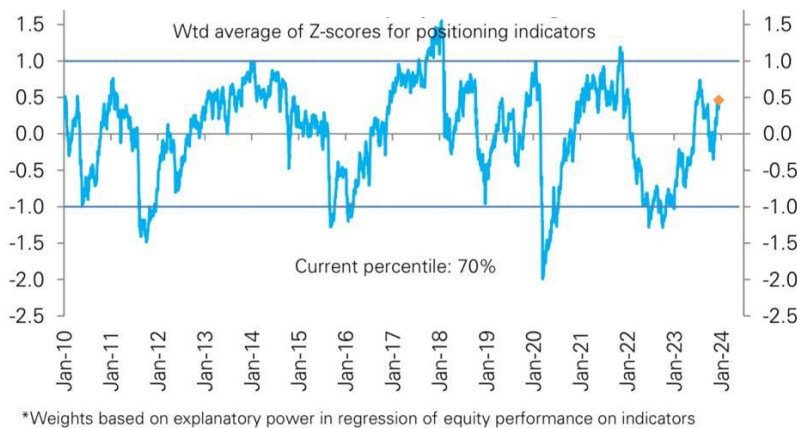


Source: Deutsche Bank Asset Allocation

The above chart shows that Discretionary investors have already bought quite lot of equities and are solidly overweighted, while Systematics only recently started to do so, and thus have the capacity to add more (as long as prices keep on rising and volatility continues to make new lows).

Systematics have room to add more.

Consolidated Equity Positioning



Source: Deutsche Bank Asset Allocation

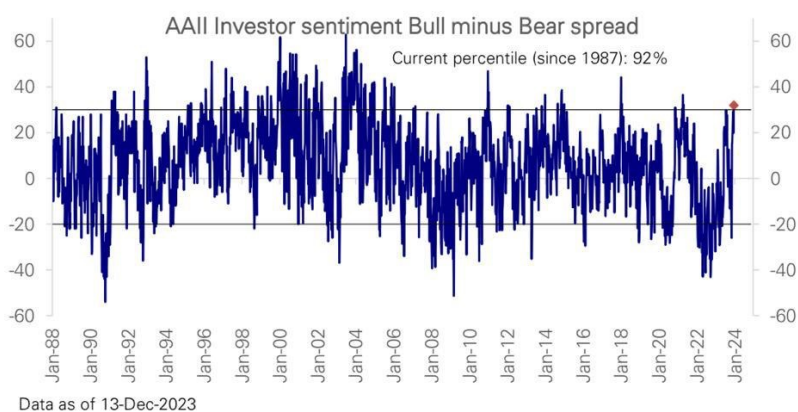
Putting the two types of investors together, one notes that they have are now clearly overweight equities. However, they are yet to completely fill their boots !

Sentiment of Equity Investors

Key sentiment indicators currently point to an exuberant investor, contrary to last December. The

chart below, based in the excellent work by the Deutsche Bank Global Strategy team, shows the spread (or difference between) the number of bulls versus bears. Currently, the difference points to a much larger number of bulls, and the spread is at peak levels. Market corrections tend to occur when we have such a strong consensus of bulls (*last December was the opposite*).

Investor Bull Minus Bear Spread

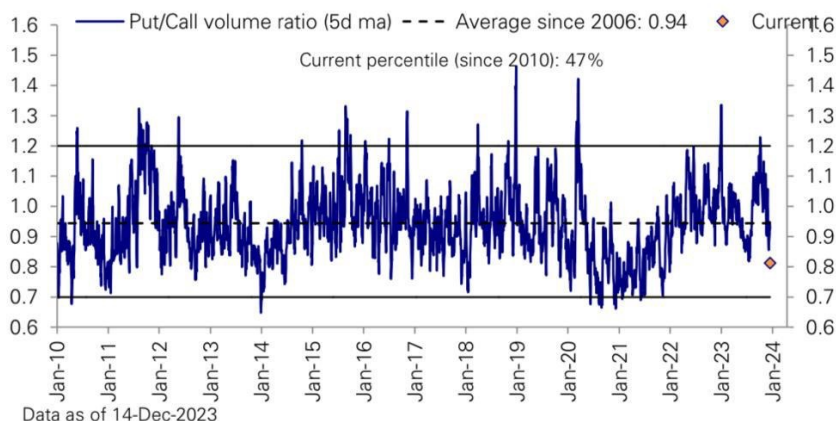


Source: Barron's, Haver Analytics, Deutsche Bank Asset Allocation

Another illustration of the euphoric feeling of investors shows up in a very low number of put options (to protect the downside) vs a very high number of call options (to capture the upside). The chart below shows a very low put to call ratio, demonstrating the high bullish sentiment.

Market seeing euphoria.

Equity Put/Call Volume Ratio



Source: CBOE, Haver Analytics, Deutsche Bank Asset Allocation

The last sentiment measure is the CNN Fear & Greed index. Here it shows that Investor's sentiment has recently swung into the Extreme Greed zone. This suggests that a large number of investors have bought stocks and are currently feeling quite complacent and happy. Exactly a year ago, at this time, Fear dominated (Index at 39).

Fear & Greed Index

- *What emotion is driving the market now?*



Source: CNN Business

From Fear to Greed.

In brief, both Positioning and Sentiment data suggest that most investors are very bullish and hold a positive view about next year's financial markets. This therefore begs the question: with most having already bought, who are the next new buyers? And what happens if the Goldilocks scenario doesn't eventuate, as hoped for?

Strategy Recommendations

At GOJI, we are the first to admit that it would make our lives so much easier if we were to agree and go along with the bullish Goldilocks view, as far as the outlook for the global economy and financial markets in 2024 is concerned.

The Goldilocks crowd would have as little cash as possible, and as much equities and long-dated bonds in their multi-asset or balanced portfolio as their risk tolerance would permit.

Within the Equities portfolio, Value/Cyclicals, Technology and, to a lesser extent, Emerging Markets would be overweighted. Within the Fixed Income portfolio, high yield bonds and long-dated

government bonds would be preferred. Within their Currency choices, the US Dollar would be downgraded to underweight, while Emerging currencies, the Yen and other currencies would be upgraded.

All the above tactics and strategy recommendations do have fundamental merit. However, given the expensive valuation resulting from the substantial rally and the euphoric sentiment and high positioning towards the above asset classes, in our humble opinion, to implement them now is likely to end up being an expensive and regrettable decision.

Our previous discussion and critique of the Goldilocks scenario lead us to recommend that one should wait for a better opportunity to buy risk assets. We thus suggest that, in the near term, clients should consider taking advantage of the euphoric rally to lock in some profit in expensive risk assets and stocks, with proceeds going to USD cash. We believe that the leading global risk index, the S&P 500, is about some 10-15% overvalued. Bonds have also become more expensive, and the US Dollar cheaper.

Within the Commodities' universe, we would suggest that Gold and other precious metals, together with Oil, should be held in a multi-asset or balanced portfolio. It is a good hedge against Geo-political uncertainties and war conflict in multiple locations.

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