Signia Invest Insights

31 December 2023

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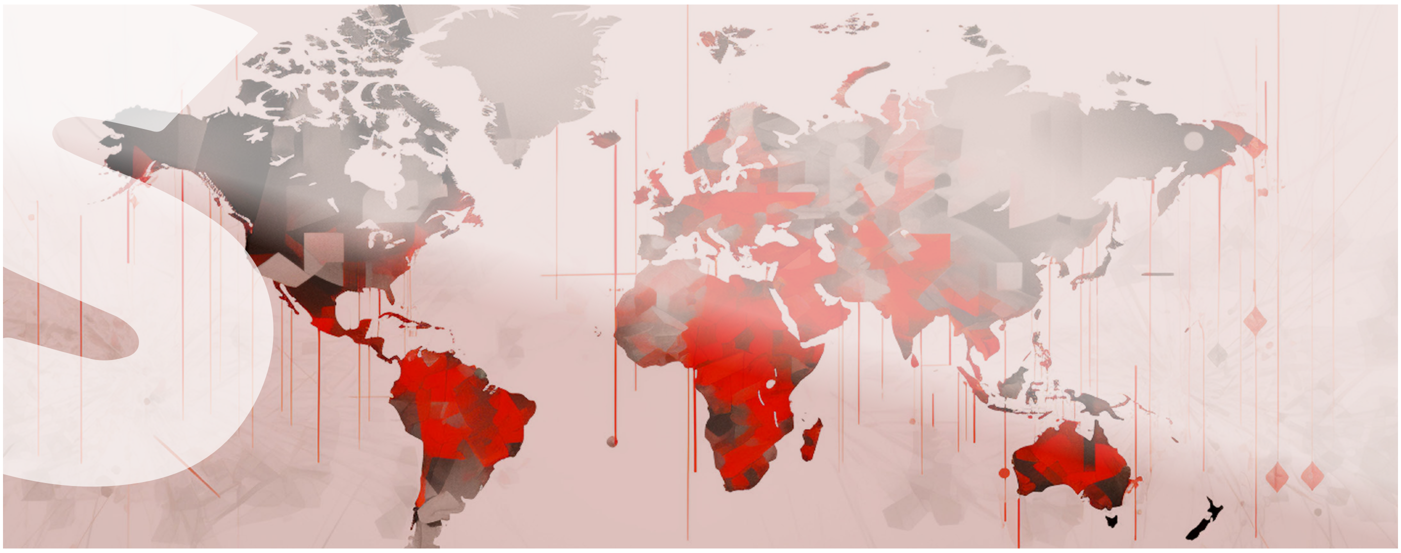
Market Review and Outlook



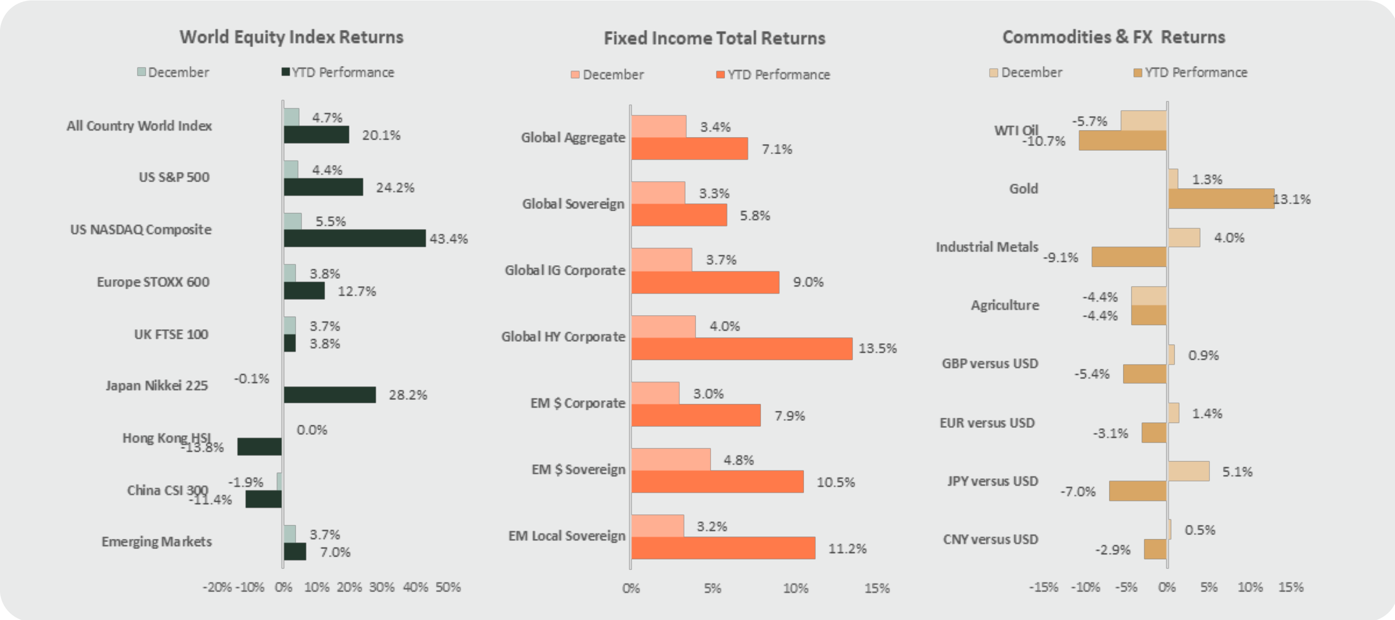
- It's been a slow start to 2024 with markets experiencing a hangover from a very strong and inclusive Santa rally. The S&P 500 ended the year by posting 9 consecutive weekly gains for the first time since 2004. The rally, which started in November and was predicated on expectations for a dovish Fed pivot in 2024, gathered pace in December, as vindication from a surprisingly dovish December FOMC meeting helped turbocharge the year-end rally, which was one of the fastest advances ever for a major US index within a span of two months.

- The release of the Fed's quarterly Dot Plot showed the median dot from officials pencilled in 75 basis points of expected rate cuts for this year, and Chair Powell, who has been somewhat neutral on his 2024 rate outlook until now, didn't push back on the rate cut discussion either. In fact, Powell's dot for 2024 was incrementally 50 basis points lower than his previous one in September, confirming in his press conference that participants no longer expected further hikes and that "we're very focused on not making that mistake" of keeping policy tight for too long. Unsurprisingly, money markets have got carried away and have moved to price earlier and more aggressive rate cuts, with Fed funds futures moving to fully price a 25 basis point cut by the March meeting. It does strike me that, with US equity markets sitting near all-time highs and unemployment still close to historic lows, it feels like an odd time for a dovish signal to embark on a path of monetary easing.

- Nevertheless, December saw strong gains for investors generally across the equity and fixed income boards. The MSCI ACWI gained 4.7% to end the year up 20.1%, driven almost exclusively by the US markets (essentially the handful of Magnificent 7 stocks), which saw the S&P 500 and Nasdaq Composite post 2023 gains of 24.2% and 43.4%, respectively. European indices continued their weaker path with the STOXX 600 ending the year up 'only' 12.7%, yet still ahead of the anaemic FTSE 100, which eked out a remarkably disappointing 3.8% return for UK investors over the course of the year. The big surprise in December was Japan, where a previously solid Nikkei 225 stumbled, declining -0.1% during the month, as the Yen strengthened an impressive 5% against the US Dollar, albeit from a very weak base, but Japanese equities still managed to return 28.2% overall in 2023.

- Bond markets displayed particularly strong monthly performance with the global aggregate index up 3.4% to end the year up 7.1%, whilst global high yield bonds outperformed, returning 13.5% during the year. Not a bad result for fixed income investors in a year which has been fraught with risks and uncertainties, from aggressive Fed tightening to a regional banking crisis and then supercharged US growth in the third quarter. Whilst the market outlook that's priced in for 2024 is now rosier, an easy ride for bond investors feels far too simplistic and somewhat optimistic given the lessons they've taught us over recent years as we continue the transition from an era of zero interest rates.

MARKET PERFORMANCE AS OF 31 DECEMBER 2023:

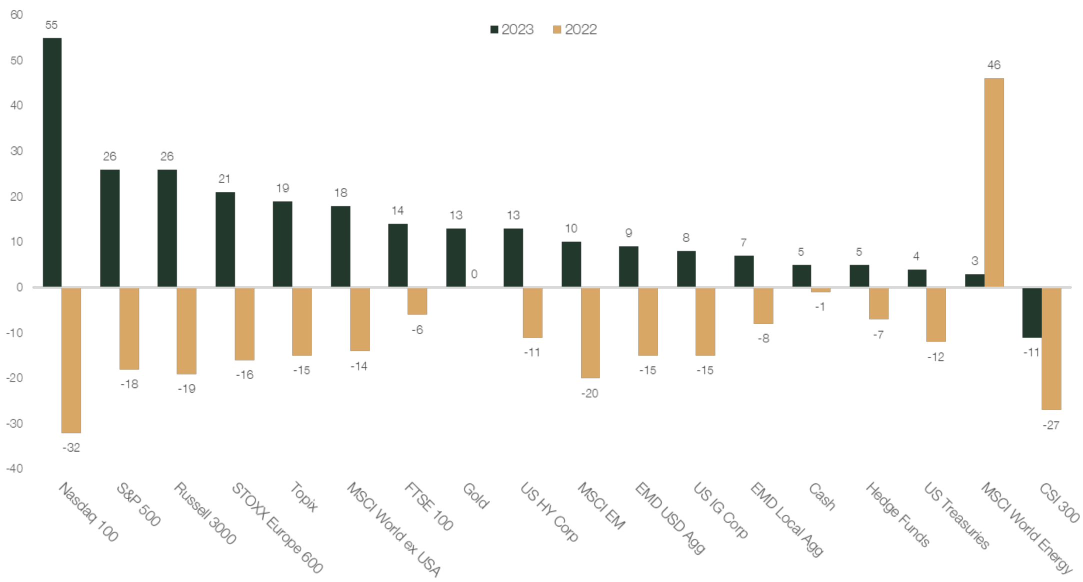


Source: Bloomberg Finance L.P., Arbion Ltd

- If there was a theme in 2023, it was performance concentration, which reached a point last year where the top ten mega-cap stocks were responsible for more than 124% of index performance. This figure fell to 70% in the end for the full year 2023 but is still near all-time record highs. The picture is even more extreme when we look at the concentration of the top five performers (~25%) which is at a new record. At the end of Q3, the Magnificent 7 represented 28% of the S&P500 while representing only 17% of its earnings. However, on an earnings per share basis one could argue that their valuations are justified given the continued strength and stability of their earnings power compared to the rest of the US and world equity markets.

- This performance concentration is seen in the significant outperformance of the Nasdaq and US equity markets in 2023, which can be broadly contextualised as a rebound year for markets from their steep 2022 drawdowns, where the Nasdaq and US equity markets were the major underperformers. Notable exceptions on the equity side were energy companies that benefitted from rising oil and gas prices following Russia's invasion of Ukraine in 2022, and the Chinese stock markets, which remain a basket case on the world stage and overall did not participate in this year's rally.

ASSET CLASS TOTAL RETURNS IN USD (%) – 2023 WAS LARGELY A REBOUND YEAR:

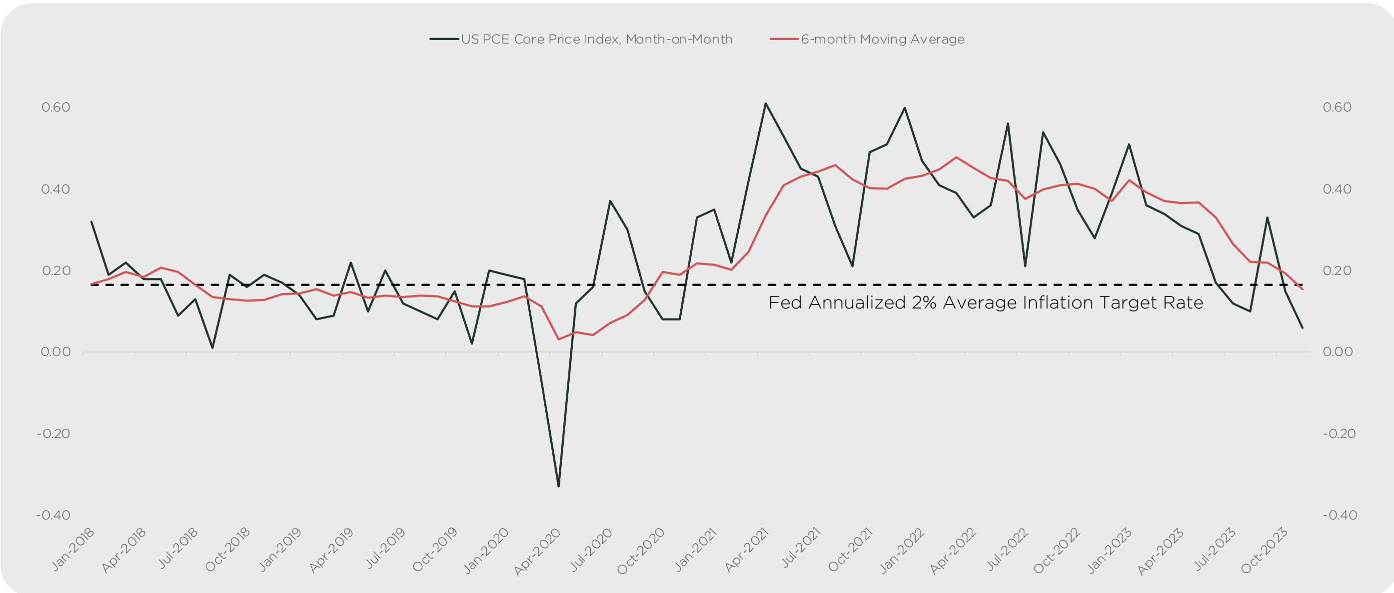


Source: Bloomberg Finance L.P., Arbion Ltd

- After the Fed's dovish turn late last year, the market quickly pivoted from an expectation of further rate hikes to pricing in almost six cuts for the US and the Eurozone this year. Whether this can be achieved without an approaching recession and on the back of a continued deficit-funded stimulus remains to be seen. The caveats in the recently published Fed minutes from its December meeting say as much: "It was possible that the economy could evolve in a manner that would make further increases in the target rate appropriate" and "Several also observed that circumstances might warrant keeping the target range at its current value for longer than they currently anticipated." Hence, we believe that it will be difficult to get a meaningful number of rate cuts in the absence of a substantially slower economy or hard landing scenario, which would not be bullish for risk assets.

- That said, Fed committee members have made numerous reference to the slowing of their preferred inflation gauge, the US Personal Consumption Expenditure Core Price Index, particularly over the last 6 months. When we look at the deceleration of month-on-month Core PCE price momentum on a rolling 6-month a basis (red line in the chart below), we can clearly see what the Fed are referring to and what has helped prompt them into a dovish pivot, as this measure has not only reached their 2% inflation target but is at risk of materially undershooting it in the first half of 2024.

WHY THE FED DECIDED TO MOVE IN DECEMBER – CORE PCE INFLATION HAS RETURNED TO TARGET:



Source: Bloomberg Finance L.P., Arbion Ltd

- 2024 will be a year in which national elections will take place in countries that represent more than 40% of the world's population and 80% of its stock market capitalization. It will also be the year with the highest concentration of elections in a long while to come with 65 such decisions expected over the next twelve months. Two of them stand out for their geopolitical importance: the upcoming January elections in Taiwan and the US elections in November. In Taiwan, it appears likely that the pro-independence DPP has good chances to win whilst the outcome in the US is unclear and largely subject to who will be nominated to run. The current frontrunners, Biden and Trump, are both equally unpopular at the moment. There are also elections scheduled in Russia in March and in the autumn in the UK, the outcomes of both being relatively predictable at this stage.

- The upcoming US elections promise to be intense for as long as Donald Trump is in the race. The Biden administration will have to focus on avoiding a recession at almost any cost as otherwise history suggests that the challenger will win the race. Further aggravating the issue is the nature of Donald Trump who keeps promising to "drain the swamp" which is no empty threat. Therefore, most institutions, likely including the Fed, are to be biased somewhat and will provide whatever support they can to smooth out any bumps along the road this year. This means that fiscal austerity is clearly off the menu in 2024 and we would therefore expect a continuation of substantial deficit spending throughout the period. It is noteworthy that without massive government deficits, growth in the US economy would have been negligible over recent years. 2023's likely 5.3% nominal GDP growth pales in comparison to a 6.3% budget deficit.

- On the corporate side, earnings expectations have been relatively stable over the second half of 2023, albeit slightly down from levels observed earlier in the year. 2024 forecasts have been anchored around the $225 level per S&P 500 share and, as a result, implied 2023/2024 earnings growth expectations have increased from 9% in January 2023 to 14% in December. With markets rising faster than earnings forecasts, multiples have expanded accordingly and now stand at 24x and 21x based on expected 2023 and 2024 earnings, respectively.

- Overall, the outlook for the current year looks favourable for risk assets with inflation on the way down, central banks on the sidelines for now and further stimulus for the US economy being a positive risk that could well come through. That said, it is human nature to get carried away after a very strong year end or market period, and valuations are no longer cheap. If the goldilocks environment that is currently expected in 2024 does not transpire, then reality could bite and markets could be vulnerable to disappointment, so tread positively but carefully in what I expect to be another fascinating and challenging year in markets!

ROBERT LEE

CO-HEAD OF MULTI-ASSET INVESTMENTS, HEAD OF RATES

Robert has been managing the wealth of private clients since 2006 as a portfolio manager and fixed income specialist. He is jointly responsible for the multi-asset investment team, global fixed income strategies, and Arbion's retail funds business. Previously, he worked for Lehman Brothers on the European Capital Markets team, and then Coutts & Co where he was a member of the fixed income and foreign exchange selection committees, responsible for managing the advisory and discretionary portfolios for private clients and institutions.

Robert is a Chartered Financial Analyst and a member of the Chartered Institute for Securities & Investment.

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