Investment Outlook

A monthly round-up of global markets and trends

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The Great Escape for equities

An apt way to describe how equities performed in 2023 can be taken from the title of the classic Second World War film, *'The Great Escape'.* Stocks rallied as the global economy escaped the worst scenario of a sharp downturn after the biggest inflation and interest rate shock for 40 years.

Of course, it's not been entirely plain sailing. Rising bond yields, fears of a deep recession, inflation and a lack of market breadth have periodically led to bouts of market volatility. Despite this, the MSCI All Country World equity benchmark index broke out of its roller coaster range that began in early 2022 when Jerome Powell, Chair of the Federal Reserve, warned of higher future US interest rates.

Sticking with the Hollywood theme, the key macro drivers in 2024 follow on from last year and can be characterised by the titles of three other films. First, there's *'9 to 5'*, the 1980 comedy starring Dolly Parton that captures life in a US office environment. As more jobs are created, aggregate hours worked across the economy increase and so does take-home pay, which supports consumption. While the US unemployment rate rose slightly last year, this is due to more people moving back into the labour force, attracted by higher wages, and out of necessity as the cost-of-living crisis bites. Looking forward to 2024, a gradual increase in the labour supply can reduce the risk of economic overheating and extend the business cycle.

Second is *'Rear Window'*. Just as in the 1954 Alfred Hitchcock film, central bankers were caught watching and waiting when the pandemic-led inflation shock took hold, forcing them to raise interest rates sharply. However, they will be relieved that inflation is now decelerating, providing room for interest rate cuts in 2024. The Fed's December economic projections now show three rate cuts by the end of 2024. If history is any guide, the state of the economy will be an important determinant of equity performance. Since 1974, the Fed has delivered eight interest rate cutting cycles, with a recession materialising on four occasions. When the US economy managed to avoid a recession during these cycles, the S&P 500 rose by an average of 18% over the following 12 months. However, when the economy moved into recession, the stock market fell by an average of 8% over the same time frame.[1]

And finally, there's *'The Magnificent Seven'.* The title of the famous Western movie captures the Artificial Intelligence (AI)-related theme of the so-called magnificent seven stocks of Alphabet (formerly Google), Apple, Amazon, Microsoft, Meta (formerly Facebook), Nvidia and Tesla. These companies dominated markets in 2023, delivering returns of 107% to investors. The strong gains seen in the AI space should lead to increased business confidence, manufacturing activity and greater company investment. Analysts expect Nvidia, a chip designer whose products are extensively used in AI hardware, to post 67% revenue growth in 2024, after a 100%-plus gain in 2023.[2]

Five market themes for 2024

1. **Equities to outperform bonds:** Solid top-line sales growth and resilient corporate pricing power can keep profit margins elevated, which can support company earnings and share prices. The backdrop for bonds is also positive, as central banks are expected to cut interest rates and that should lead to higher bond prices. Nevertheless, given the balance of risks, equities probably look a better option at current valuations.
2. **US stock market rally to broaden out:** If the US avoids a recession, then we could see the market broaden out beyond AI-led stocks to unloved areas of the market, like energy and small caps. Even so, core quality stocks that typically have strong balance sheets, stable sales, attractive margins and generate cashflow still have a place in portfolios over the business cycle, including the AI-related stocks.
3. **Favour UK internationals:** The UK large cap equity market can, broadly speaking, be split into domestics and internationals. Domestics earn a higher share of their revenue in the UK and internationals earn a higher share overseas. While both types of company can play an important role in portfolios, in 2024 we favour internationals over domestics for two reasons. First, internationals are more exposed to the global economy, which we expect to perform better than the UK economy. Second, internationals offer better relative value given their more favourable earnings outlook. The risk to this view is that domestics could receive a sizeable relative boost if we see a stronger pound this year.
4. **Tailwinds to support government bonds:** For most of last year, it looked like government bonds were on course to post two consecutive years of negative returns. But investors were saved in the final quarter of the year when government bonds rallied strongly. In 2024, we expect a more favourable environment as growth slows, inflation continues to decelerate and central banks start cutting interest rates. With the UK's growth outlook looking weaker than its peers, we like exposure to the gilt market.
5. **US dollar depreciation and gold appreciation:** Expect the US dollar to depreciate as reviving risk appetite and the overvaluation of the greenback against other major currencies unwinds. Gold should benefit given its role as a portfolio diversifier and an alternative to the fiat currency debasement associated with rising government debt. This was particularly notable during the bond and equity sell-off in 2022 when the gold bullion price was largely flat.

In summary, the inflation shock of 2022 did not morph into a growth shock in 2023, reducing hard landing fears. As interest rates start to come down this could release liquidity into the financial system - Goldman Sachs, an investment bank, estimates that in 2023 investors poured $1.4tn into US money market funds (i.e. quasi-cash instruments) and just $95bn into US equities.[3] A potential release of this liquidity creates opportunities across equity markets, in UK internationals, gilts and gold in 2024, with the US dollar set to be the big loser.

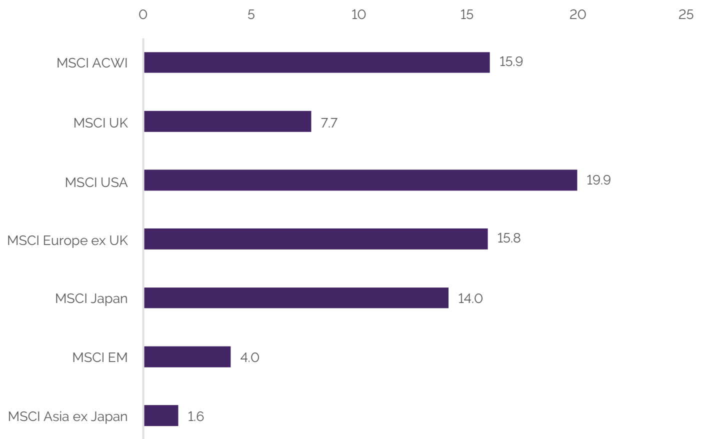
Sources:
[1] LSEG Datastream/Evelyn Partners
[2] Bloomberg
[3] Goldman Sachs, US weekly kickstart, 15 December 2023

Market highlights

Equities

Last year began with a majority of economists forecasting a recession in advanced economies, but, overall, growth remained surprisingly resilient through the year. This contributed to a good year for global equity markets, which increased by 15.9% for sterling investors. The bulk of these returns occurred in the last two months of the year as markets began to anticipate interest rate cuts sooner than had been expected. The US equity market was the star performer, with the MSCI USA Index returning 19.9% in sterling terms. Positive investor sentiment towards artificial intelligence (AI) following the release of new generative AI technologies aided this outperformance. Europe fared better than expected as a major energy shortage was averted. The UK underperformed other major regions due to its bias towards defensive 'value' sectors such as healthcare, consumer staples and materials, but still returned 7.7% for the year. Asia struggled as the reopening of China's economy failed to meet investors' lofty expectations.

Equity performance in 2023 (%)

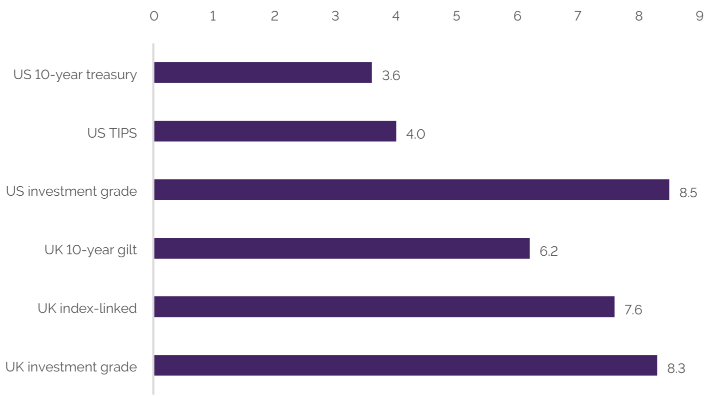


Source: LSEG Datastream/Evelyn Partners,
Performance as total returns in pounds sterling as at 31 December 2023
Past performance is not a guide to future performance

Fixed income

Rising interest rates, increasing bond issuance and stronger-than-expected economic data pushed US treasury bond yields higher for most of the year. As a result, the US 10-year bond yield hit 5%, its highest level since July 2007. This, coupled with weak performance in 2022, meant that US 10-year treasury holders experienced one of the largest peak-to-trough drawdowns in history. However, towards the end of the year, inflation fell faster than expected, causing the US Federal Reserve (Fed) to drop its 'higher for longer' stance on interest rates and begin to signal interest rate cuts in 2024. This downward movement in interest rate expectations helped drive bond yields lower: the US 10-year treasury yield has fallen by over 1 percentage point since the middle of October when treasury yields peaked (yields move inversely to prices). Corporate bonds also benefited from falling rate expectations and credit spreads (the extra yield on a corporate bond compared to a government bond) tightening.

Fixed income performance in 2023 (%)

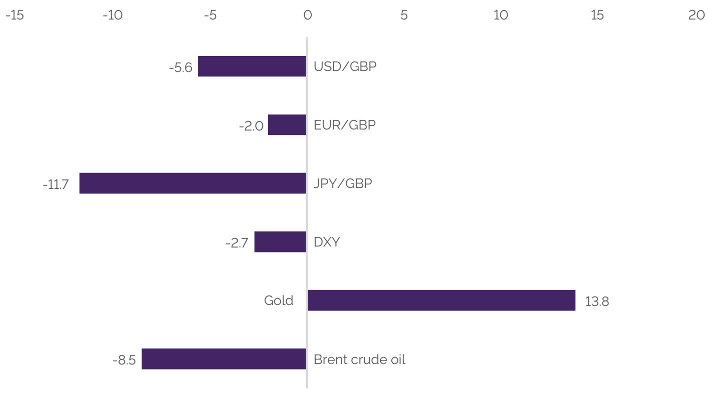


Source: LSEG Datastream/Evelyn Partners,
Performance as total returns in local currency terms as at 31 December 2023
Past performance is not a guide to future performance

Currencies and commodities

It was a volatile year for the US dollar (USD), with the currency rallying during the summer as the Fed's rhetoric pointed to interest rates remaining elevated for longer. However, during the final months of 2023, US interest rate expectations fell relative to those in the rest of the world. This led to a weaker greenback to close out the year - relative to sterling, the US dollar depreciated to $1.27. The backdrop of geopolitical instability led to a volatile year for commodities. Despite OPEC+ oil supply cuts, Brent crude fell by 8.5% during 2023, whereas a more favourable interest rate outlook and increased purchases by central banks proved supportive for gold. The yellow metal rallied by 13.8% in 2023, briefly making new all-time highs in December before retreating slightly to end the year at $2,065/troy oz.

Currencies and commodities performance in 2023 (%)



Source: LSEG Datastream/Evelyn Partners,
Performance in US dollars as at 31 December 2023
Past performance is not a guide to future performance

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	4.1	6.4	15.9	78.2
MSCI UK	3.8	2.3	7.7	39.5
MSCI UK Broad	4.4	3.2	8.0	36.3
MSCI USA	4.0	7.2	19.9	107.5
MSCI Europe ex UK	4.4	7.6	15.8	66.1
MSCI Japan	3.7	3.6	14.0	42.2
MSCI Asia Pacific ex Japan	8.3	6.7	0.5	32.7
MSCI Emerging Markets	3.2	3.3	4.0	22.0
Bonds				
iBoxx GBP Gilts	5.7	8.5	3.6	-14.1
iBoxx USD Treasuries	2.7	1.2	-1.8	2.3
iBoxx GBP Corporate	4.6	8.2	9.7	4.6
Commodities and trade-weighted currencies				
Oil Brent Crude ($/barrel)	-3.7	-18.6	-8.5	46.2
Gold ($/ounce)	1.4	11.2	13.8	61.2
GBP/USD	0.7	4.4	6.0	0.1
GBP/EUR	-0.5	0.1	2.4	3.6
EUR/USD	1.2	4.3	3.5	-3.4
USD/JPY	-4.6	-5.5	6.8	28.5

Market commentary

The final month of the year provided investors with some festive cheer as the so-called 'Santa rally' - the tendency for the stock market to increase during the Christmas season - came to fruition. December's meeting of the Federal Open Market Committee (the group responsible for setting interest rates in the US) saw amended forward guidance, indicating they expect to cut interest rates three times in 2024. This change saw risk assets rally across the board, with the MSCI All Country World Index delivering returns of 4.1% in sterling terms for the month. Fixed income securities also delivered strong returns, with gilts gaining 5.7% and sterling corporate bonds returning 4.6%. Gold continued its rally, leading to its price increasing 11.2% over the last quarter.

Key macro data	Latest	2024 Consensus forecast	Spot rates	31-Dec	Yields (%)	31-Dec
UK GDP (YoY%)	0.27	0.30	GBP/USD	1.27	MSCI UK	4.08
UK CPI Inflation (YoY%)	3.90	3.00	GBP/Euro	1.15	MSCI UK broad	3.96
Bank of England Base	5.25	4.50	Euro/USD	1.10	10 Year Gilt	3.72

The market commentary, values and charts as at 31 December 2023. Total returns in sterling. Returns are shown on a total return (TR) basis ie including dividends reinvested (unless otherwise stated). Net return (NR) is total return including dividends reinvested after the deduction of withholding tax. Source: LSEG Datastream/Bloomberg

Sources

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