Outlook 2024

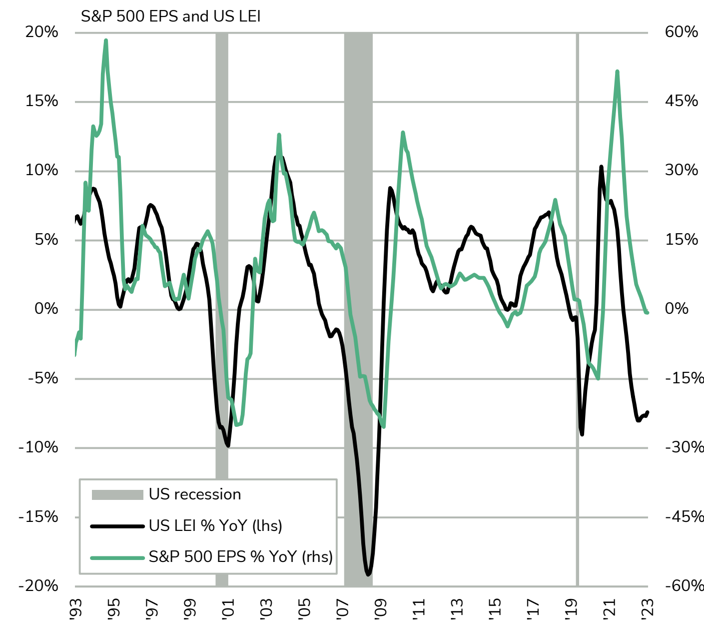
Asset classes

11 December 2023

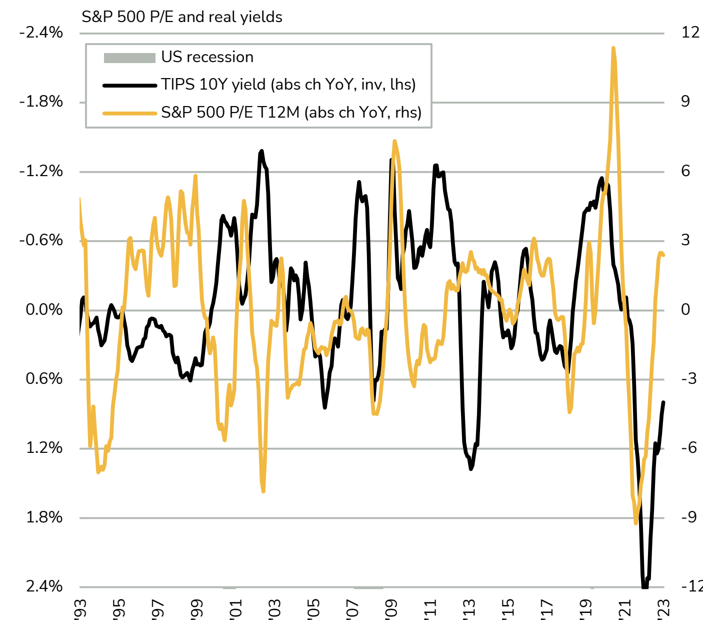
SIGNET

Equities
Resilience confirmed

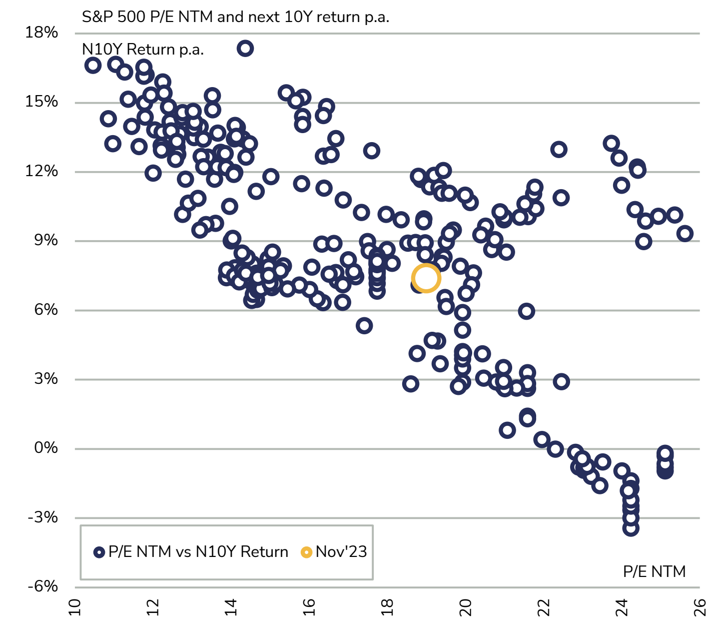
1. EPS growth defies bottoming indicators.



2. Multiples are supported by falling real yields.



3. Mid-single-digit return in next decade is likely.



Equities may perform quite well in 2024

- Despite eye-catching headlines in the media at the end of last year and the beginning of this year, major global economies did not slide into recession.
- Though economic deceleration continued, companies in general were able to pass on inflation pressures to consumers, increase margins, and deliver EPS growth. Top-down estimation of trailing 12M EPS growth of S&P 500 is zero (**fig. 1**), while bottom-up shows moderate +3% (latest 3Q23 numbers). Net income margins increased by 0.3 p.p.
- With clear signs of business activity acceleration in selected but Uber-important sectors, we believe that index-wise EPS growth in major developed market indices in '24 would be between low to mid-single-digits.
- However, equities may provide much higher performance due to multiple expansions, supported by a decrease in base rates.
- Equity valuations are highly sensitive to real rates and have front-loaded growth during 2023 in anticipation of the end of monetary tightening, overall abundant liquidity (e.g. the Fed's reserve balance with fellow banks is +8% Nov/Nov) and fading recession fears (**fig. 2**).
- Should monetary trends set in 2023 remain the same next year, equities may get additional inflows on substantial drawdowns.
- Valuation is probably the single most important factor in determining future returns for equities. The classic mantra of "*buy low, sell high"* works quite well for the long term. High valuations generally decrease the chances of material positive returns, low valuations increase those chances.
- Currently, the S&P 500 index is valued at 19x P/E NTM (**fig. 3**), which is in line with the long-term average of 17.5x (since Jan'91). If history is any guide, this is not an expensive valuation for this index. Passive investors may count on high-single digit returns per annum during the next decade.

Charts source. (1, 2, 3) The Conference Board, Bloomberg, proprietary calculations.

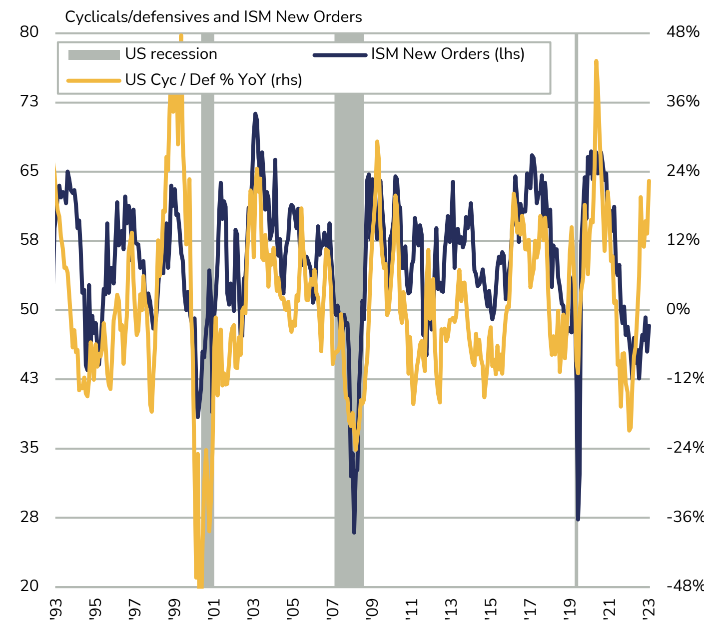
Equities. Factors and sectors
Riding on a wave

There are multiple reasons for growth

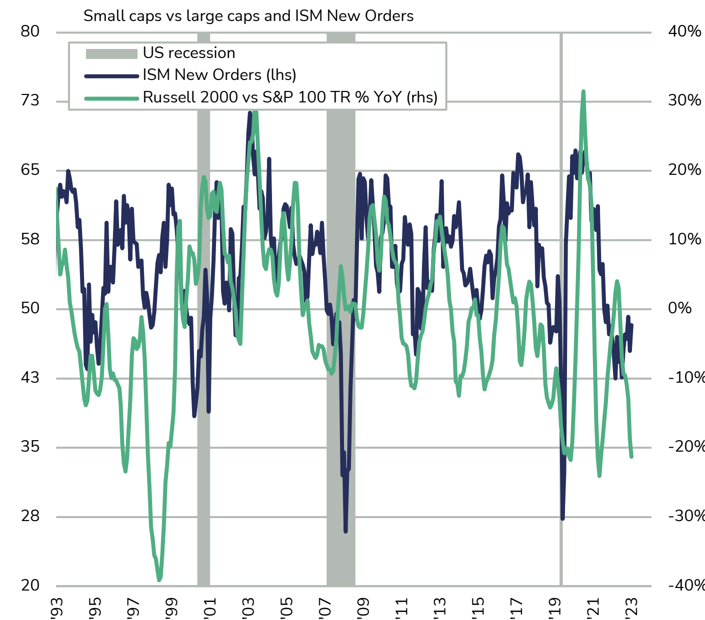
- Cyclical equities made a striking comeback in 2023. After entering a bear market zone in 2022 (-22%, here and after — US sectors), this year's return of 25% (YTD through Nov) has almost offset all losses. Defensives were beautifully boring in 2022 (-1.2%) and ugly boring in 2023 (-3.9% YTD through Nov).
- Cyclical equities normally lead major economic indicators and are now priced in for an acceleration in economic activity (**fig. 1**).
- Overall, we tend to agree that cyclicals will drive future broad market performance, however, however the gap vs defensives may be excessive at the moment. Should cyclicals enter an overvaluation zone, defensives — led by healthcare — could be a good alternative.
- Driven by the performance of *Magnificent 7*, large cap equities have once again beaten mid and small caps (+28.0% vs +4.1% YTD through Nov).
- The ecosystems of large cap technology and communications companies create additional demand for their products and services. Like the iPhone was a major game changer in 2007, now we may experience another boost in technological changes and productivity driven by AI.
- Medium and small companies, being major suppliers of tech giants, will inevitably benefit from such changes. Especially when growth waves spread around the economy (**fig. 2**). We have a constructive view on mid and small caps in 2024.
- There were a lot of debates about the valuations of IT-related equities in 2023.
- Growth is the key reason why valuation levels in the technology space make sense for us. Technology, communications, and consumer discretionary companies are expected to deliver the highest growth in next 2 years: 35%, 46% and 30% respectively (in terms of EPS, not per annum, **fig. 3**). On average, this is more than twice as much as the whole index (16%).
- If major IT-related companies continue to surprise investors on the upside, and this is our base case, there will be a substantial — if not growing — valuation premium to other firms.

Notes. Cyclical sectors are communications, consumer discretionary, energy, financials, industrials, materials, real estate, technology. Defensive sectors are staples, health care, utilities. Charts source. (1, 2) ISM, Bloomberg, proprietary calculations. (3) Bloomberg, proprietary calculations.

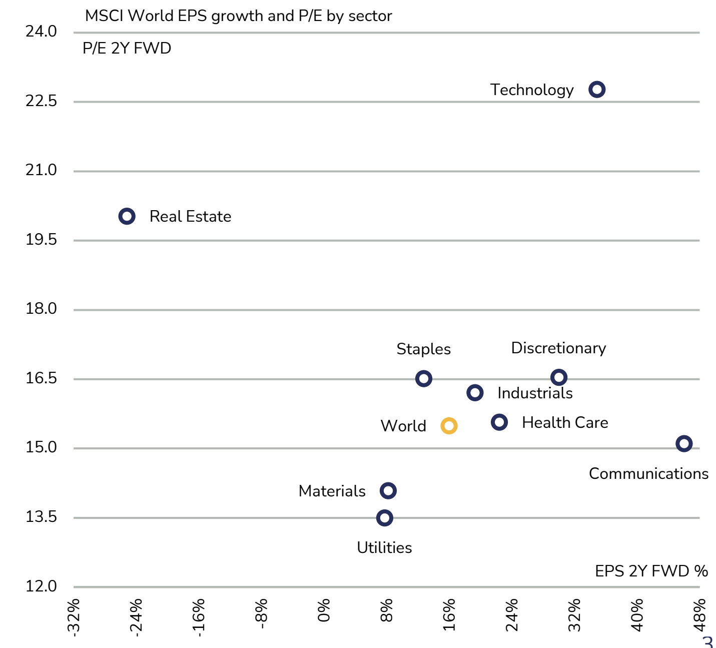
1. Cyclicals are pricing acceleration of activity.



2. Small caps may strike back.

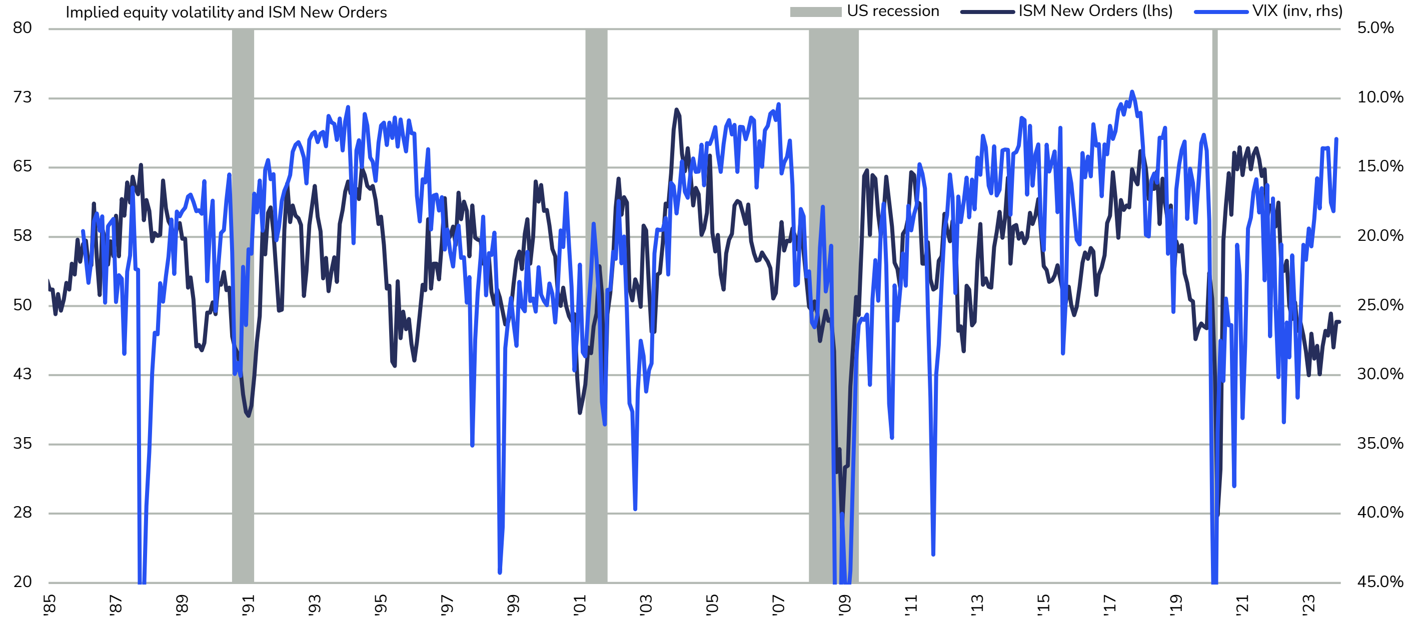


3. Why IT is not cheap? Because it is growing.

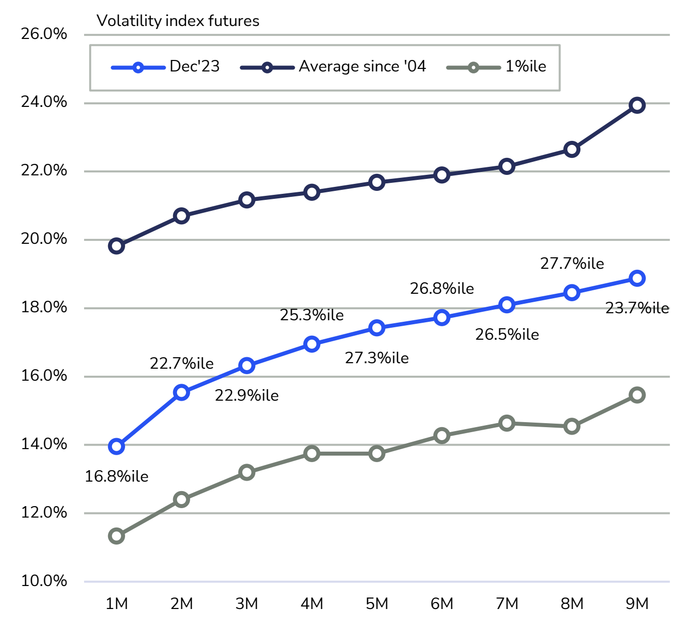


Equities. Volatility
Just in case

1. Volatility is pricing strong recovery, however it is low by historical standards.



2. Buying cheap volatility may be a good hedge.



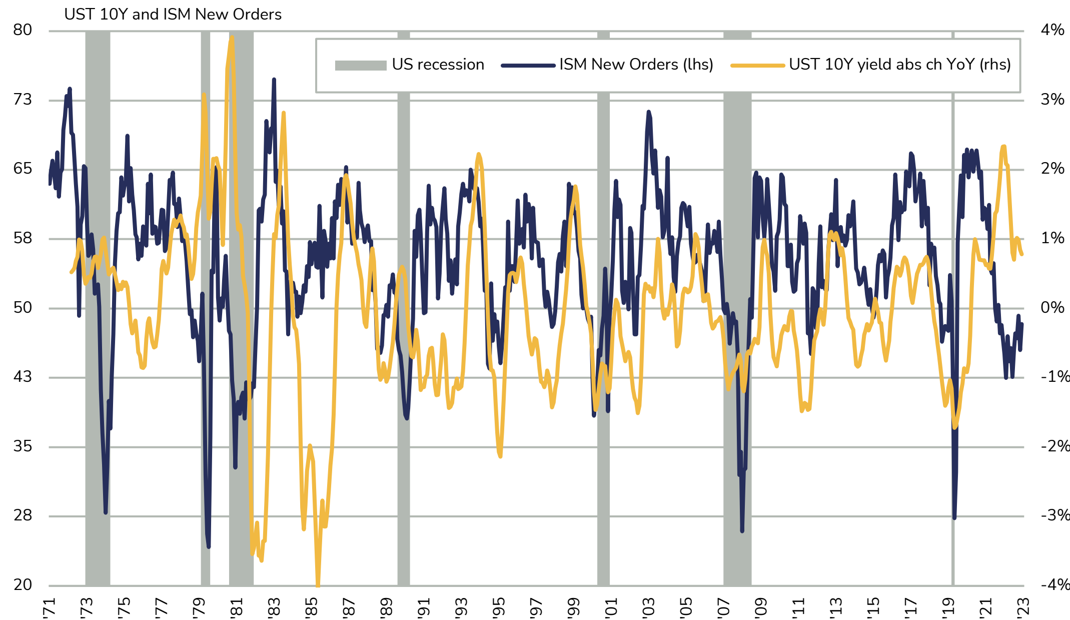
Low volatility is a sign of normalization

- After reaching an all time high closing mark of 82.69% in Mar'20 the equity volatility index (VIX) gradually declined to the mid-teens level in late '21. 2022 brought a lot of uncertainty to financial markets, and the year average VIX level was above 25.5%.
- Now, on the back of an economic recovery and inflation normalization, the VIX is flirting with a low teen levels again.
- Though we believe in further economic recovery and even potential acceleration, we should definitely highlight that the current equity volatility is probably too low by historical standards and compared to overall business activity levels (**fig. 1**).
- As seen in early Dec'23, next year's volatility index futures do not price in any significant risks. The average level of 2M—9M contracts is only 17.4% (**fig. 2**, light blue line), which is lower than the historical average of 21.9% (dark blue line).
- In percentile terms, this is approximately the 25%ile, which means that only a quarter of historical VIX futures values have been lower.
- The lowest one percent of VIX futures values brings us to an average level of 14% (grey line).
- This all means that less risk-tolerant investors in equities may purchase hedging instruments, definitely subject to experience and understanding of such products, to benefit from low volatility and hedge the risk of a negative revaluation in case of an equity market drawdown.

Charts source. (1) ISM, CBOE, Bloomberg. (2) CBOE, Bloomberg.

Fixed income. Base rates and spreads
Goldilocks and the two bulls

1. Base rates are high both for recessionary and non-recessionary scenarios.

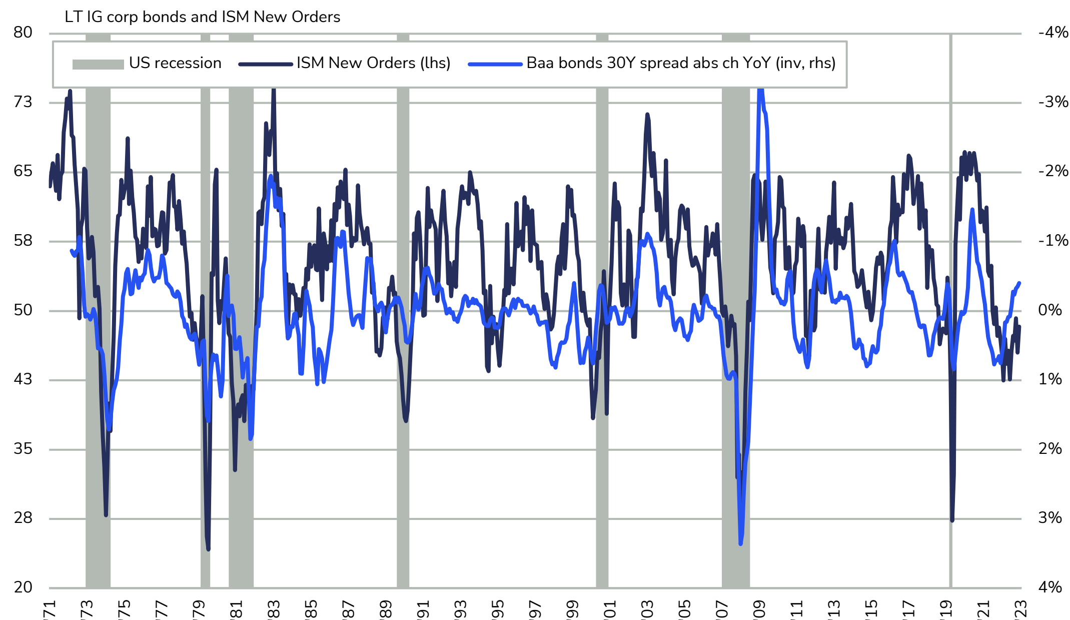


2024 may be another positive year for fixed income

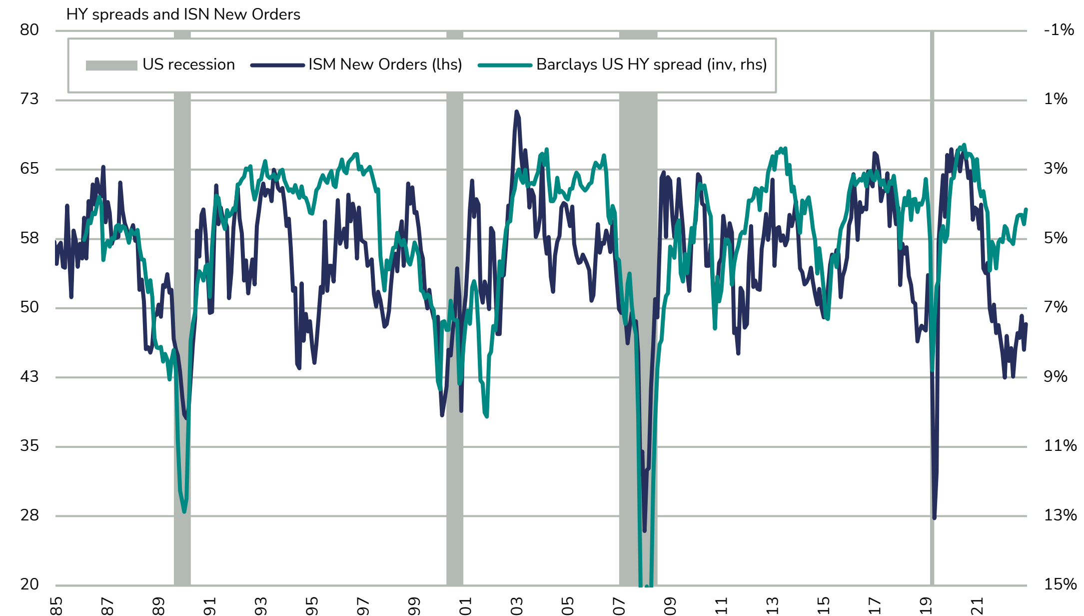
- Inflation peaked in 2H22 in the developed markets. Central banks' base rates peaked approximately one year after. US data: Jun'22 vs Jul'23 respectively. EZ data: Oct'22 vs Sep'23 respectively.
- Now, when inflation is no longer a problem, more bets are coming out that central banks will not hold restrictive monetary policy for too long. This would drive base rates down, and government bonds would outperform.
- In case a recessionary scenario is realized — which is highly unlikely in 2024 in our view — deteriorating business activity would drive prices down, and central banks would have to step in. And this is again quite a positive factor for government bonds (**fig. 1**).
- As discussed previously, we see multiple signs that economic activity may pick up in 2024. Such an environment is normally positive for credit spreads (**fig. 2**), which is another source of outperformance for bonds, now corporate-related. Staying in high yield rated bonds should not be a problem for risk-tolerant investors, given the expected improvement in business activity (**fig. 3**).

Charts source. (1, 3) ISM, Bloomberg. (2) ISM, Moody's, Bloomberg.

2. If economic activity picks up, this would drive IG spreads further down.

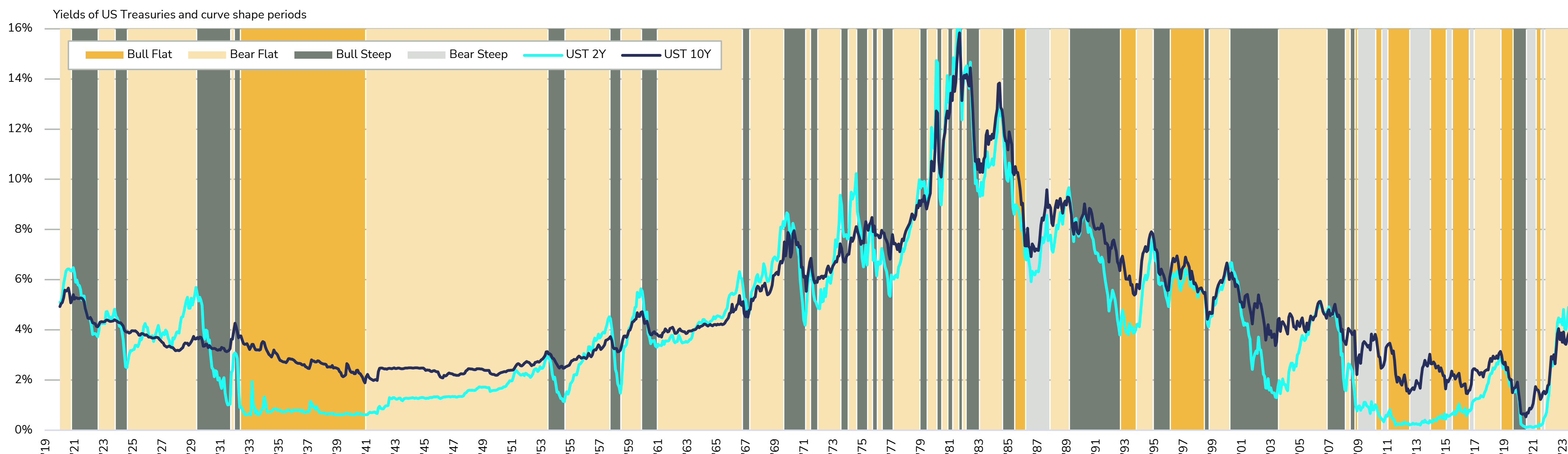


3. High yield should be fine while economy is growing.



Fixed income. Curve and duration
Long live the bonds

1. Long term base interest rates are still below short term due to subdued inflation expectations. Bear steepening of the curve is the shortest phase in cycle.



2. Long end of the curve may outperform

*Empiric probability of switching phase in **6M** after being 3—5M in bear steepening*

		To			
		Bull Flat	Bear Flat	Bull Steep	Bear Steep
From	Bull Flat	71%	4%	8%	17%
	Bear Flat	5%	95%	0%	0%
	Bull Steep	10%	5%	75%	10%
	Bear Steep	41%	6%	0%	53%

*Empiric probability of switching phase in **1Y** after being 3—5M in bear steepening*

		To			
		Bull Flat	Bear Flat	Bull Steep	Bear Steep
From	Bull Flat	33%	17%	13%	38%
	Bear Flat	0%	68%	27%	5%
	Bull Steep	30%	20%	30%	20%
	Bear Steep	47%	24%	0%	29%

Charts and tables source. Proprietary calculations based on Bloomberg and the Fed.

USD base rates curve

- Since Jun'23 the USD base rates curve is in bear steepening mode (**fig. 1**, light grey areas). Yield on long-end US Treasuries (here and after — 10Y) moved higher than yield on short-end UST (here and after — 2Y). The latter has actually fallen in anticipation of less restrictive monetary policy from the Fed.
- Based on previous history, bond investors may still find themselves in the bear steepening phase (e.g. as a consequence of diminishing bets on Fed cuts) as primary case (53%, **fig. 2**, upper). Alternatively — this may be a bull flattening phase (41%), where long-end bonds outperform short-end.
- By the end of 2024, the most probable scenario is bull flattening (47%, **fig. 2**, lower), reflecting market participants' views that inflation is well tamed and long-end bonds still provide good value.
- Investors with a relatively high risk appetite may benefit from such developments by increasing duration in portfolios. Locking in yields for a long period of time may overweigh opportunities for short term and frequent reinvestment of capital. Overall, we are positive on duration in '24.

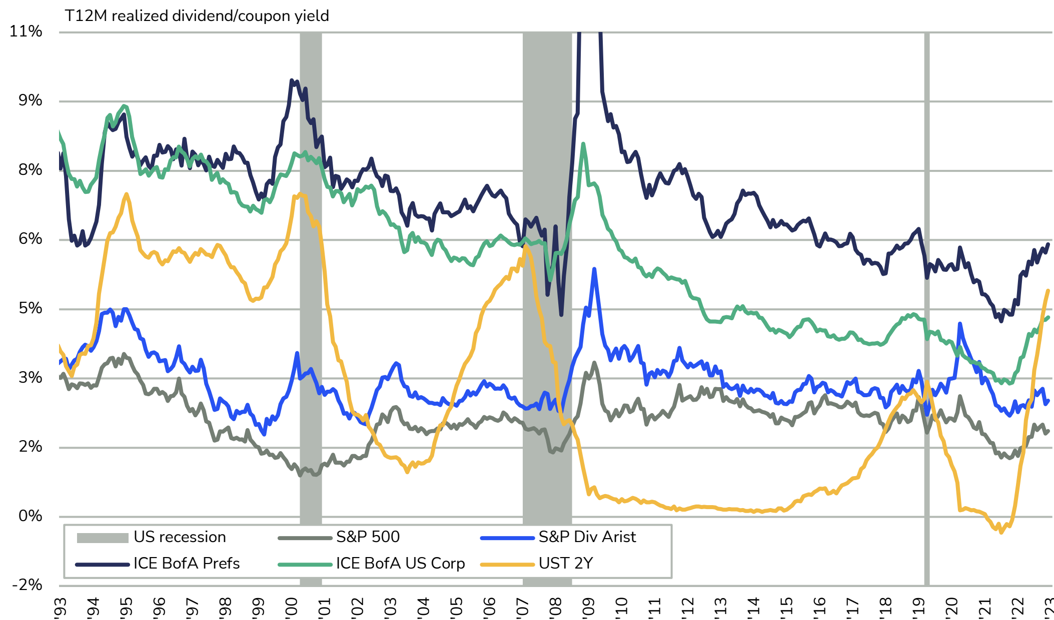
Money markets
Enjoy while you can

Money markets still provide reasonable return for risk averse investors

- Eleven consecutive rate hikes by the Fed in Mar'22—Jul'23 have brought yields in USD-based money markets to 5.0—5.5% by the end of 2023.
- These levels were last seen in 2007, and a whole new generation of investors who grew up a amid zero-interest rate policy was puzzled by the new environment.
- Now, money markets still provide a good alternative for yield-seeking investors to buying assets with higher risks (**fig. 1**). Yields on short-term US government bonds still exceed the dividend yield of the S&P 500, consistent dividend payers (dividend aristocrats) and the current yield (not yield to maturity) for the broad corporate bond index.
- Risk-averse investors may still enjoy mid-single-digit returns (on an annualized basis) for the next 6—9 months, in our view.
- Currency-wise, the story is still about the USD in our view. Taking liquidity into consideration, we still consider USD government bonds to be the best investment in money markets from a risk and reward perspective. A credit rating downgrade by Fitch in Aug'23 did not cause any material changes in the assessment of overall US risks.
- NZD- and GBP-based investors may enjoy comparable to USD returns for comparable credit risks.
- Investors in the eurozone do not get a significant pickup from investing into credits of lower quality (**fig. 2**).
- Short-term Swiss or Japanese government bonds will bring only miniscule income gains of 0—1% p.a.

Charts source. (1, 2) Bloomberg.

1. Bonds — a reasonable alternative to risky assets in getting current income.



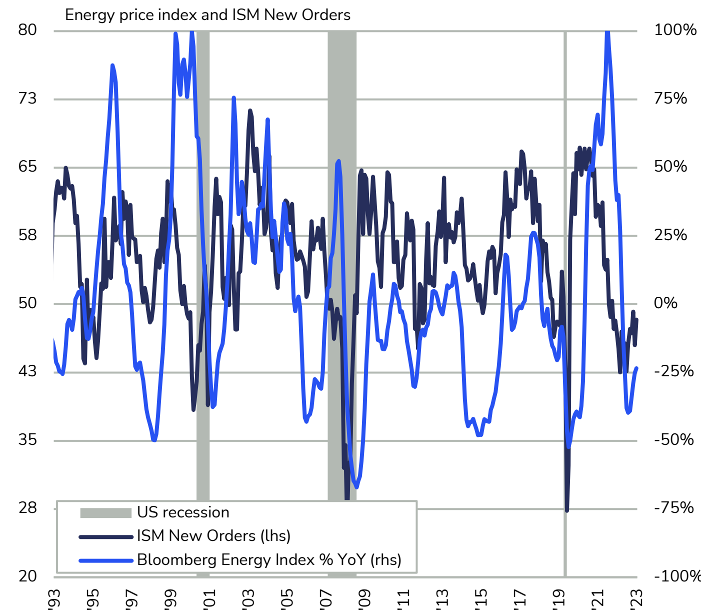
2. AAA—AA rated issuers can bring over 4% p.a. in local FX in next 2 years.

Commodities
Sixteen tons, what do you get?

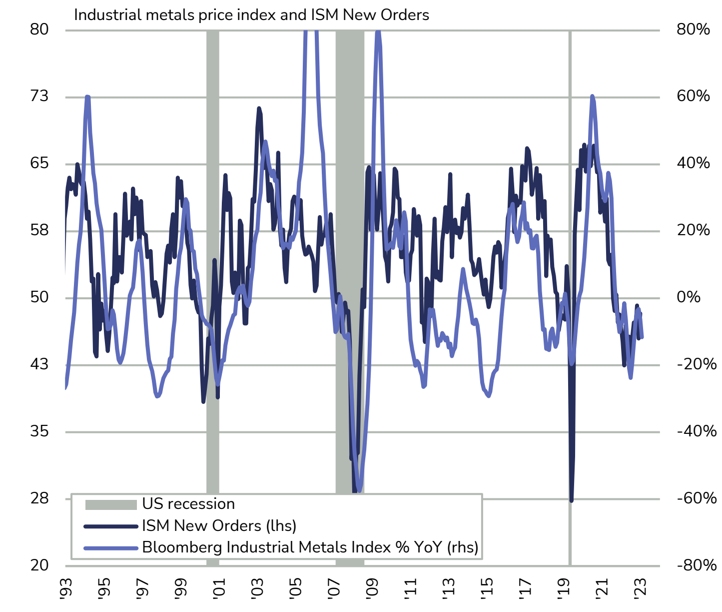
Cyclical play

- *Oil*. Despite the conflict in the Middle East and OPEC+ coordinated actions in 2023, the price of oil is down -4% YoY (Nov/Nov, both Brent and WTI). We see the deceleration of the global economy and overall decarbonization trends as the main reasons for that. Though switching to green energy seems to be an unbreakable multidecade process that decreases demand for fossil fuel and its price, we may see a moderate rise in oil prices on the back of economy acceleration (**fig. 1**).
- *Industrial metals* can also perform well in an acceleration phase (**fig. 2**). However, sluggish economic growth in China, the major consumer of base metals, could undermine a price recovery.
- *Gold* was holding quite well in 2023 (+15% YoY Nov/Nov) despite high interest rates in anticipation of softer monetary policy. Though we believe that gold is fundamentally overpriced, the positive momentum may still prevail in 2024 (**fig. 3**).
- *Agricultural goods*' prices are down on a YoY basis on average, e.g. strong cocoa (+69%)and sugar prices (41%) are offset by negative dynamics in wheat (-27%) and rapeseed (-25%). None of the supply chain risks materialized in 2023. Relatively high global temperatures in 2023 caused by El Niño were, in general, supportive for crops and negative for prices. According to NOAA, normalization of temperatures may occur by the end of 1H24, which is likely to support the prices of soft commodities.

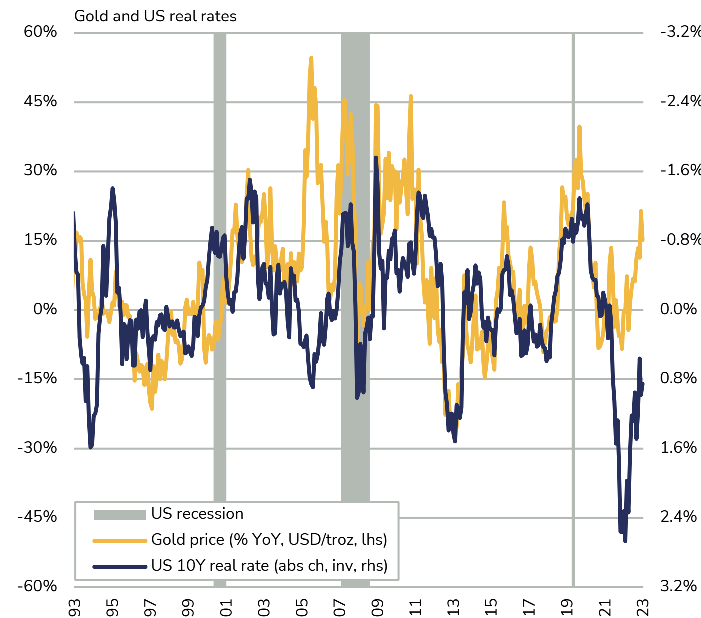
1. Oil prices may benefit from activity pick up...



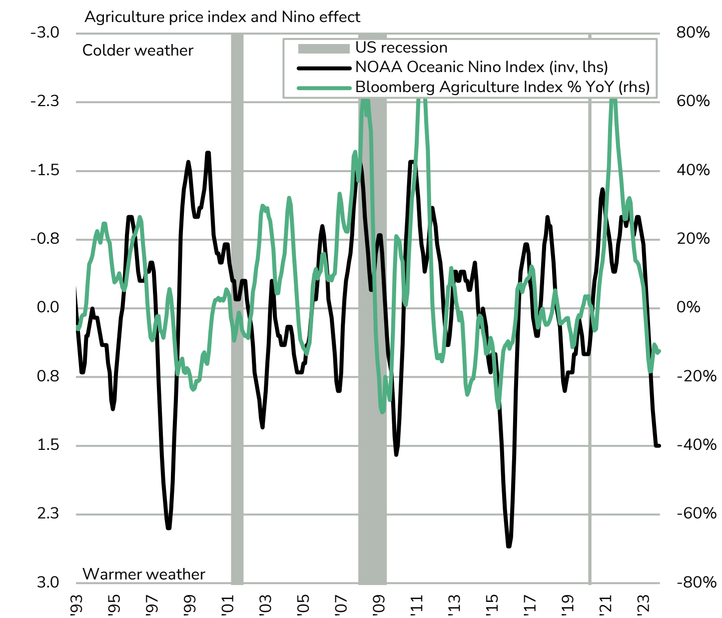
2. ...As well as prices of base metals.



3. Gold shrugged off high rates, may rise further.



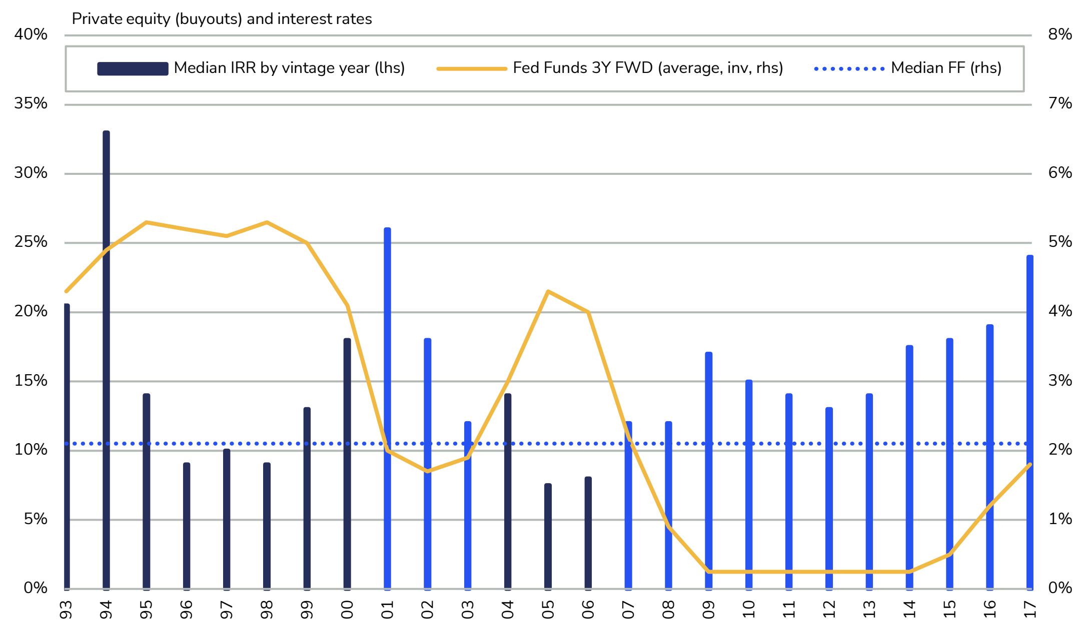
4. Low agricultural prices amid warm weather.



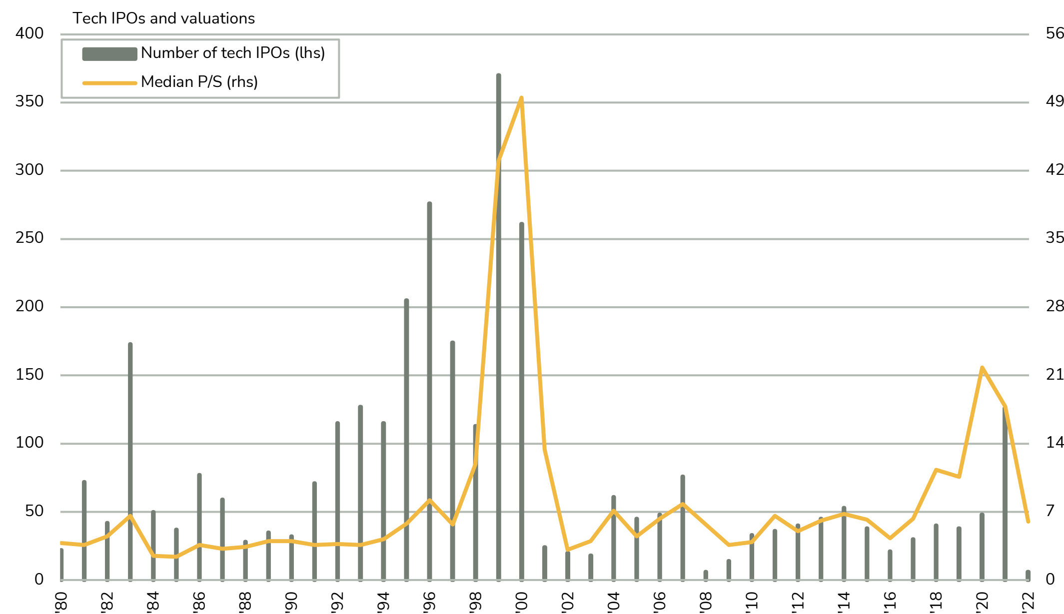
Charts source. (1, 2, 3) Bloomberg. (4) NOAA, Bloomberg.

Private equity and venture capital
What goes up, must go down

1. Private equity returns were skewed up during to zero rate policy periods.



2. Small dotcom bubble of 2020—2021 is now burst.



PE and VC firms will struggle to deliver high returns amid normal interest rates

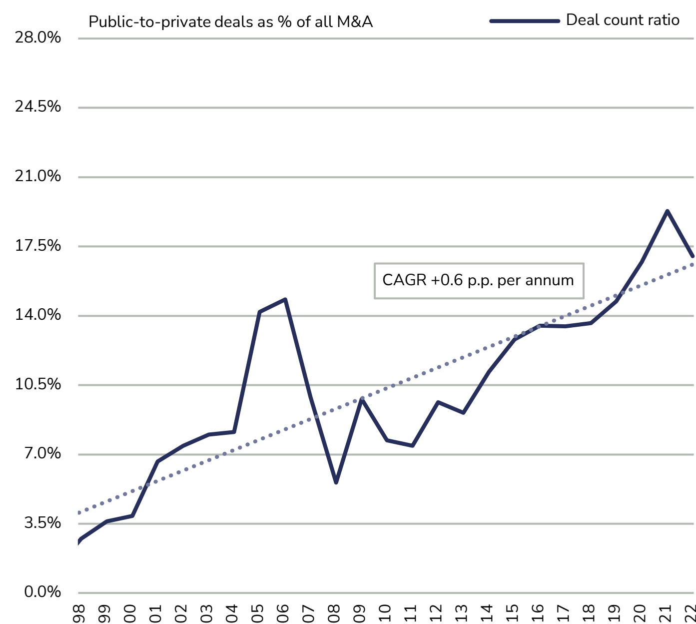
- Normalization of interest rates and monetary policy means the end of substantial outperformance of private equity and venture capital products, in our view. And if risk/reward ratios are adjusted for liquidity, PE and VC products will most likely lag behind publicly traded peers.
- A sizeable portion of PE/VC outperformance comes from access to cheap and abundant liquidity. In 2008—2021, even conservative investors were switching from close-to-zero yields in traditional bonds to non-zero returns in PE/VC space, and they were ready to take additional market and liquidity risks investing in such assets.
- PE/VC funds that managed to attract money in the beginning of the low interest rate environment (**fig. 1**, light blue) were likely to outperform funds that were operating amid higher rates (**fig. 1**, dark blue).
- According to our calculations, the top-6 PE firms have increased AUM by a factor of 7.4x in 2008—2021. While the top-14 traditional public markets managers by a factor of 4.9x.

- Such demand created a Ponzi-like strategy, which drove valuations to unsustainably high levels (**fig. 2**). When private companies in the tech space were making IPOs, they were able to sell shares at valuations exceeding 21x P/S, which is the second highest by historical standards and 3—4 times higher than during 2002—2019.
- The drawdown in the index of unprofitable technology companies calculated by Morgan Stanley exceeds 61% (Feb'21—Nov'23). The famous ARK Innovation ETF is down more than 70% from peak levels (same period). At the same time, the VC funds index calculated by Cambridge Associates is down only 21% from its local peak (Dec'21—Jun'23).
- We believe that low-quality investments in PE/VC space are still generally overvalued. Investors in PE/VC products may face multi-year underperformance vs public peers.

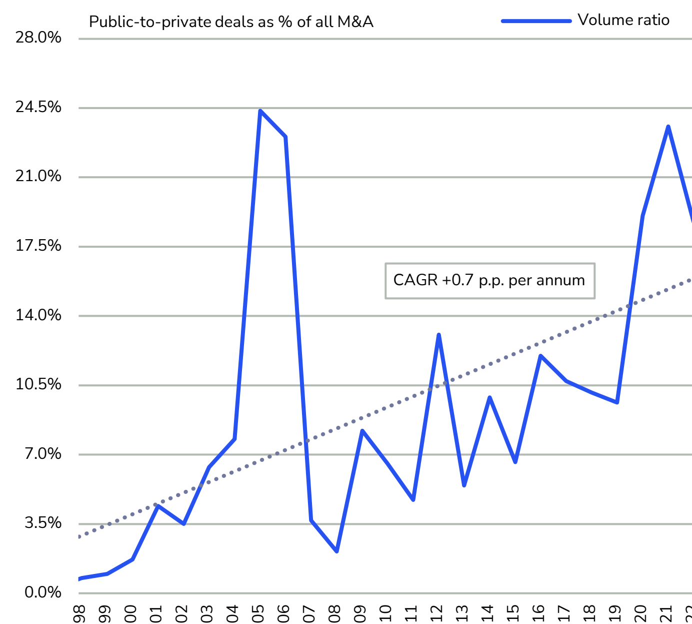
Charts source. (1) Cambridge Associates, Goldman Sachs, Bloomberg. (2) Warrington College of Business.

Private equity and venture capital. Public to private deals
Doing private? Think public

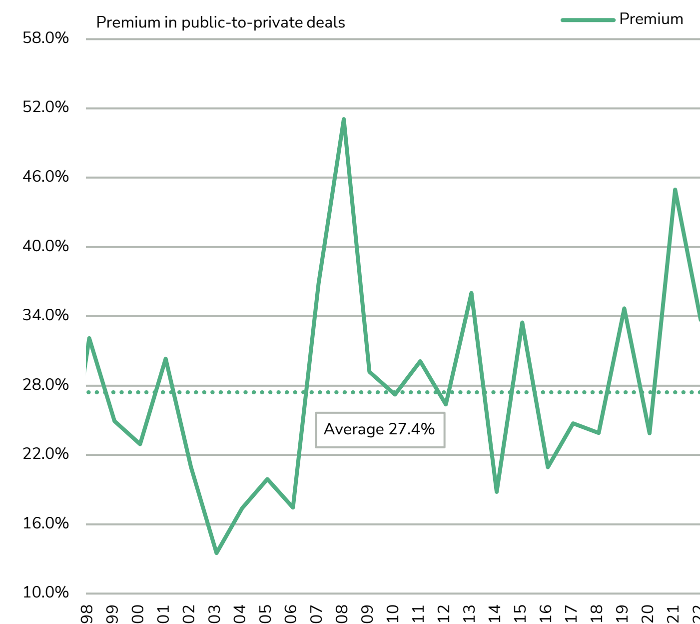
1. Public-to-private deals are getting popular...



2. ...And bigger.



3. Taking private requires paying hefty premium.



There are more opportunities on public side

- Although private market valuations declined from c.10x EV/EBITDA in 2021 to 8.8x in 1H23, global M&A deal activity has declined by 34% and 32% in value and deal count terms, respectively (source: here and in other paragraphs on this page — PitchBook M&A Report 2Q23).
- This negative trend is explained by several factors, including (a) seller-buyer valuation disconnect, (b) high interest rates, (c) changes in capital structure of leveraged buyouts.
- At the same time, the amount of unspent dry powder that has yet to be called and invested by these sponsors is estimated at the level of $1.35 trln, just 9.7% shy of its all-time high.

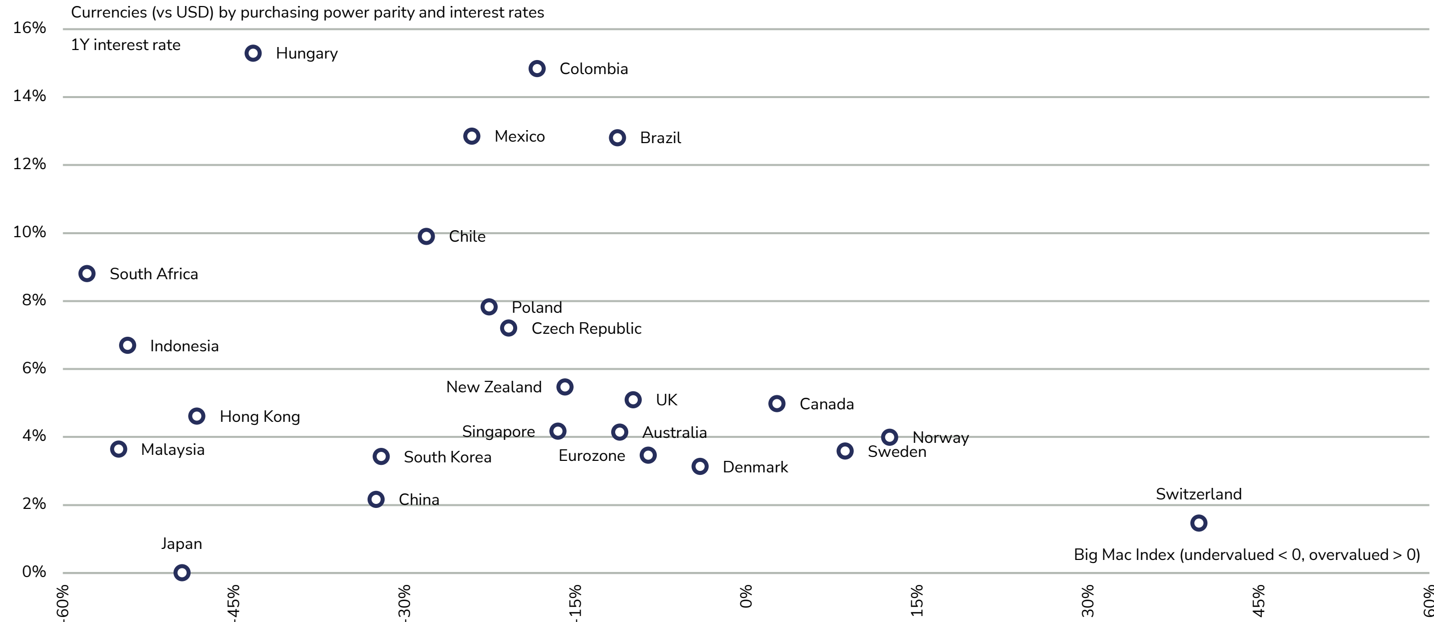
- A period of high interest rates proved to be a challenging environment for private equity investments as leveraged buyout deal economics stopped working in favor of so-called financial sponsors.
- Given that financial sponsors rely on floating-rate debt to finance leveraged buyout transactions, the yield-to-maturity of leveraged buyout loans increased to 9.5% in 1H23 vs 6.2% in 1H22.
- Simultaneously, PE funds need to decrease debt to keep interest costs in check. Debt as a percentage of LBO enterprise value has averaged 43.3% on broadly syndicated loans so far this year, down sharply from its five-year average of 52.2%

- Still-depressed public equity valuations of mid and small caps provide an opportunity for both well-capitalized public firms and private equity to purchase undervalued businesses
- The deal count of public-to-private deals as a percent of all M&A deals is at 17.4% and flirting around all-time highs (**fig. 1**). The same conclusion can be drawn about the volume of public-to-private deals as a percent of all M&A deals (**fig. 2**). Private equity buyers are more enthusiastic about public equities than opportunities in the private space.
- Moreover, financial sponsors are happy to pay a 35% premium to public market valuation levels, well above historic averages of 27% (**fig. 3**).

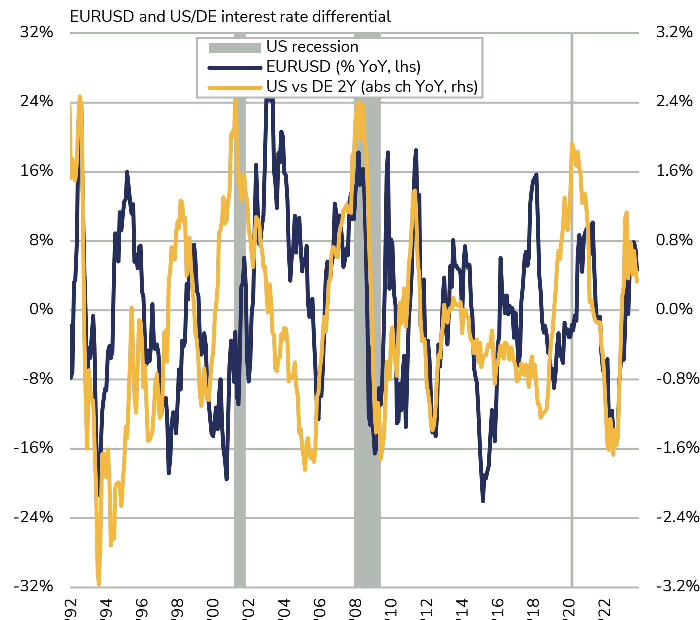
Charts source. (1, 2, 3) Bloomberg.

Currencies
All the things I could do

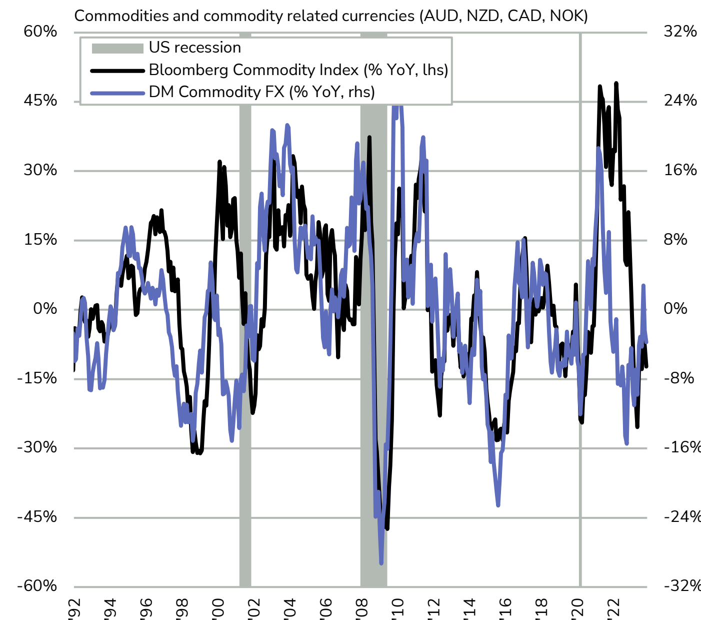
1. Risk takers may get extra carry performance in non-major currencies and even count on appreciation.



1. EUR may appreciate vs USD on hawkish ECB.



2. Commodity currencies are fairly priced.



Interest rates will drive FX movements

- CHF and GBP were the best-performing developed market currencies in 2023 (+7.8% and +3.8%, here and after — % YoY Nov/Nov vs USD). GBP has recovered after the budget and government mess in 3Q22, while CHF proved its European safe heaven status once again. NOK was the worst performer in 2023 (-8.8%) on the decline in oil prices, while the second-worst JPY (-7.8%) was a victim of the Bank of Japan's policy to keep interest rates relatively low.
- The Fed sticks to its restrictive policy to keep base rates high, which supports inflows into the USD. Other than USD, major global currencies, e.g. GBP, NZD, AUD, may appear undervalued on a PPP basis (**fig. 1**, horizontal, Big Mac Index), while providing comparable interest returns. High risk tolerant investors may receive mid-teen yields in BRL, MXN, COP and HUF with a chance of appreciation vs USD. However, we would highlight that these currencies, among other EM, experience multi-decade devaluation trends interrupted by strong but short-lived revaluations.
- EURUSD dynamics are a "*who blinks first*" game between the Fed and ECB (**fig. 2**). Should the Fed cut the rates first or simply provide any relevant guidance, this would drive EURUSD further up (+3.5% YoY). This is our base-case scenario for 2024.
- Commodity-related developed market currencies (AUD, NZD, CAD, NOK) seem to be fairly priced against commodity indices (**fig. 3**). Sideways trading with slight appreciation is our base case for the next year.

Charts source. (1) The Economist, Bloomberg. (2, 3) Bloomberg, proprietary calculations.

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