BIL Investment Outlook 2024

NOTHING BUT SUN AND THE GRASS WHICH LOOKS GREEN?

BANQUE
INTERNATIONALE
À LUXEMBOURG

2024 INVESTMENT OUTLOOK

01

Macroeconomic Outlook

- Below-trend global growth expected as the impact of policy tightening seeps into the real economy (normally happens with an 18-24 month lag).
- Soft landing scenario increasingly likely in the US. If we do see a contraction, expect it to be short and sweet
- The euro zone might already be in recession and there are very few catalysts for a rebound. Meagre full-year growth is the best case scenario, while an external shock could push the bloc into a deeper downturn.

02

Central Bank Outlook

- Headline inflation is retreating meaning central banks have probably concluded their hiking cycles. Markets appear overoptimistic about the number of rate cuts we will see in 2024.
- The Fed has adopted a dovish stance and pencils in 75bp of rate cuts in 2024. Amid lingering wage pressures, the ECB has not yet discussed rate cuts.

03

Fixed Income

- With yields now at some of the most attractive levels seen in decades, 2024 will be about actively managing duration in order to lock in income. We especially like investment grade bonds, given that corporate fundamentals are strong and maturity walls are well-managed.
- We are prudent on High Yield, with the uncertain economic outlook compelling us to play at the higher end of the quality curve.

04

Gold

- While some consolidation is possible in the short-term, we are constructive over the longer-term, with the gold price typically rising in the run up to and in the aftermath of the first rate cut of a cycle.

05

Oil

- We predict that the oil market will find itself in surplus over the first half of 2024 amid a dramatic slowdown in the pace of demand growth. OPEC+ production cuts and geopolitics may put a floor under the price.

06

Equities

- Earnings delivery will be a key catalyst for markets next year and this could be more challenging for firms in a slower growth environment. Rather than fighting against the current sentiment, we enter the year with a moderate allocation to equities, albeit using a bottom-up approach, focusing on companies with strong individual investment cases.
- We are slightly overweight on the US, neutral on China, Emerging Markets and Japan, and tactically underweight Europe.
- Taking a more strategic view, investors shouldn't ignore the mega trends reshaping the world around us: digitalisation, the sustainable transition and healthcare innovation.

07

Private Markets

- Private equity valuations have decreased substantially, offering opportunities, especially in the secondary space. We particularly like sectors with secular growth that are benefitting from broader market tailwinds, such as infrastructure, digitalisation and renewables.
- In private credit, 2024 is poised to be a "golden year" for new vintages. With interest rates much higher and capital more scarce, private debt providers can fill the gap left by traditional lenders. Recent past vintages may struggle amid an economic downturn if there hasn't been considerable underwriting discipline.

BIL
1856

INTRODUCTION

Lionel De Broux

GROUP CHIEF
INVESTMENT OFFICER

As at 15 December 2023

NOTHING BUT SUN... AND THE GRASS, WHICH LOOKS GREEN?

Our title this year is borrowed from Blue Beard, a French folktale, the most famous surviving version of which was written by Charles Perrault and published in Paris in 1697. It is taken from a scene in which the central character, whose life is in imminent danger, has asked her sister to look out the window to see if her brothers are on the way to rescue her. Sister Anne, as she is called, strains her eyes looking out across the horizon but she repeatedly says that she sees "nothing but the sun... and the grass, which looks green".

Economists and market participants can likely relate. At the onset of 2023, amid one of the fastest central bank hiking campaigns on record, the wide consensus expectation was for a recession within the next twelve months. However, despite several leading indicators flashing red, it never arrived. In fact, the US economy has churned out even stronger growth this year than it did in 2022, while the euro zone has broadly stagnated.

With the economy resilient and demand still strong, the battle against inflation trundled on, with core readings proving particularly sticky. Central banks adopted a hawkish "higher for longer" stance which weighed heavily on bonds up until Q4, when investors rushed to bake in rate cut bets. Equities managed a strong year, wrongfooting those who adopted more defensive portfolio positioning in anticipation of a downturn.

But what's important now is what happens next.

Returning to the Blue Beard tale, in the eleventh hour, a cloud of dust on the horizon signals the arrival of the brothers on horseback and Blue Beard meets his fate. From an economic point of view, it appears that the economic landing that seemed so certain to arrive in 2023 may simply have been delayed as well.

2024 is expected to bring below-trend global growth as tighter financial conditions continue making their way into the real economy. The good news is that headline inflation continues to retreat, meaning that major central banks have likely concluded their hiking cycles. However, we think the market is too optimistic about the number of cuts they will deliver.

Geopolitical tensions are likely to remain elevated and, at the same time, it will be the biggest election year in history. Not only will we have the highly polarised US Presidential election in November, 39 other countries will hold elections. That means roughly 41% of the global population will take to the polls in the next twelve months. As the tectonic plates of power shift, policy uncertainty will be higher.[1]

1 https://www.bloomberg.com/news/newsletters/2023-11-01/2024-is-election-year-in-40-countries-and-podcast-elon-inc-launches-next-week

BIL 1856

Slower growth, overoptimism about policy easing, [geo]political uncertainty and relatively high valuations present a challenging terrain for risk assets in the first half of 2024.

In the equity space, this merits a defensive allocation, with quality being the name of the game. The exception is our overweight to IT, a more aggressive sector that we believe will be supported by a recovery in hardware and an expansion of the cloud. Regionally, we enter the year with a mild overweight on US equities, while being neutral Emerging Markets, Japan and China. We are tactically underweight Europe.

In the bond space, we've spent the past twelve months gradually building up duration and yield-generating capabilities. This proved beneficial amid the recent repricing which saw the market front-load the bulk of 2024's potential capital gains in the space of a few weeks. Now, as expectations about the timing and magnitude of rate cuts are buffeted by cross currents of central bank communication, macro data, hope and fear, our objective is to actively manage duration and size opportunities to capture and lock in income. We see the most value in investment grade credit, where yields have approached their most attractive levels since the great financial crisis. At the same time, corporate balance sheets in this segment appear robust enough to weather a macro slowdown.

More strategically, we will be on the lookout for entry points that enable us to strengthen our exposure to dovetailing structural shifts that are actively and rapidly reshaping the world around us:

- Digitalisation, big data and the AI revolution
- The sustainable transition
- Healthcare innovation, primarily in biotechnology and oncology

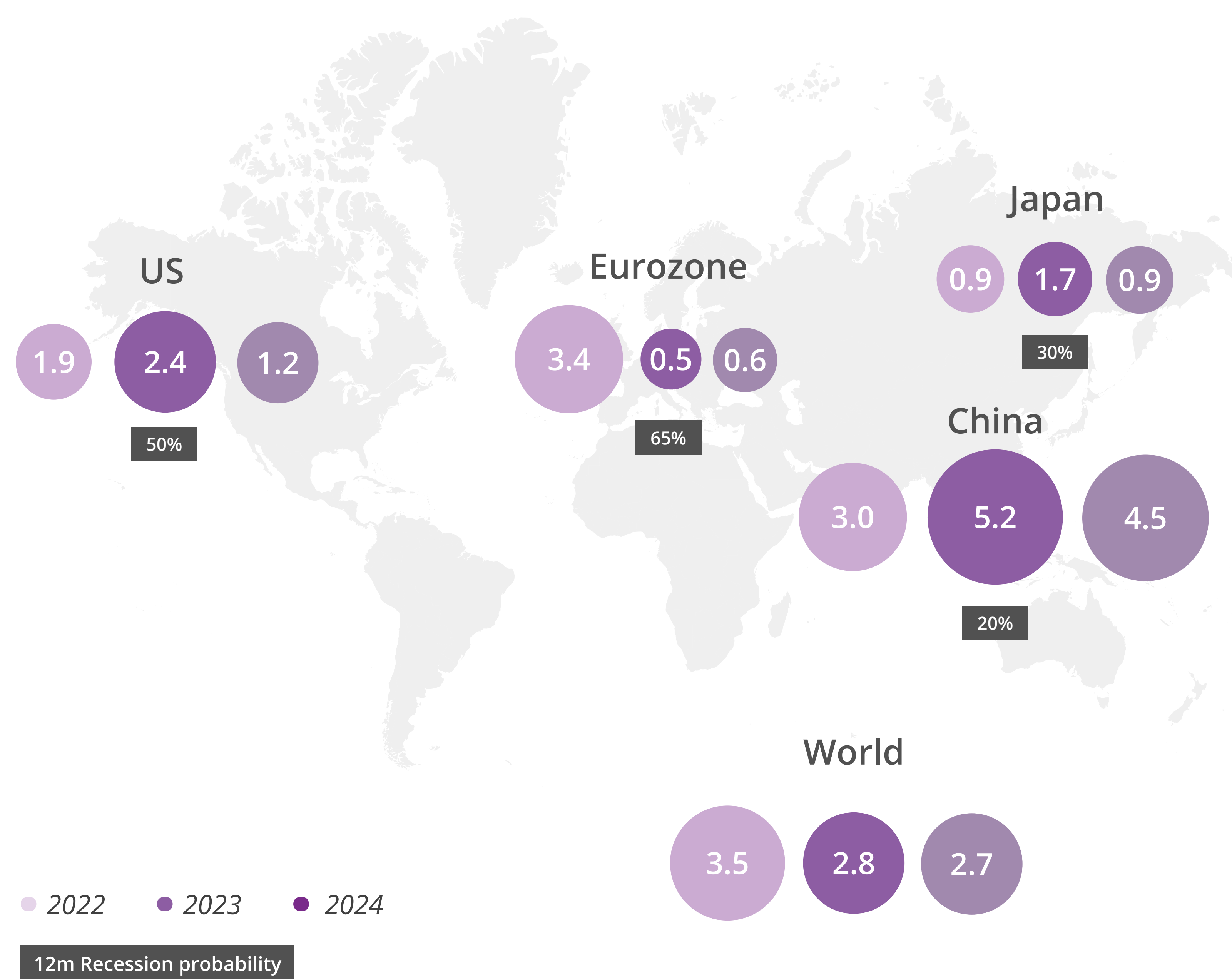
2023 has proven that such themes are not immune to the ups and downs of the traditional economic cycle; this should be used to our advantage.

Lionel De Broux
Group CIO, BIL

BIL 1856

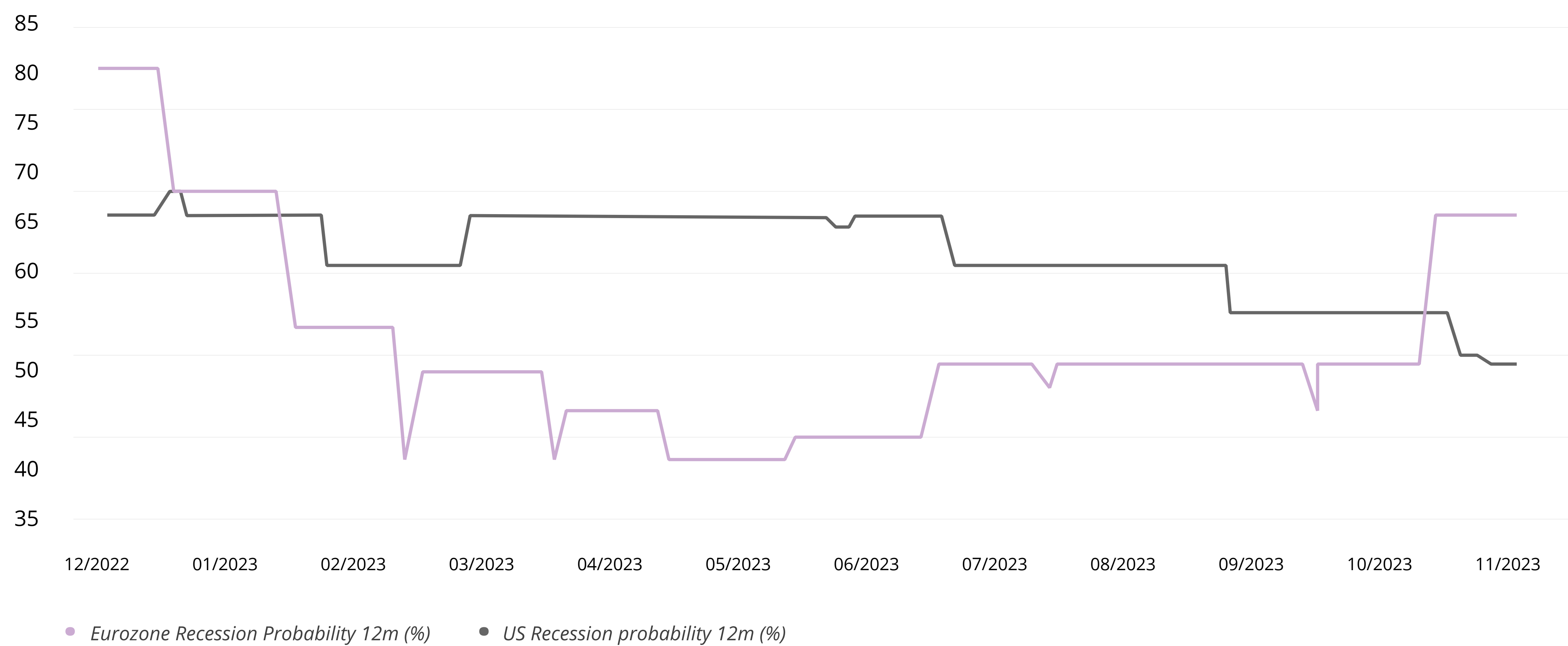
MACROECONOMIC OUTLOOK

Bloomberg Consensus Expectations for Real GDP Growth (%, YoY)



Source: Bloomberg, BIL. As at 11/12/23

At the end onset of 2023, investors expecting a recession adopted defensive positioning



Source: Bloomberg Consensus Forecasts, BIL

GLOBAL OVERVIEW

Restrictive policy will begin to have more tangible effects on corporate investment and consumption.

Over the next few quarters, and after impressive resilience that caught many investors off guard, the USD 100 trillion global economy[2] will have to catch its breath. With macro headwinds gathering overhead, the IMF expects full-year global growth of 2.9% in 2024, whereas Bloomberg consensus estimates put it at 2.7%: both fall well below the historical average of 3.8%.[3]

One of the key headwinds will be tighter financial conditions. An old rule of thumb is that it takes around 18 to 24 months for changes in monetary policy to show up in the real economy. Given that the Fed kicked off its rate hiking campaign in March 2022, and the ECB in the following July, we are far from being out of the danger zone with regard to moves they have already made.

Having already plunged housing markets into a deep freeze, as we move into 2024, restrictive policy will begin to have more tangible effects on corporate investment and consumption. Simultaneously, fiscal policy is set to become a drag, potentially subtracting around 0.3 percentage points from growth in developed markets next year.

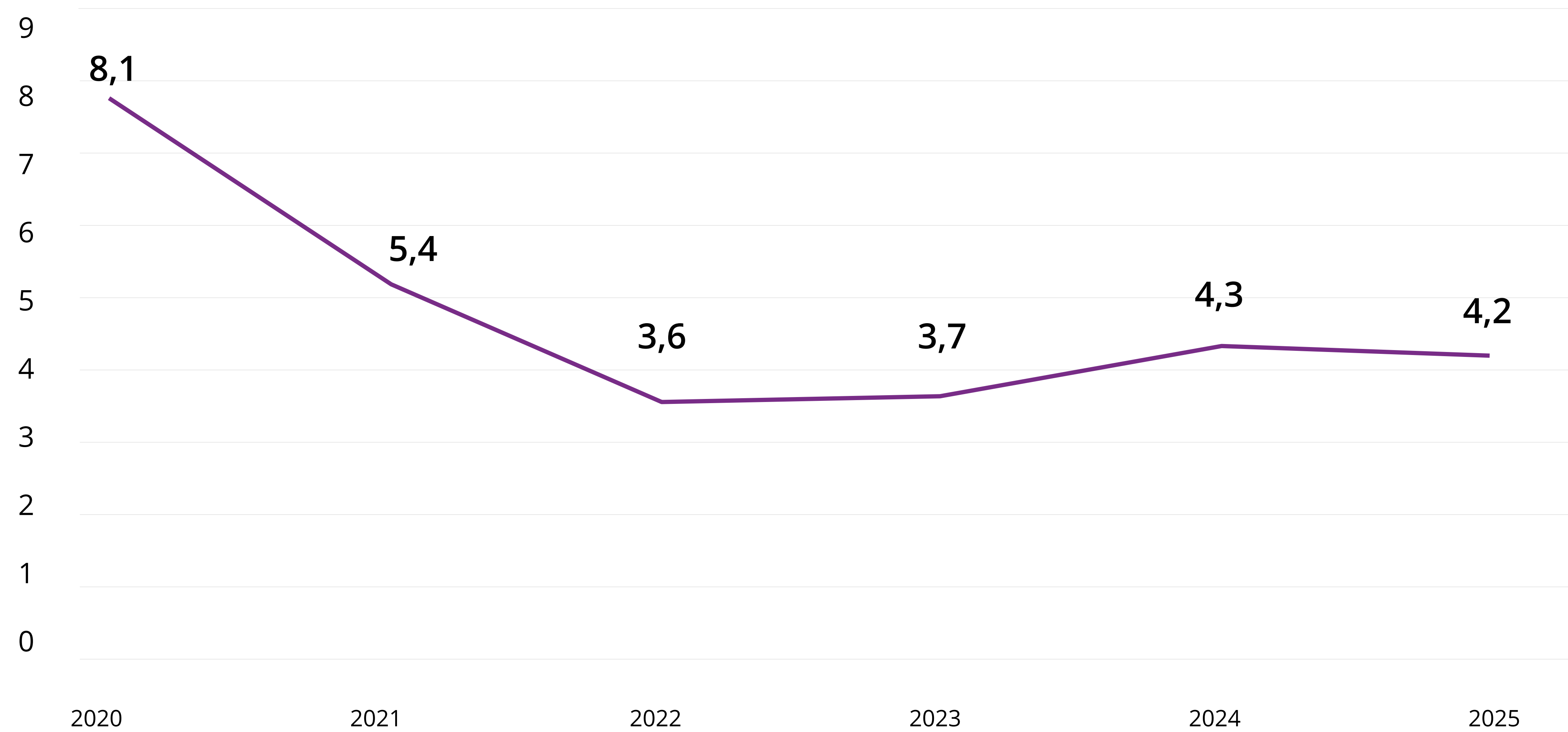
The silver lining is that throughout 2024, no major uptick in unemployment is forecast, which should help guard against a deeper downturn on both sides of the Atlantic.

The US stands out as the region sturdy enough to avoid recession. The outlook for the euro zone has deteriorated rapidly and we forecast another quarter of mildly negative growth in Q4, meeting the definition of a technical recession after -0.1% growth in Q3. From there, the best case scenario is meagre full-year growth, with very few catalysts for an upswing. An external shock risks tipping the euro zone into a deeper recession.

The silver lining is that throughout 2024, no major uptick in unemployment is forecast, which should help guard against a deeper downturn on both sides of the Atlantic. The reason for labour markets' relative resilience is multifaceted, ranging from demographics and a shrinking workforce to the fact that corporate balance sheets are much stronger than they were before prior slowdowns. Additionally, companies appear reluctant to make layoffs following the "Great Resignation" that made it very difficult to attract and retain talent.

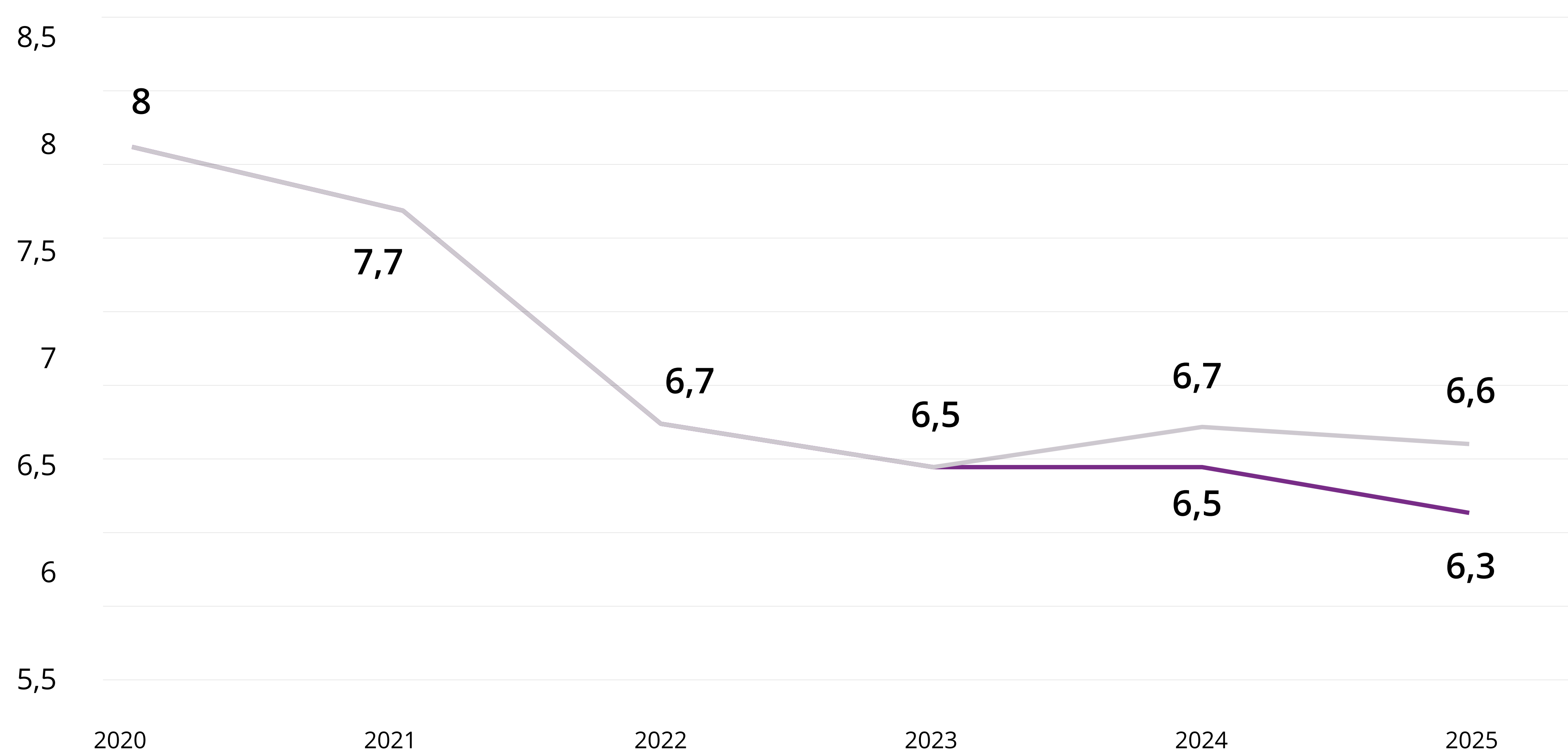
2 According to Statista
3 From 2000-2019. Source: IMF

US Unemployment Rate (%)
Actual and Bloomberg Consensus Expectations



Source: Bloomberg

Euro Area Unemployment Rate (%)
Actual and Expected



European Commission Autumn Forecast *Bloomberg Concensus*

Source: Bloomberg

THE US: SLOWING DOWN FROM A POSITION OF STRENGTH

As we move into 2024, long-anticipated headwinds will start eating away at US consumers' willingness and ability to continue spending.

Pandemic excess savings to the tune of USD 2.1 trillion have now largely been spent, and the hiatus on student loan repayments has come to an end.

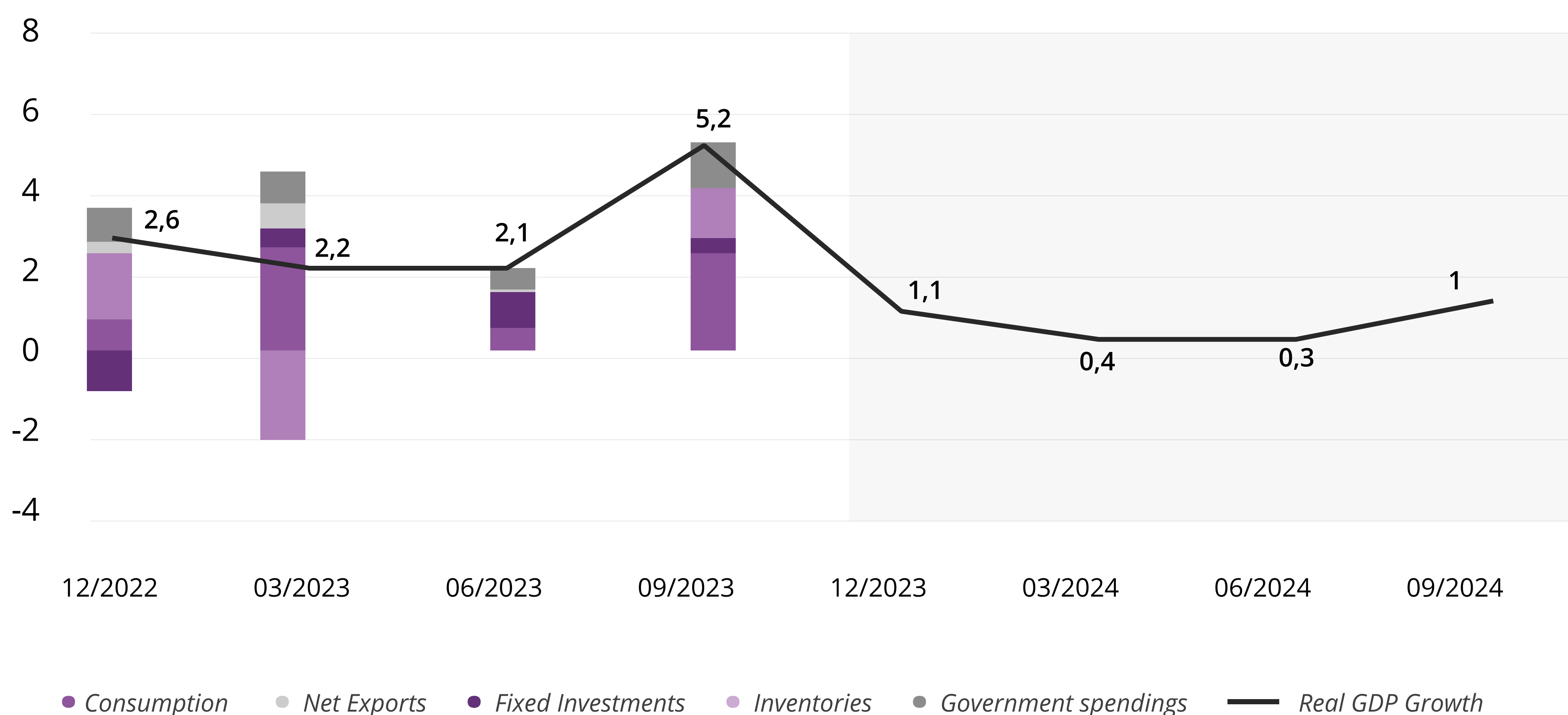
We expect the pace of US growth to slow meaningfully in 2024, coming in at less than half of what it was in 2023. Current data suggest it can avoid sub-zero growth. If a contraction does materialise, we believe it will be both short and shallow.

Much of the US economy's strength has been attributable to its seemingly infallible consumers. Supported by strong labour markets, residual pandemic savings and the fact that only about 10% of mortgages are variable (versus 30% in the euro zone), US households have been spending like it's 1999. The most up-to-date data from Black Friday and Cyber Monday show that they have not yet capitulated.

However, as we move into 2024, long-anticipated headwinds will start eating away at US consumers' willingness and ability to continue spending. Confidence has eased in recent months, indebtedness is on the rise, and we are seeing a growing number of loans slipping into delinquency. Moreover, pandemic excess savings to the tune of USD 2.1 trillion have now largely been spent, and the hiatus on student loan repayments has come to an end.

It is not just consumers that have been big spenders. The economy is still basking in the afterglow of the massive stimulus rolled out at the beginning of Biden's term: the Bipartisan Infrastructure Law, the CHIPS & Science Act and the Inflation Reduction Act (IRA), which will introduce USD 2 trillion in new federal spending over the next ten years, have helped spur growth and investment as intended. Working in the economies' near-term favour is the fact that strong fiscal consolidation is unlikely in a presidential election year, even if fiscal hawks get louder following the 2023 debt limit showdown.

US GDP Growth: Realised and Expected (%, QoQ)



Source: Bloomberg, BIL as of 12 December 2023

BIL 1856

EUROZONE: A LACK OF GROWTH CATALYSTS AND ENERGY AS A WILDCARD

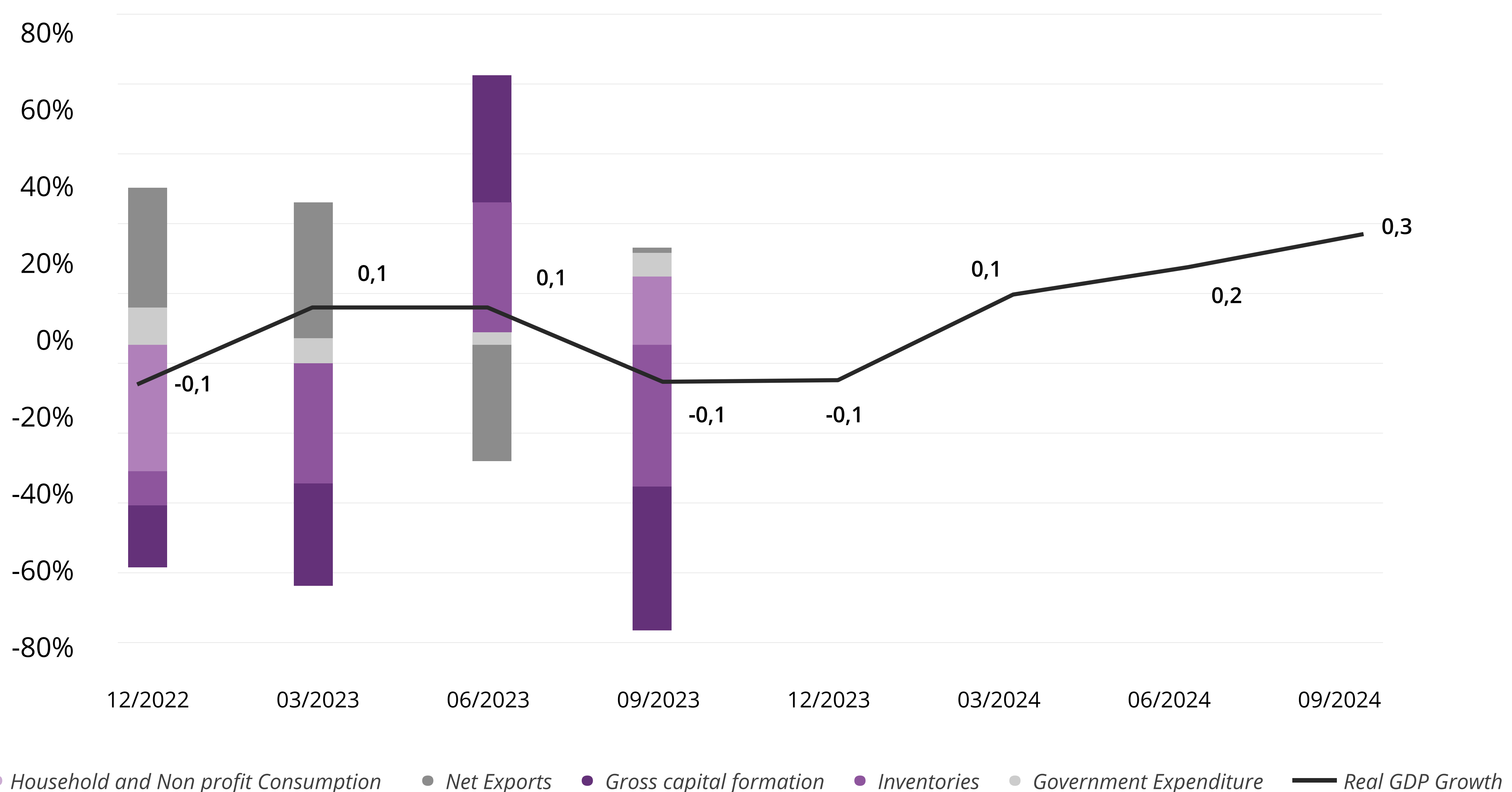
Private consumption is only expected to really start recovering mid-2024 amid falling inflation, no major uptick in unemployment and real wages turning positive

In Europe, there is a distinct lack of potential growth drivers in the near term.

Households are still sitting on about EUR 1 trillion of pandemic-era savings, but hopes for these to fuel a near-term consumer boom are misplaced. Consumer confidence is still below the long-term average, while people are forgoing consumption to pay down debts, or, to invest in longer-term instruments in search of yield. As such, private consumption is only expected to really start recovering mid-2024 amid falling inflation, no major uptick in unemployment and real wages turning positive.

In the fiscal space, EU rules limiting national budget deficits were suspended over the past three years. With their recommencement looming, consensus coalesces around the idea that more fiscal flexibility is required. Those discussions are likely to drag into 2024, most likely resulting in a dilution of the rules, but still resulting in some fiscal tightening for most countries. In Germany, debt brake reform is seen as unlikely in the short term.

Euro zone GDP growth: realised and expected (%, QoQ)



Source: Bloomberg, BIL as of 12 December 2023

The problem in Europe is that energy is now a joker card: unpredictable and uncertain.

The problem in Europe is that energy is now a wild card: unpredictable and uncertain. Governments have managed to replace Russian gas almost seamlessly, avoiding the rationing many had feared, and even filling storage levels for winter 2023 ahead of target. However, Europe's reliance on global energy markets leaves it vulnerable. The benchmark natural gas price is still about double what it was in November 2019, and it is also subject to wild fluctuations: for example, the 40% increase in a single week after the conflict in Israel broke out.

Germany, traditionally the growth engine of Europe, has been disproportionately affected, with its economic model built on the twin pillars of cheap energy from Russia and manufacturing exports.

While the manufacturing sector has suffered at a global level amid weak demand, this was especially true in Europe as goods producers grappled with their newfound energy dynamics. Germany, traditionally the growth engine of Europe, has been disproportionately affected, with its economic model built on the twin pillars of cheap energy from Russia and manufacturing exports. A recent decision of the German constitutional court to block government plans to reallocate EUR 60 billion of unused Covid funds towards its climate and transformational fund casts further doubt on the outlook.

The euro zone service sector is now "catching down" to manufacturing and has already spent four months in contraction.

Manufacturing PMI	30/04/2023	31/05/2023	30/06/2023	31/07/2023	31/08/2023	30/09/2023	31/10/2023	30/11/2023
China	49,5	50,9	50,5	49,2	51,0	50,6	49,5	50,7
Developed Markets	48,5	47,6	46,3	47,1	46,8	47,4	47,5	47,7
Emerging Markets	50,5	51,4	51,1	50,2	51,4	50,9	50,1	50,9
Eurozone	45,8	44,8	43,4	42,7	43,5	43,4	43,1	44,2
France	45,6	45,7	46,0	45,1	46,0	44,2	42,8	42,9
Germany	44,5	43,2	40,6	38,8	39,1	39,6	40,8	42,6
Italy	46,8	45,9	43,8	44,5	45,4	46,8	44,9	44,4
Japan	49,5	50,6	49,8	49,6	49,6	48,5	48,7	48,3
Spain	49,0	48,4	48,0	47,8	46,5	47,7	45,1	46,3
United Kingdom	47,8	47,1	46,5	45,3	43,0	44,3	44,8	47,2
United States	50,2	48,4	46,3	49,0	47,9	49,8	50,0	49,4
World	49,6	49,5	48,7	48,6	49,0	49,2	48,8	49,3

Services PMI	30/04/2023	31/05/2023	30/06/2023	31/07/2023	31/08/2023	30/09/2023	31/10/2023	30/11/2023
China	56,4	57,1	53,9	54,1	51,8	50,2	50,4	51,5
Developed Markets	54,5	54,8	53,5	51,8	50,1	50,1	49,8	50,0
Emerging Markets	57,2	56,7	54,6	54,5	53,1	51,9	51,7	52,1
Eurozone	56,2	55,1	52,0	50,9	47,9	48,7	47,8	48,7
France	54,6	52,5	48,0	47,1	46,0	44,4	45,2	45,4
Germany	56,0	57,2	54,1	52,3	47,3	50,3	48,2	49,6
Italy	57,6	54,0	52,2	51,5	49,8	49,9	47,7	49,5
Japan	55,4	55,9	54,0	53,8	54,3	53,8	51,6	50,8
Spain	57,9	56,7	53,4	52,8	49,3	50,5	51,1	51,0
United Kingdom	55,9	55,2	53,7	51,5	49,5	49,3	49,5	50,9
United States	53,6	54,9	54,4	52,3	50,5	50,1	50,6	50,8
World	55,3	55,3	53,8	52,6	51,0	50,7	50,4	50,6

Source: JPMorgan, Bloomberg, BIL. 50 is largely considered the line of demarcation between expansion and contraction.

CHINA: STIMULUS PENDING

China is another region where many investors wrongly predicted the growth trajectory in 2023, as a post-lockdown boom failed to come to fruition.

China is another region where many investors wrongly predicted the growth trajectory in 2023, as a post-lockdown boom failed to come to fruition. This stems from the fact that government support was far more modest, while property market worries weighed on confidence. Relatively weak demand means full-year growth for 2023 is expected at 5.2%, just a tad above Beijing's lowest growth target in over three decades, 5%.

For 2024, we think that the 4.5%-5.0% band is a more reasonable and sustainable growth target as China recalibrates its economic growth engine away from "world factory" mode to the so-called "3 high" mode (focusing on high-tech, high-value added and high-end manufacturing).

Consumption appears to be gradually picking up, but households are shying away from large-ticket durable and luxury goods. Spending is poised to be service-led in the future, congruent with the structural shift toward the labour-intensive tertiary sector.

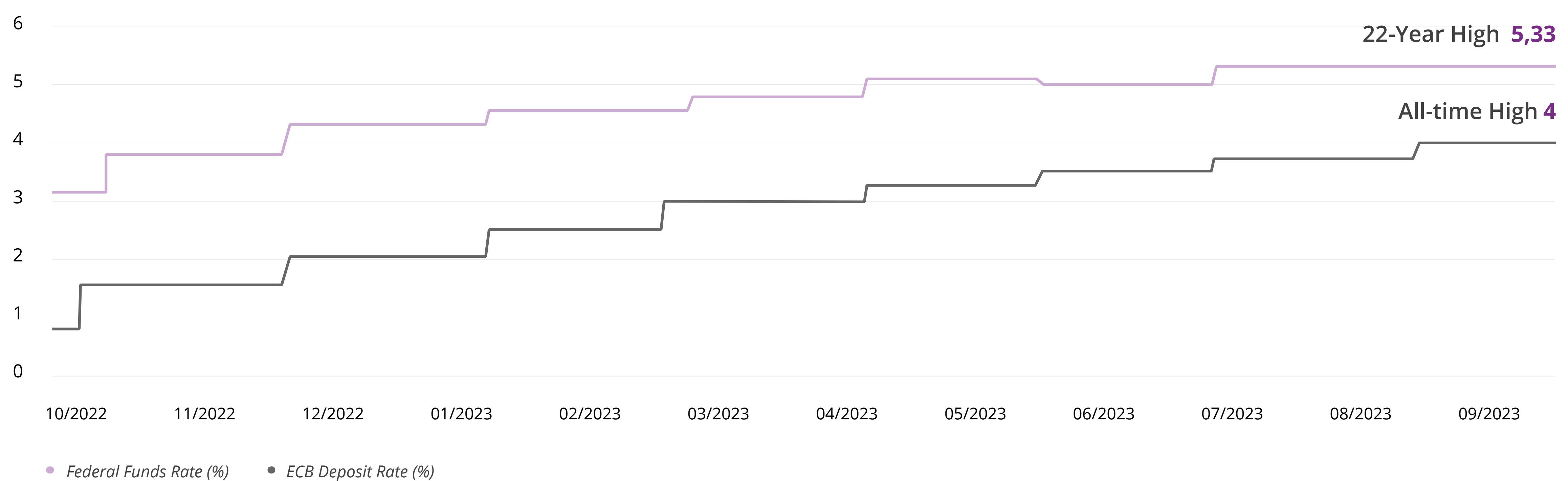
The low inflation, low interest rate environment means Beijing has sufficient room for major stimulus.

But the decisive factor for China's growth next year will be the extent of government support. The low inflation, low interest rate environment means Beijing has sufficient room for major stimulus. Our analysts believe that a large-scale stimulus plan is potentially being considered at the top decision-making level. Monetary policy wise, China is set to enter a rate-cutting cycle because of the dual urgency of debt restructuring and economic growth stabilisation.

CENTRAL BANK OUTLOOK

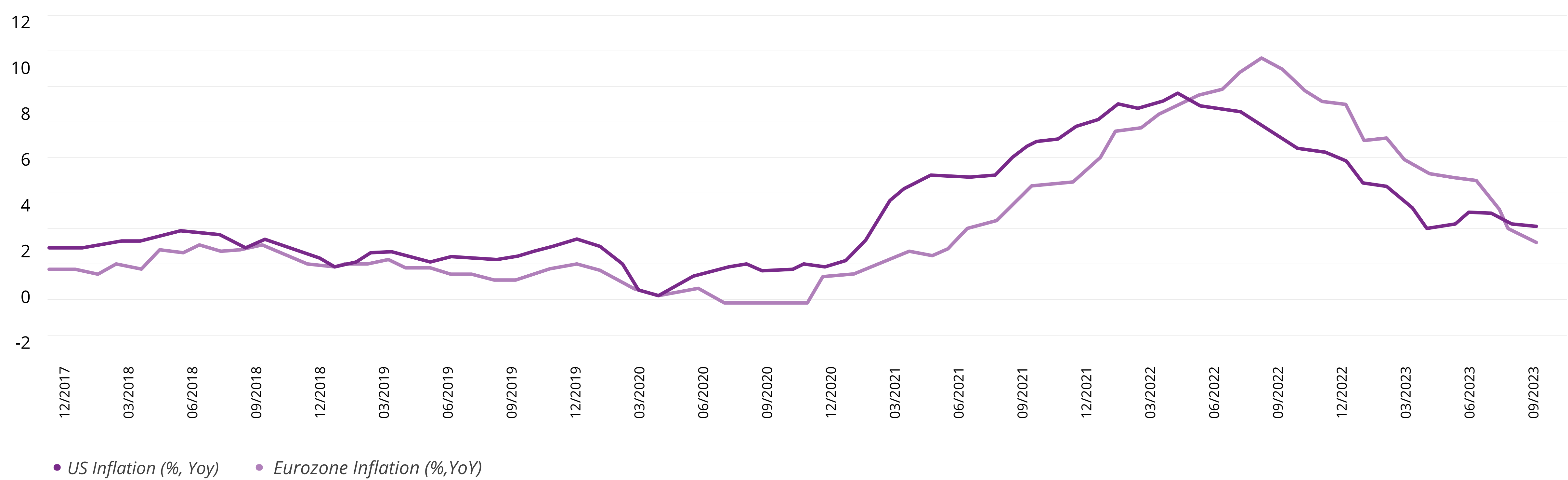
At the onset of 2023, markets expected that the Fed would cut rates throughout the year. Now it feels as though we are in a time loop, like in the movie Groundhog Day, with expectations for 2024 almost the same as those that were held at the onset of 2023. Will markets be as wrong in 2024 as they were in 2023? We don't think so.

No interest rate cuts materialised in 2023 as central banks adopted «higher for longer»



Source: Bloomberg, BIL

Headline inflation in retreat



Source: Bloomberg, BIL

The refreshed dot-plot now signals that the Fed plans to cut rates by 75bp in 2024.

The ECB said it did not even discuss rate cuts at its December meeting. We believe it could keep rates on hold, at least until negotiated wage growth peaks.

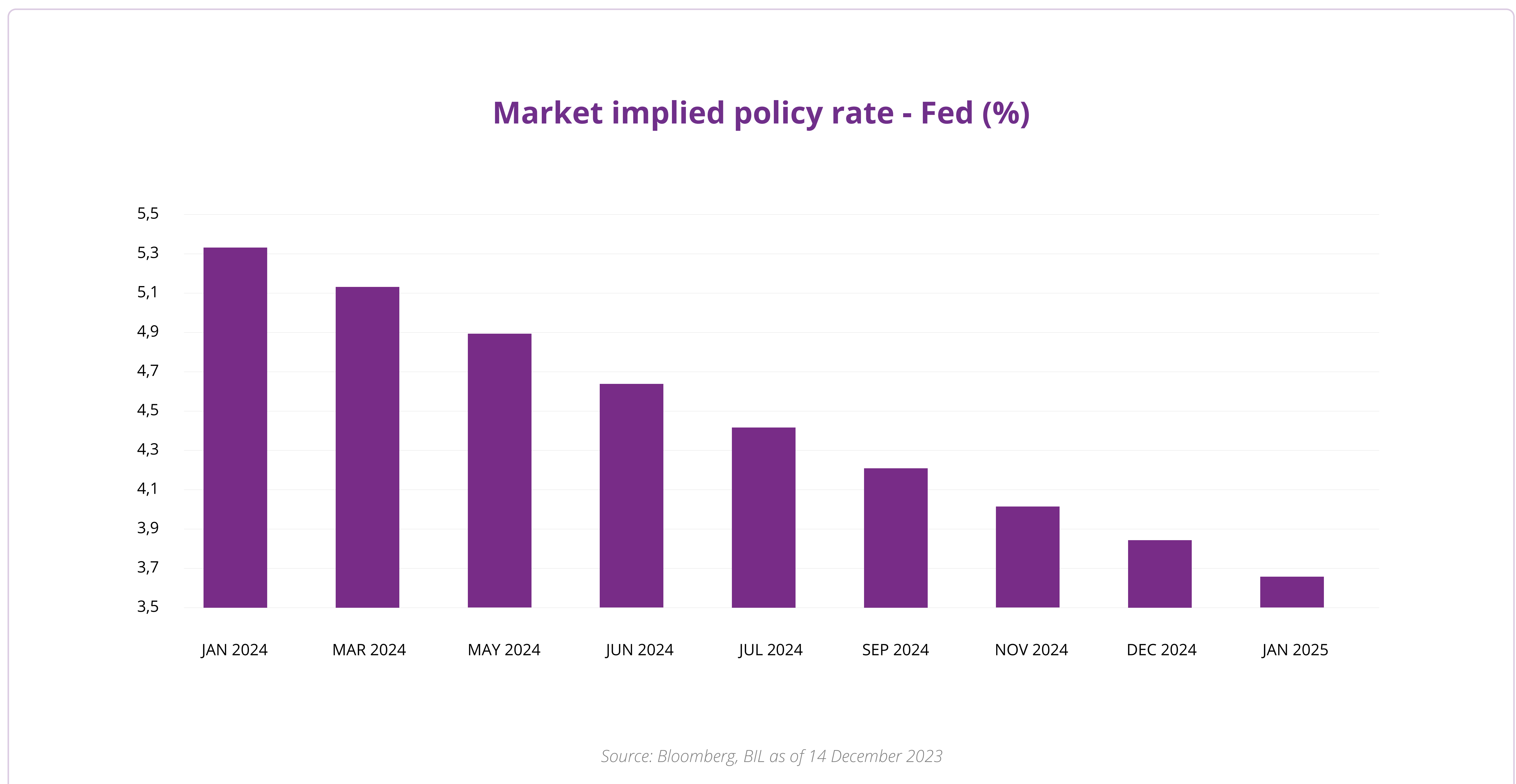
Headline inflation has come down meaningfully on both sides of the Atlantic paving the way for the Fed and the ECB to conclude their hiking campaigns.

The market received a huge Christmas present from the Fed at the December FOMC, with Powell essentially closing the door on further monetary tightening, thus validating the move from 5% to 4% on US Treasury yields. Has the Fed moved too early? Only time will tell if the fight against inflation has been won, and the economy preserved. The refreshed dot-plot now signals that it plans to cut rates by 75bp in 2024, but Fed Chair Powell emphasised that this is an amalgamation of forecasts and not a plan. The market, on the other hand, is banking on about 150bp of cuts, which we see as overoptimistic.

In the euro zone, the ECB said it did not even discuss rate cuts at its December meeting. We believe it could keep rates on hold, at least until negotiated wage growth peaks. Against a backdrop of weak productivity growth, the risk of a wage-price spiral lingers, and a meeting-by-meeting and data-dependent approach is most likely, with growth and inflation forecasts likely being lowered as we go along. We might also deduce from the December policy meetings that the Fed will be first to begin cutting rates. Of course, when the Fed leads, others will follow.

For long-term investors like us, it is not so much a matter of whether rate cuts come in, say, June or July: what's most important is that 2024 brings a material change in monetary policy. Until then, we can probably expect the market to go through bouts of overoptimism regarding the quantity of cuts – and then volatility as some of those expected cuts turn out to be a fata morgana.

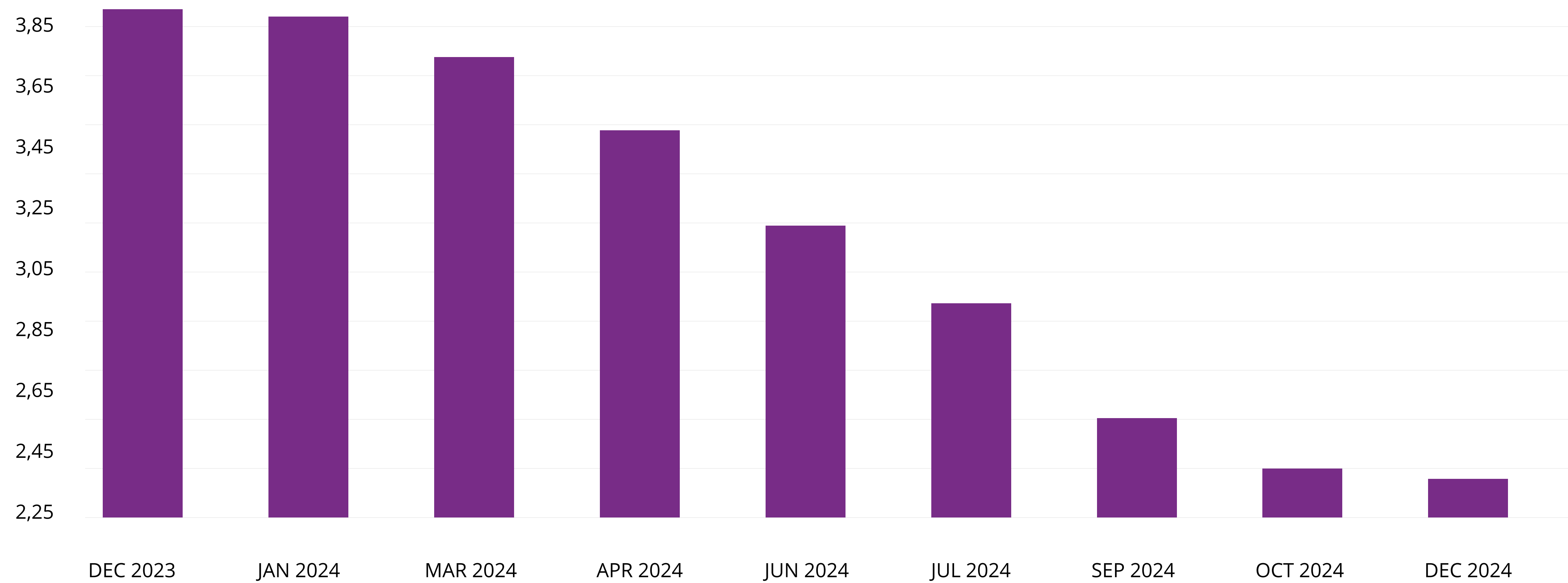
MARKETS APPEAR OVEROPTIMISTIC ABOUT CENTRAL BANK RATE CUTS



Source: Bloomberg, BIL as of 14 December 2023

BIL 1856

Market implied policy rate - ECB (%)



Source: Bloomberg, BIL as of 14 December 2023

Dollar downside may only be more manifest once the Fed actually starts cutting.

Eventual rate cuts, coupled with fading US macro exceptionalism, should provide some relief to other currencies at the expense of the dollar. However, to the extent that it rarely pays to fight the Fed, dollar downside may only be more manifest once the Fed actually starts cutting, absent an unforeseen shock.

Besides interest rate adjustments, the balance sheet is another powerful tool available to central banks. The Fed began unwinding its balance sheet in 2022 and has succeeded in reducing it by USD 1.2 trillion so far. The ECB has also sharply shrunk its balance sheet by letting TLTRO loans mature and by stepping down reinvestments from its purchase programs (no reinvestments of redemptions from July 2023 onwards). Only for the PEPP[4] program (launched during the Covid crisis) will the ECB continue reinvesting maturities until mid-2024.

Overall, we expect that central banks will continue their balance sheet reduction in 2024 and that the impact for markets will be limited.

Overall, we expect that central banks will continue their balance sheet reduction in 2024 and that the impact for markets will be limited. Any concerns about a faster-than-expected ECB balance sheet wind-down could lead to higher intra-European spreads, but the ECB is cognisant of this and will proceed with care in its actions and communication.

4 Pandemic Emergency Purchase Program

FIXED INCOME

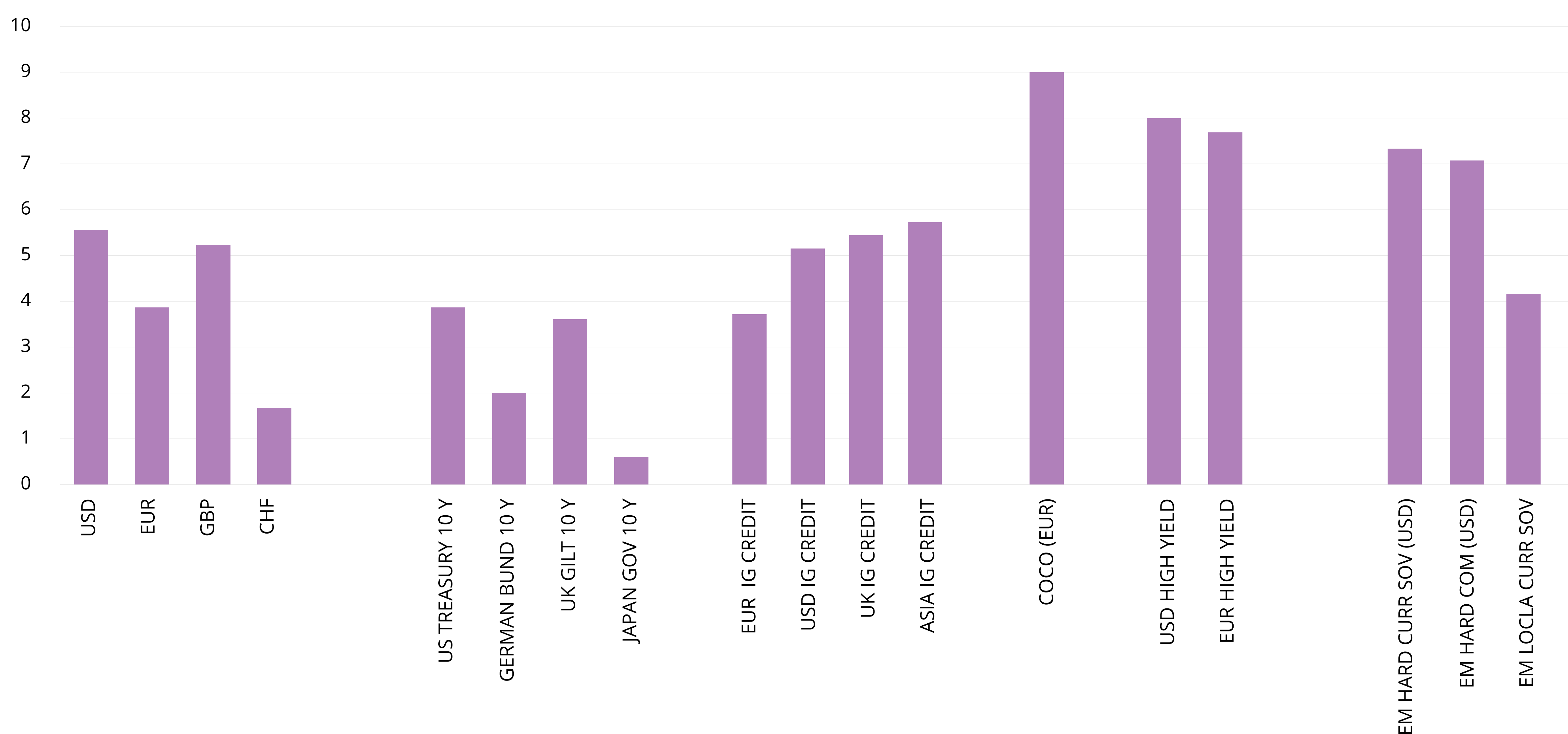
With central banks having concluded their hiking cycles, the biggest negative overhang for fixed income markets has been removed.

With central banks having concluded their hiking cycles, the biggest negative overhang for fixed income markets has been removed. Markets were quick to reflect this, and much of 2024's potential upside appears to have already been realised for those who had built up duration, as we advocated through 2023.

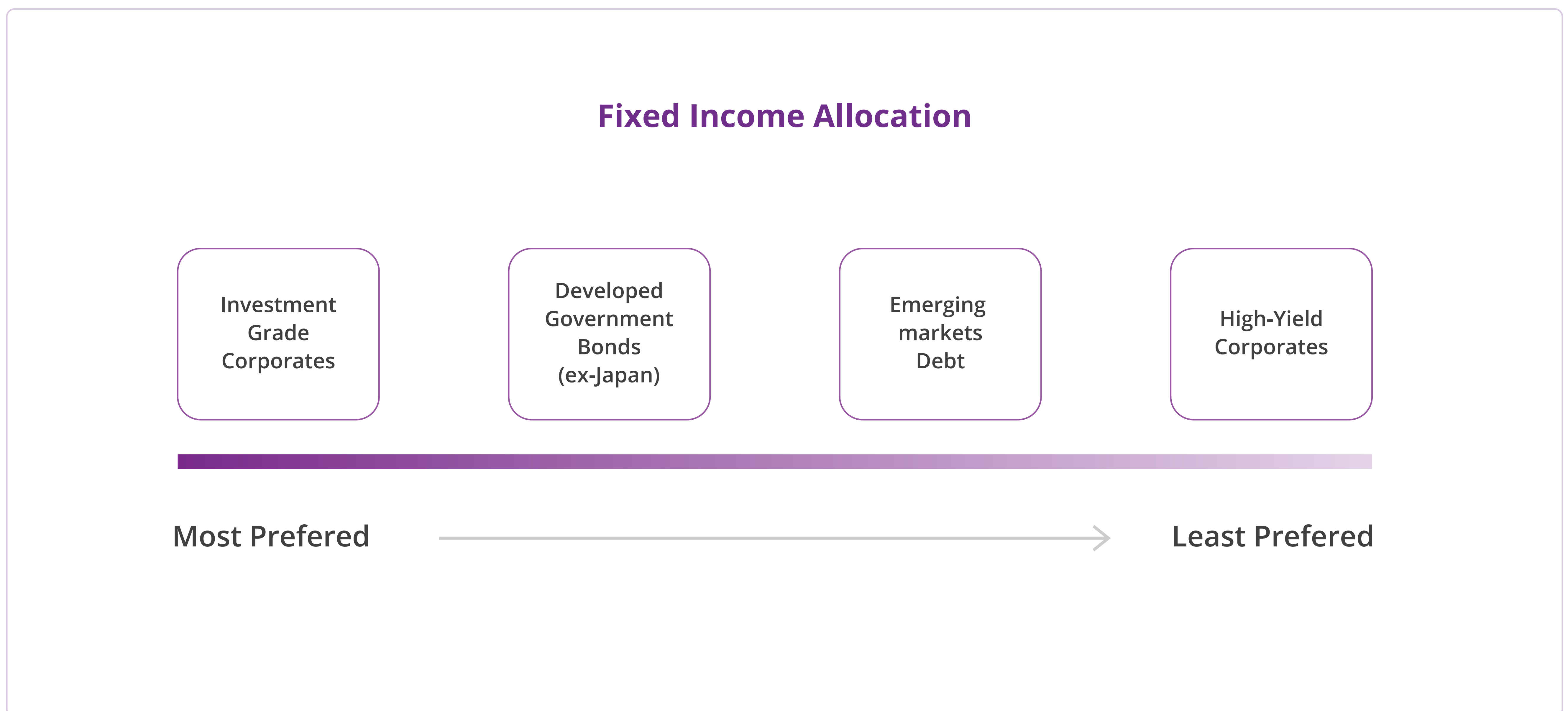
The questions driving markets today are: when will central banks start cutting rates? And by how much will they come down throughout the year? Uncertainty around both points will bring volatility and require active management of duration. The good news, however, is that carry is historically high, meaning investors can count on fixed income to do as its name suggests – create regular income – while also providing a buffer when risk sentiment turns sour.

Another pertinent question now is whether the 2-year Treasury yield can really break free and head lower as a driver of the yield curve, steepening it out from the front end. That traditionally happens on a three-month run ahead of an actual rate cut. We're on the cusp of this, but not quite there just yet.

Yield for a selection of Fixed Income Assets (%)



Source: Bloomberg, BIL as of 14 December 2023



We enter the year overweight on corporate investment grade (IG) bonds, which should fare well, given that corporate fundamentals are strong and maturity walls are well-managed.

2024 will be about moving up the quality curve, with yield tourists likely to return to their home turf, leaving the high-yield universe to the specialists and risk-takers. In turn, we think allocations to quality investment grade and government bonds will increase as this was and will again become the cornerstone of a well-constructed portfolio.

As such, we enter the year overweight on corporate investment grade (IG) bonds, which should fare well, given that corporate fundamentals are strong (both EU and US IG corporates exhibit strong balance sheets) and maturity walls are well-managed (companies have been [pro]active in pushing them out). With issuers viewing current rates as expensive, further issuance could be delayed. A reduced supply of IG bonds is likely to be met with substantial investor demand, creating a favourable technical backdrop. While there is a chance of spreads widening slightly on slowing growth concerns, the extra carry could well outweigh this factor for **quality** IG instruments.

We also like government bonds and are actively looking out for further opportunities to lock in attractive yield levels. The exception is clearly Japan, where we expect the Bank of Japan to normalise interest rate policy, leading to higher rates (and negative returns). While investors love targets, be it for bond yields or equity prices, for us, the direction in which bond yields are trending is more important than a precise destination. For those seeking an anchor point, we envisage the US10Y at 3.75% by 2024 year-end, and the 10Y Bund around 2.0%. For both regions we foresee positive returns but also bouts of volatility at the beginning of the year, as market expectations for rate cuts will clash with central banks' rhetoric on the fight against inflation.

We are prudent on High Yield (HY) bonds, anticipating some decompression between IG and HY spreads and given the uncertain economic outlook that compels us to play at the higher end of the quality curve.

Investors will also be trying to ascertain the fair value for the 10-year Treasury yield. We think it's around 3.75% (premised on the view that the funds rate arrives at 3% in the longer run, plus a 75bp curve in addition to that). We expect the German 10y Bund to undergo wild swings during 2024 but expect, too, that long-term rates will not be far off the levels seen today. Both targets are based on the assumption that nothing breaks in the system.

We are prudent on High Yield (HY) bonds, anticipating some decompression between IG and HY spreads and given the uncertain economic outlook that compels us to play at the higher end of the quality curve. Where we do have high yield exposure, we prefer US-based issuers. The Fed's newfound dovishness and the early termination of its interest rate cycle should provide an oxygen boost for companies desperate to refinance outstanding bonds.

We are somewhat reluctant on Emerging Market (EM) debt, believing that high rates in developed markets will likely cannibalise investor interest in this asset class. At the index level, the yield offered by EM Sovereign debt (local currency) almost mirrors that of US Treasuries. Emerging Market hard currency (EMHC) bonds still offer a significant pick-up over developed market sovereigns, but technicals are unfavourable. EM HC bond funds have suffered from outflows as yields on US Treasuries and Corporates became attractive again. Overall, we do expect a positive return next year for EM HC debt, but whether the asset class will be able to outperform US Treasuries and US credit remains to be seen.

One should not forget that cash yields are fleeting. Once central banks start cutting rates, investors will no longer be able to reinvest with the same favourable conditions.

Currently, we prefer US BBB-rated Corporates over EMHC. Both have displayed high correlations historically, but with the Fed making a dovish pivot, the increased possibility of a soft landing creates a benign environment for US credit. EMFX could also benefit from a more dovish Fed. While the Fed was previously expected to hold rates higher for longer, their most recent communication could put them in the lead when it comes to rate cuts for developed markets, leading to some USD weakness. That is, if the global economy manages to escape a severe downturn.

... and looking glasses, in which you might see yourself from head to foot; some of them were framed with glass, others with silver, plain and gilded... Charles Perrault, Bluebeard

With regard to **duration**, shorter has been better for the past few years. The yield curve was (and still is) inverted, so short-duration investments shielded investors from the losses and volatility at the longer end of the curve, while providing a higher yield at the point of purchase.

Yield curves are still inverted today, so investors are not able to capture the so-called term premium by reaching further out on the curve. Many are therefore happy to invest in short-term bonds or money market instruments given the high cash yield. But one should not forget that cash yields are fleeting. Once central banks start cutting rates, investors will no longer be able to reinvest with the same favourable conditions. We have gradually added duration in anticipation of this, in order to lock in more attractive yields. If markets curb their enthusiasm around rate cuts, we will potentially use the weakness to make further additions. Ultimately, if bond yields retreat, duration can act as a turbo for the performance of bond portfolios holding longer-dated bonds.

GOLD

TACTICAL UNDERWEIGHT – CONSTRUCTIVE IN THE LONG TERM

" Here, "said he", "are the keys to the two great wardrobes, wherein I have my best furniture... These open my strongboxes, which hold my money, both gold and silver; these my caskets of jewels." Charles Perrault, Blue Beard

Fed rate decisions will dictate the trajectory of gold, with prices quite tightly tethered to bond yields. Despite ongoing tensions in the Middle East, rate cut expectations are clearly the key catalyst driving the gold price. If markets temper their view on rate cuts, bringing the extent of easing in line with the Fed's dot-plot, we might see a consolidation in the gold price in the short term. However, over the longer term, we adopt an extremely constructive view, noting that over the last three Fed rate-cutting cycles, gold rallied on average by 4% in the six months leading up to the first cut, before increasing by another 15% in the six months after the initial rate cut. History, of course, never repeats itself, but it does tend to rhyme.

OIL

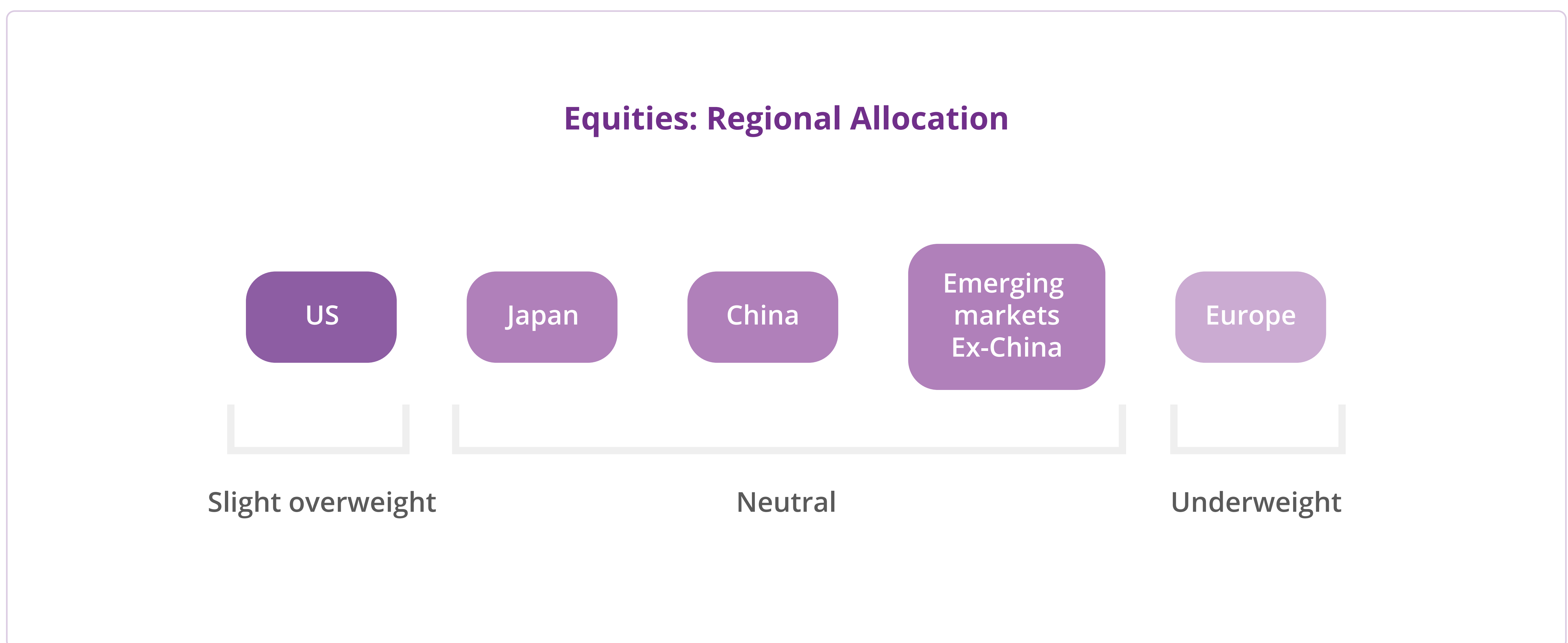
NEUTRAL

We predict that the oil market will find itself in surplus over the first half of 2024 amid a dramatic slowdown in the pace of demand growth as the post-pandemic rebound peters out and energy usage grows more efficient. However, the trajectory of oil prices will largely be dictated by OPEC production policy and discipline. In 2023, Saudi Arabia and Russia both adhered to their commitments to cut 1.3 million bpd, surprising the market seeing that, on previous occasions, production cut announcements had been implemented half-heartedly.

Already eight OPEC+ producers have announced production cuts of 2.2 million bpd for Q1 2024. This has done little to stabilise prices so far, and it is possible that softening demand and resilient non-OPEC supply (especially from the US) might compel OPEC+ to tighten its belt even further.

The ongoing conflict in the Middle East also adds another layer of uncertainty. If it were to spread, it would likely exert upward pressure on the oil price. In the meantime, concerns about demand remain to the fore as growth slows.

EQUITIES



In 2024, with central banks seemingly finished hiking, earnings delivery will take precedence.

In 2023, equities were hostage to moves in yields as the pendulum swang between expectations for a "dovish pivot" and "higher for longer". In 2024, with central banks seemingly finished hiking, earnings delivery will take precedence. An environment of slowing growth could make it more challenging for companies to deliver on current expectations, which are still quite optimistic at the index level. However, confidence is the most decisive factor for markets in the near term. As long as the market **trusts** that earnings will increase and estimates will bottom out soon, stocks could continue to go up.

Rather than fighting against the market, we enter 2024 pursuing a bottom-up approach, focusing on companies with strong individual investment cases, rather than having a strong conviction about any particular region or sector. This means quality is key in our stock selection process, with a focus on companies that boast robust balance sheets and relative earnings stability.

In terms of sector picks, we apply a barbell strategy. This involves balancing a positive stance on IT (a more aggressive sector underpinned by expectations for a recovery in hardware (smartphones, PCs, ...) and an ongoing development of the cloud software sphere, driven by AI), with more defensive plays, namely utilities and staples. The recent drop in market interest rates renders defensive companies with high dividend payouts, backed by stable free cash flows, more attractive.

We enter 2024 pursuing a bottom-up approach, focusing on companies with strong individual investment cases.

We are also adding one geopolitical hedge into the mix: energy. When oil prices go up, bond yields go up too because of inflation fears. This helps neither bond investors nor equity investors, with energy stocks the only real beneficiary. Note that there were 183 regional and local conflicts happening in 2023, the highest number in three decades.[5]

5 International Institute for Strategic Studies Annual Conflict Survey

EQUITIES: REGIONS

Oxford University Press just announced the "Word of the Year 2023", as "rizz", a colloquial word meaning charisma or attractiveness, and a nice way to summarise our regional views is to say that, in our eyes, the US is still the region with the most rizz. It has exhibited better-than-expected growth in recent years, while fiscal stimulus in the form of the Inflation Reduction Act and the CHIPS Act is fostering infrastructure investment and the development of new technologies.

For the US, expectations for full-year 2024 earnings growth have been stable over the past year, barely budging from the 11% mark.

The consensus view for the US economy being a soft landing, expectations for full-year 2024 earnings growth have been stable over the past year, barely budging from the 11% mark, even if the bulk of that is expected to occur in the final part of the year, driven by Fed rate cuts and fading inflation, which will boost fundamentals in most sectors. The consensus operating margin for S&P 500 companies – a strong leading indicator of stock price direction – appears to have bottomed out, at least in the near term, which, if confirmed could support equities. It's worth adding that earnings could also spring a positive surprise when we factor in **stock buy-backs:** the seven biggest US companies are expected to buy back USD 190 billion worth of shares next year alone.

Given the above, investors might wonder why we haven't built up a larger overweight exposure to the US. The reason is that the sheer attractiveness of the US stock market, with its resilient economy and "Magnificent Seven" stocks, has pushed up valuations. While sentiment and technicals still dominate in the short term, 2024 could be the year that its rizz finally fizzles out, as investors get back to basics and turn to European equities because of the low valuations on offer.

Another factor to consider is the strength of the dollar. A stronger dollar reduces the dollar-equivalent value of a non-US stock's return, thus driving US investors to stay at home. If the tentative trend of weakness in the US dollar takes hold, other regions could outperform the US in 2024.

A final reason not to put all our eggs into the US stock market is the possibility of geopolitical tensions. Those tensions pose a bigger risk to the technology stocks that have dominated the US market for the past decade (except in 2022). Not only does technology have the highest foreign exposure of all sectors, but its supply chains are also vulnerable should geopolitical tensions escalate further.

Turning to Europe, we believe the immediate macro weakening calls for an underweight stance. Full-year earnings estimates have not shown the same stability as those in the US, having gradually declined throughout 2023, reaching 6% today.

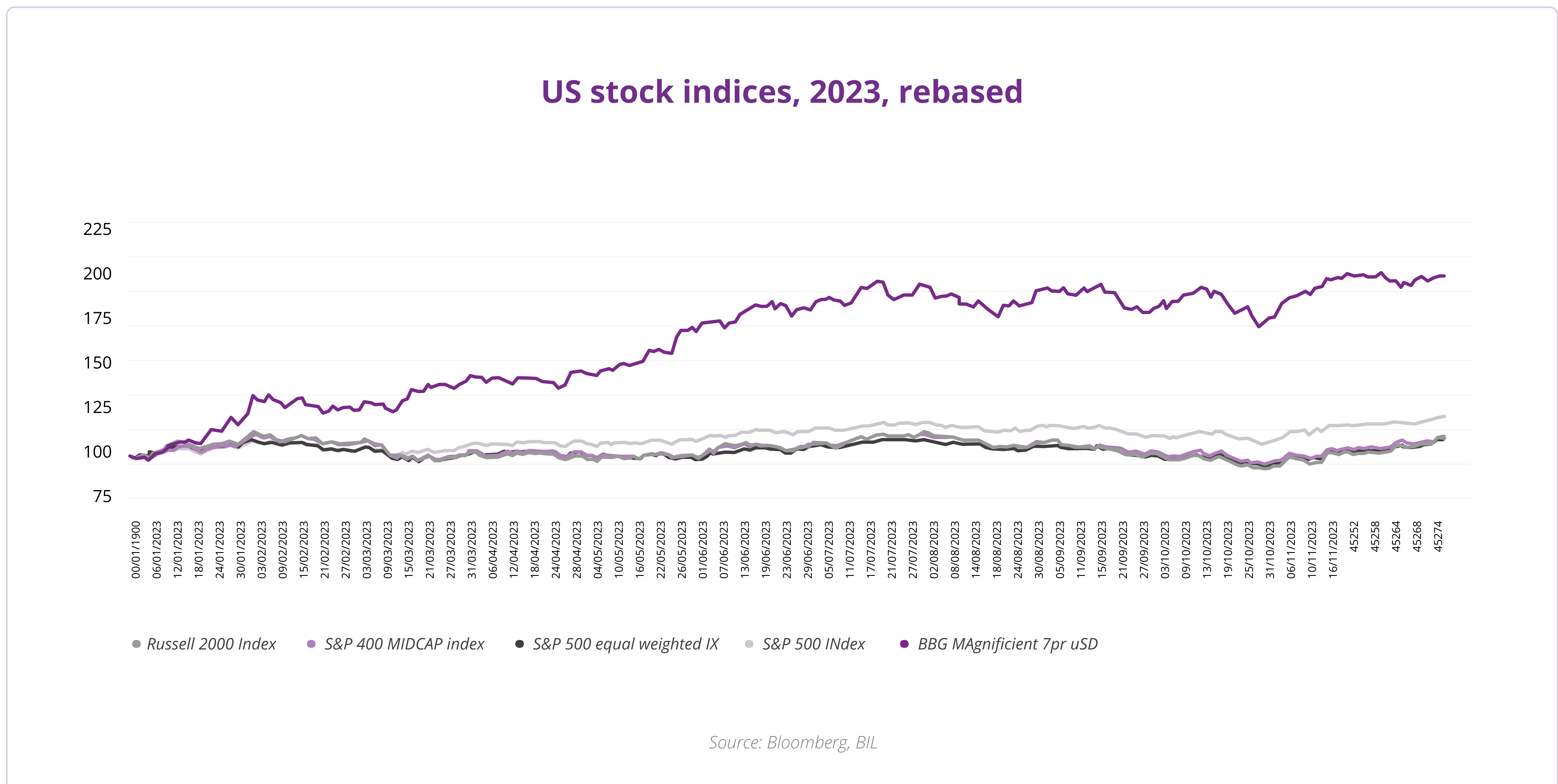
Turning to Europe, we believe the immediate macro weakening calls for an underweight stance. **Full-year earnings estimates** have not shown the same stability as those in the US, having gradually declined throughout 2023, reaching 6% today. Those expectations still appear on the high side considering the gloomy company guidance. However, even if earnings come in below consensus, European equities might keep their composure as long as a deeper, more pronounced recession is avoided.

Being neutral on Chinese equities (albeit with the position representing a small segment of our overall portfolio make-up) might be perceived as a risky bet. The economy is still in recovery mode, while full restoration of investor confidence will take time. Moreover, if Donald Trump wins the election (he maintains a formidable lead in both the national and the state primary polls), we could expect a more hawkish US policy stance towards China. However, valuations are attractive across various sectors, and we do not want to be completely out of the market, anticipating that major government support could throw an important curve ball next year. Unexpected favourable policies could also drive potential upside. For the A-share market, catching those plays after the fact will be difficult, given that thematic rotations are on average much faster and more speculative.

EQUITIES: A NOTE ON STYLE

Over the past year, equity gains were largely driven by tech and the AI rally. Gains on the S&P 500 have been powered by the "Magnificent 7"

Over the past year, equity gains were largely driven by tech and the AI rally. Gains on the S&P 500 have been powered by the "Magnificent Seven" (Apple, Microsoft, Amazon, Nvidia, Tesla, Alphabet, Meta) and, in some instances over the past twelve months, the rest of the S&P 500 (colloquially referred to as the S&P 493) actually detracted from performance. As we enter 2024, the US continues to be a two-speed market, with concentration risk evident.



Small caps have trailed the S&P 500, as they suffer more from the high cost of debt, while they are more exposed to the rate cycle than their larger counterparts. History shows that US small caps tend to outperform the broader market between the last Fed rate hike and the first cut. At the same time, they currently have a huge valuation advantage: they are much cheaper.

Providing the soft-landing scenario prevails, US equity strength is likely to broaden out as the year progresses and we might warm to small and mid-cap stocks.

EQUITIES: MEGA TRENDS

Taking a more strategic view, investors shouldn't ignore the mega trends reshaping the world around us: digitalisation, the sustainable transition and healthcare innovation.

Although these themes are not fully immune to the ups and downs of the economic cycle, as demonstrated by the underperformance of the renewable energy sector in 2023, we believe their relevance will continue to grow over the longterm and that they could contribute meaningfully to portfolio returns, if the exposure is carefully managed, adjusted and pruned when necessary.

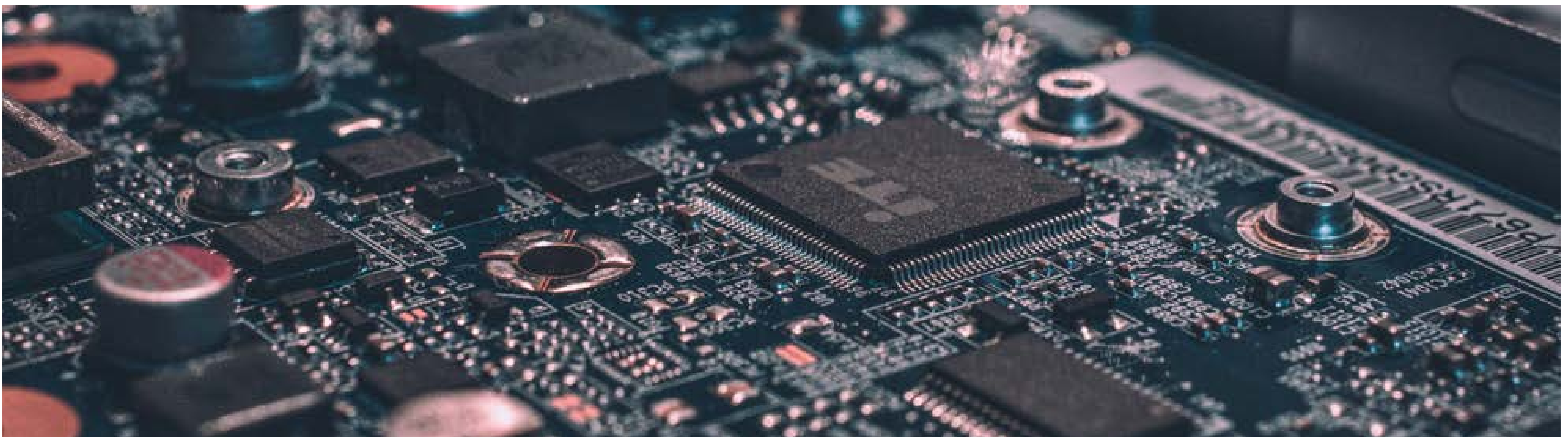
DIGITALISATION, BIG DATA AND THE AI REVOLUTION

The first major trend we are incorporating into our portfolio construction is the ongoing shift towards a digital society. We are swiftly moving towards an era of "smart everything" – a smarter, more connected world encapsulating Artificial Intelligence (AI), machine-to-machine communication, the Internet of Things, as well as virtual and augmented reality.

Last year, AI entered the mainstream, thanks to the roll-out of ChatGPT. Since then, it has snowballed, with other competitors entering the space; for example, Google, which released its Genesis AI tool in December. From 2023 to 2030, the expected annual growth rate of AI is 37.7%, with 64% of businesses currently expecting AI to increase productivity.[6]

The array of creative and innovative applications of AI is vast, as large language models expand to become multimodal, meaning they can generalise, understand and operate across different types of information including text, code, audio, image and video.

One of the areas where AI yields immense potential is in processing big data – allowing us to use previously untapped goldmines of information. We have no shortage of data, but if that data is unstructured, it is essentially chaos. Data wrangling (the transformation of raw, unstructured information into structured data) essentially turns this chaos into clarity. Until now, this process has been tedious and time-consuming. Automation and AI change that, streamlining the process, reducing the need for manual intervention and enhancing data quality.



The use cases for this data, again with the help of AI to find the hidden gems and patterns, are innumerable. One of the most obvious might be using consumer data to better understand their motivations, preferences, and habits, to serve them better than competitors. However, that's just the tip of the iceberg. Data is all around us, and using AI to gather, sort and use that information will bring efficiencies in almost every segment of the economy. To illustrate, let's take a less obvious example: the business of melting snow in winter.

In the US, a single snow day can cost billions of dollars in lost wages and retail sales. State and local agencies spend around USD 2.3 billion each year on ploughing and salting highways, while the corrosion of vehicles and infrastructure by road salt costs some USD 5 billion in damages annually. Beyond that, there is a risk that when the snow melts, the salt runs into fresh water supplies, posing serious health risks. Using information collected by smart sensors and IoT technology, AI tools can create precision routes for smart snowplows, based on live data sets, that reduce plow time and salt only where it is absolutely necessary and in exact quantities.

6 https://www.forbes.com/advisor/business/ai-statistics/

We appear to be on the brink of a new-age gold rush which involves harvesting, processing and capitalising on the vast amounts of data that lie at our fingertips.

What's interesting about this analogy is that the original California Gold Rush of the 19th Century gave rise to the pick-and-shovel investment strategy, consisting of buying the shares of companies providing the tools or services an industry uses to produce a product. The most obvious AI players have rallied substantially throughout 2023 and are also subject to growing regulatory scrutiny (for example, the UK's competition regulator is examining Microsoft's relationship with OpenAI). As such, we think it best to focus on mid-cap names and enablers of the AI revolution; for example, those creating 5G networks and cloud-based infrastructures.

Indeed, incremental spending on generative-AI projects will likely be one of the main catalysts that fuel a rebound in cloud-infrastructure growth rates in 2024. From there, we also expect an expansion in cloud infrastructure-as-a-service (IaaS), driven by the need for corporations to innovate and shift more workloads to the public cloud.

Hardware is another area that warrants consideration. Our analysts predict that the global computer hardware and storage category is in the early stages of an earnings growth cycle, with key markets (server, storage, PCs and smartphones) poised for growth in 2024 after bottoming out in 2023.

The flip side of a new, smarter and data-driven society is that so much of our personal data will be online. This, alongside the growing number of cyberattacks, makes enhanced digital defence systems increasingly indispensable for individuals, corporations and governments. As such, cybersecurity is an important sub-theme that we have included in our portfolio construction for some time now. This theme will benefit from regulatory tailwinds as governments step up requirements in the way of online security. Already in November, the first draft of the European Union Cyber Resilience Act (CRA) was agreed. The first regulation of its kind, the CRA seeks to impose new cybersecurity requirements, and will mean manufacturers, importers and even distributors of products with digital elements – in other words, anything with a microchip – will be required to take a number of stringent security measures.

THE SUSTAINABLE TRANSITION

The need to move away from fossil fuels is becoming ever more pressing, with carbon emissions considered a key culprit in global warming. The Copernicus Climate Change Service reports that November 2023 was the warmest November on record. The same can be said for July, August, September and October of this year; a year punctuated by a series of adverse weather events.

While the transition might not always be smooth, ultimately, we think we are nearing the beginning of the end for fossil fuels. The IEA predicts that demand for oil, natural gas and coal will all peak before 2030, and momentum towards the clean energy economy is clearly gathering.

Renewables, including solar, wind, hydropower, biofuels and others, are at the centre of the transition to less carbon-intensive and more sustainable energy systems. Generation capacity has grown rapidly in recent years, driven by policy support and sharp cost reductions for solar photovoltaics and wind power in particular.

After the bubble burst last year, the long-term growth story for renewables endures. In the near term, tailwinds are gathering in that supply chain disruptions are easing, and government support is forthcoming – note the European Commission's Wind Power Action Plan announced in October, which aims to significantly increase wind installed capacity and improve access to financing for companies.

Importantly, a more accommodative interest rate environment will alleviate a lot of the pressure that the sector has endured over the past twelve months.

HEALTHCARE INNOVATION

The intersection between biotechnologies and AI, big data and computer science present innumerable opportunities in the healthcare sector, including facilitating a transition from generalised medicine to precision medicine to predictive medicine.

The intersection between biotechnologies and AI, big data and computer science present innumerable opportunities in the healthcare sector, including facilitating a transition from generalised medicine to precision medicine to predictive medicine.

Various processes are on the cusp of positive disruption. For example, drug development, a time-consuming and resource-intensive journey that can take years, is set to be expedited, with pharmaceutical companies leveraging platforms that use machine learning and computational chemistry to sift through vast datasets and predict the properties of potential drug candidates.

Meanwhile, the sector continues to enjoy favourable, long-term tailwinds: an increasing global population, the expanding aged population and increasing health awareness.

Investors seeking exposure to healthcare, however, should pay attention to the impact of semaglutides on their investment picks. This new class of antidiabetic drugs reportedly leads to an average 15-20% weight loss in obese patients, while also appearing to protect the heart, liver and kidneys: organs which are often put under strain by excess weight. Prescriptions are up some 300% in the US since 2020 and their growing popularity threatens to disrupt various industries, from fast food to insurance to health and fitness. Healthcare analysts say that the USD 250bn cardiovascular disease market could be reduced by 10% by 2050, and hundreds of billions' worth of additional business in treatments for diabetes, kidney and liver disease and other weight-related illnesses could be disrupted too.[7]

Beyond the broader theme of biotechnology, the field we are focused on at this time is oncology. Despite recent improvements, cancer unfortunately still claims too many lives. The silver lining is that we are seeing an uptick in momentum around innovation (new drugs) and insights (diagnostic methods). Better diagnosis and treatments are coming and while the most important results will be in terms of lives saved, companies pushing those breakthroughs have attractive return potential.

7 https://www.ft.com/content/b5b4cfc8-1d20-47a6-840f-ff84f0e067f7

PRIVATE MARKETS

Private markets offer investors diversification in that the returns on offer are very often uncorrelated with the gyrations of public market prices.

In the private equity space, valuations have decreased substantially, offering opportunities, especially in the secondary space. We believe that larger asset managers with a strong track record in different market cycles are best poised to take advantage of these conditions. We particularly like thematic sectors with secular growth that are benefitting from broader market tailwinds, such as infrastructure and renewables (which are receiving a significant boost from the IRA) and digitalisation (particularly cybersecurity).

We are cautious on real estate, with some sub-sectors expected to exhibit persistent fragility.

When it comes to private credit, we might be embarking on a “golden year” for new vintages. With interest rates much higher and capital more scarce, private debt providers can fill the gap left by traditional lenders, all the while charging higher origination fees and applying higher floors. Non-bank lenders with sufficient capital to deploy might soon have their moment in the sun, as they can create products to deliver solutions without having to overstretch in terms of leverage, borrower solvency and asset quality.

In return for reduced liquidity, investors can benefit from yield stability and a yield premium. We should, however, add that recent past vintages may struggle amid an economic downturn if there hasn’t been considerable underwriting discipline. Right now, private credit players have a limited track record in dealing with defaults.

BIL
1856

CONCLUSION

As we enter 2024, a huge source of risk has subsided. Headline inflation is trending back towards target on both sides of the Atlantic. The Fed has already adopted a dovish stance, pencilling in rate cuts for 2024, and raising the chances of a much-coveted soft landing.

The ECB, still concerned about wage growth, has refrained from discussing cuts just yet, but markets are confident that at least the hiking cycle is over, especially considering that the Eurozone might already be in recession.

The end of central bank hiking cycles is a clear positive for bond markets. With yields now at some of the most attractive levels seen in decades, 2024 will be about actively managing duration in order to lock in income. We prefer to do this in the investment grade space, while also scoping out opportunities in developed market government bonds.

Equity markets are also ebullient on the prospect of easing. While we don't want to fight this sentiment in the near-term, we play cautiously, taking a bottom-up approach and focusing on quality companies with strong balance sheets and earnings stability.

Times are good on markets for now, but we mustn't forget that the impact of previous rate hikes are largely yet to be felt. To take one final scene from our book:

"The time was filled with parties, hunting, fishing, dancing, mirth, and feasting. Nobody went to bed, but all passed the night in rallying and joking with each other. In short, everything succeeded so well that the youngest daughter began to think that the man's beard was not so very blue after all, and that he was a mighty civil gentleman."

The near-term rally can be enjoyed, but investors should not lose sight of fundamentals, as the girl allowed her perception of the villain to be skewed by the good times.

APPENDIX

IMPORTANT DATES

REFERENCES:

→ Statista → IMF → GMK

CONTRIBUTORS

Lionel De Broux

GROUP CHIEF
INVESTMENT OFFICER

Jade Bajai

MACRO STRATEGIST / INVESTMENT
COMMUNICATION MANAGER

Lieven De Witte

HEAD OF RESEARCH

Koen De Vos

SENIOR EQUITY STRATEGIST

BIL 1856

DISCLAIMER

All financial data and/or economic information released by this Publication (the "Publication"); (the "Data" or the "Financial data and/or economic information"), are provided for information purposes only, without warranty of any kind, including without limitation the warranties of merchantability, fitness for a particular purpose or warranties and non-infringement of any patent, intellectual property or proprietary rights of any party, and are not intended for trading purposes. Banque Internationale à Luxembourg SA (the "Bank") does not guarantee expressly or impliedly, the sequence, accuracy, adequacy, legality, completeness, reliability, usefulness or timeliness of any Data. All Financial data and/or economic information provided may be delayed or may contain errors or be incomplete. This disclaimer applies to both isolated and aggregate uses of the Data. All Data is provided on an "as is" basis. None of the Financial data and/or economic information contained on this Publication constitutes a solicitation, offer, opinion, or recommendation, a guarantee of results, nor a solicitation by the Bank of an offer to buy or sell any security, products and services mentioned in it or to make investments. Moreover, none of the Financial data and/or economic information contained on this Publication provides legal, tax accounting, financial or investment advice or services regarding the profitability or suitability of any security or investment. This Publication has not been prepared with the aim to take an investor's particular investment objectives, financial position or needs into account. It is up to the investor himself to consider whether the Data contained in this Publication is appropriate to his needs, financial position and objectives or to seek professional independent advice before making an investment decision based upon the Data. No investment decision whatsoever may result from solely reading this document. In order to read and understand the Financial data and/or economic information included in this document, you will need to have knowledge and experience of financial markets. If this is not the case, please contact your relationship manager. This Publication is prepared by the Bank and is based on data available to the public and upon information from sources believed to be reliable and accurate, taken from stock exchanges and third parties. The Bank, including its parent, subsidiary or affiliate entities, agents, directors, officers, employees, representatives or suppliers, shall not, directly or indirectly, be liable, in any way, for any: inaccuracies or errors in or omissions from the Financial data and/or economic information, including but not limited to financial data regardless of the cause of such or for any investment decision made, action taken, or action not taken of whatever nature in reliance upon any Data provided herein, nor for any loss or damage, direct or indirect, special or consequential, arising from any use of this Publication or of its content. This Publication is only valid at the moment of its editing, unless otherwise specified. All Financial data and/or economic information contained herein can also quickly become out-of-date. All Data is subject to change without notice and may not be incorporated in any new version of this Publication. The Bank has no obligation to update this Publication upon the availability of new data, the occurrence of new events and/or other evolutions. Before making an investment decision, the investor must read carefully the terms and conditions of the documentation relating to the specific products or services. Past performance is no guarantee of future performance. Products or services described in this Publication may not be available in all countries and may be subject to restrictions in some persons or in some countries. No part of this Publication may be reproduced, distributed, modified, linked to or used for any public or commercial purpose without the prior written consent of the Bank. In any case, all Financial data and/or economic information provided on this Publication are not intended for use by, or distribution to, any person or entity in any jurisdiction or country where such use or distribution would be contrary to law and/or regulation. If you have obtained this Publication from a source other than the Bank website, be aware that electronic documentation can be altered subsequent to original distribution.

BANQUE INTERNATIONALE À LUXEMBOURG SA

69 route d'Esch, L-2953 Luxembourg
RCS Luxembourg B-6307

T. (+352) 4590-1
F. (+352) 4590-2010

contact@bil.com
www.bil.com