Investment briefing

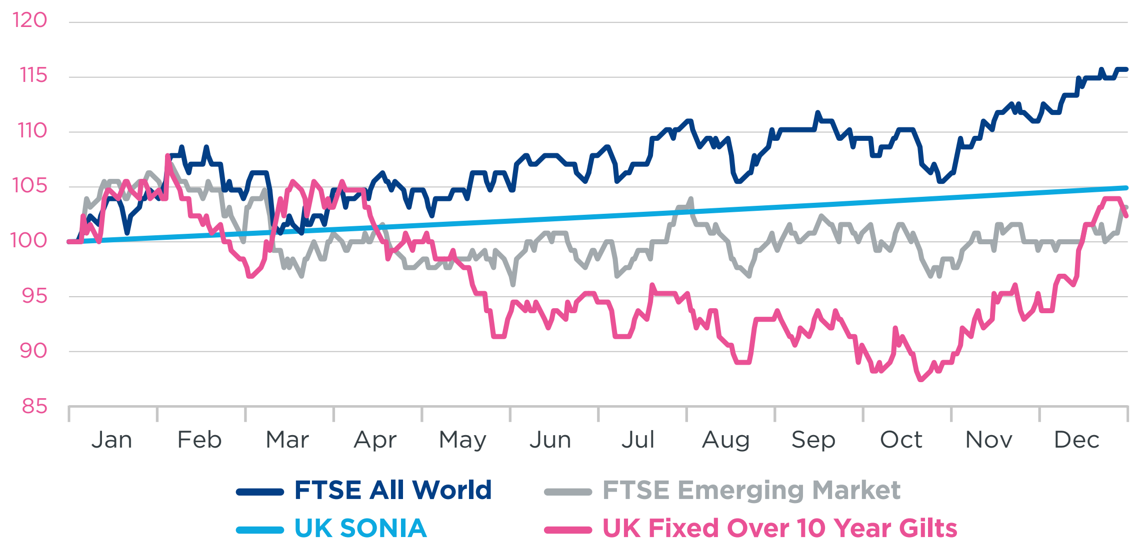
January 2024

Outlook for 2024: Election time! Politics to take centre stage in 2024

Alasdair Gill, Head of Equities at XPS Investment, reflects on 2023 as a positive year for markets, and highlights some of the key potential drivers of market returns in 2024.

The year 2023 will be remembered as a good year for asset prices – both equities and bonds delivered positive returns, and even cash rates ended the year around 5% for sterling investors, much higher than any time in the last 15 years.

Chart 1: Equities, bond and cash returns for 2023



Source: LSEG Dataroom

Where do we go from here?

Politics looks set to dominate 2024, as more than half the people in the world live in the 70 countries that are going to the polls this year – hence more people than ever are expected to be voting in 2024. Whilst the US election is already gaining acres of press attention, the big Asian democracies of India, Indonesia and Bangladesh will be going to the polls, as well as countries with dominant neighbours such as Taiwan and Mexico. Even Ukraine, Belarus and Russia are due to have elections in February/March – hence there is plenty of scope for politics to command centre stage.

So how will this impact institutional investors in the UK and how should Trustees and Fiduciaries be shaping portfolios for the year ahead? In the next few paragraphs, I will set out some thoughts as to possible opportunities and actions to take.

Economic overview

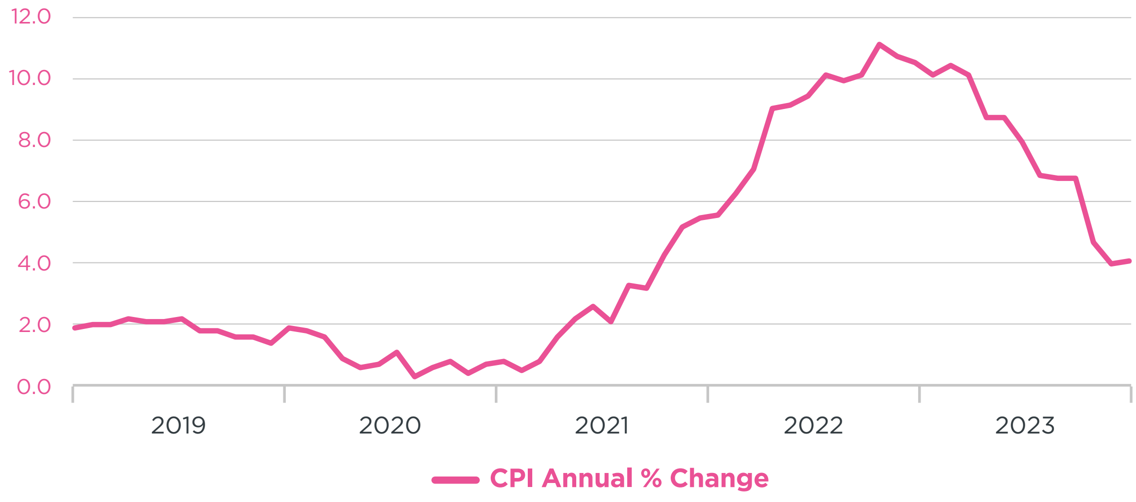
Interest rates, inflation and bond markets

For the last 2 years, inflation watching has been of key importance in western markets, as we saw inflation taking off following the COVID induced slowdown and the Ukraine conflict. However, towards the end of this year, there was a marked inflation slowdown (see chart) which was accompanied by a rally in bond markets, as bond yields fell back sharply in response towards the end of the year.

Market expectation quickly shifted from expecting rates to remain elevated towards short term interest rates to start being cut in the first half of 2024. Whether this happens in practice will be dependent on a number of factors including the labour markets and the strength of the economy in general – a more positive growth outlook could lead to interest rates remaining elevated for longer.

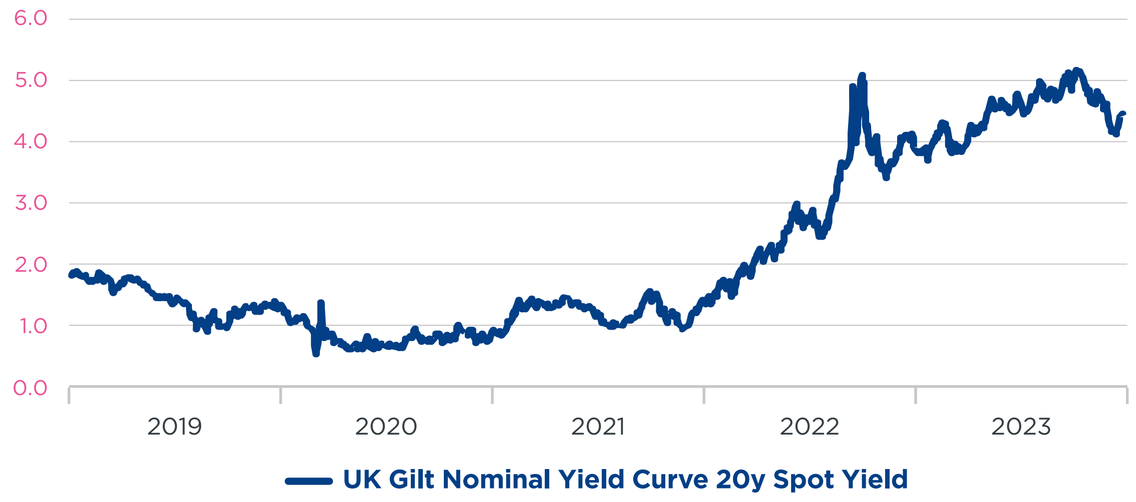
Policymakers will have to navigate this delicate balance whilst preparing for elections ahead – hence there will be a material chance of policy errors creeping into the system: for example, pre-election tax reductions could heat up the economy and re-assert upward pressure on interest rates and inflation. We therefore think that pension scheme investors should continue be wary of interest and inflation risks, and continue to hedge these as far as possible.

Chart 2: UK CPI inflation



Source: ONS

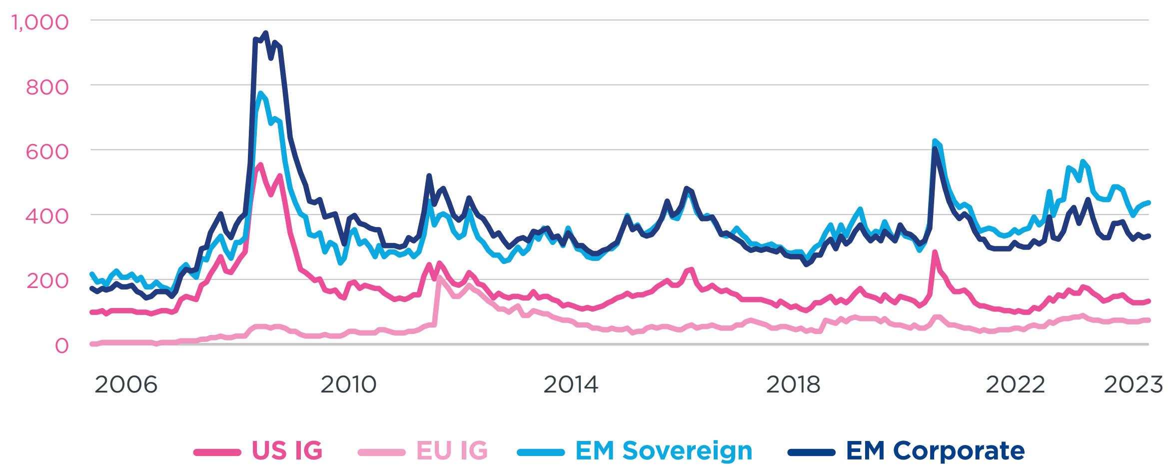
Chart 3: UK Sterling 20 year gilt yield



Source: LSEG Dataroom

What does this mean for bond markets? We have seen some tightening in credit spreads in both investment grade and high yield bonds, and so with defaults set to rise there is limited value in these markets. However emerging market debt remains attractively priced, with local currency bonds offering the most upside, particularly if US interest rates are cut which could reduce the attractiveness of the dollar. In addition, many EM economies have more scope to ease monetary policy than their developed market counterparts. However, this market is full of idiosyncratic risks, particularly given the number of elections happening in 2024, and so an active approach, potentially via a 'multi-sector credit' manager, will be important to navigate this tricky asset class.

Chart 4: EM spreads versus investment grade

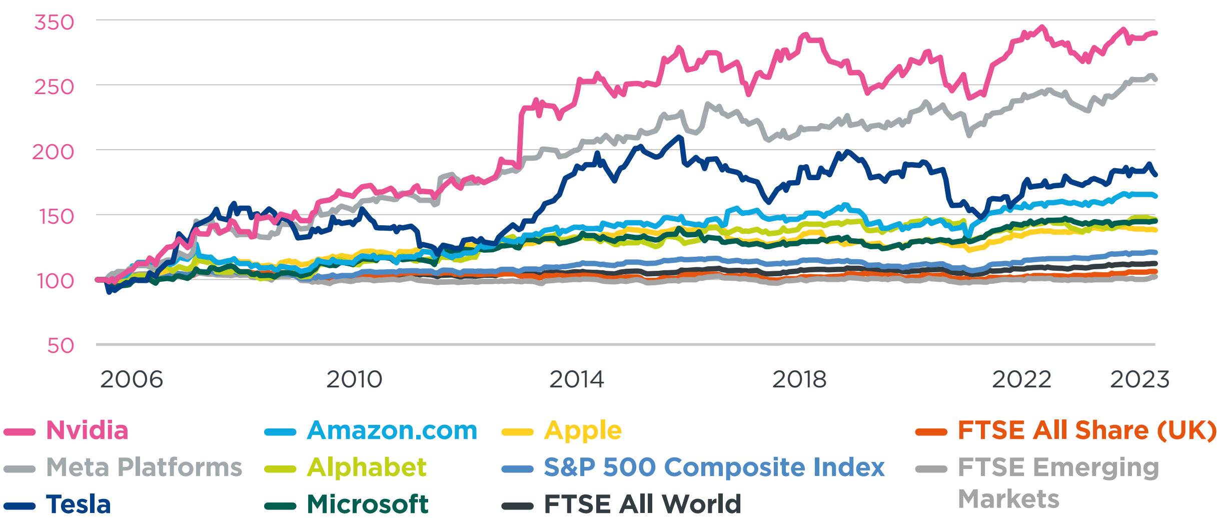


Source: JP Morgan Asset Management as at 31 December 2023

Equity markets

Last year was dominated by the 'Magnificent 7' which took over from FAANGs as the abbreviation of choice for market observers. The combined performance of Microsoft, Tesla, Apple, Amazon, Alphabet (google), Nvidia and Meta Platforms contributed around half the return on the S&P 500 last year, and these 7 stocks now account for almost 20% of global equity markets by market capitalisation (and almost 30% of the US market). Overall, global developed markets were up 17% for the year in sterling terms, compared with the UK, which remained a laggard, returning 7.9%.

Chart 5: Equity indices and the 'Magnificent 7' in 2023



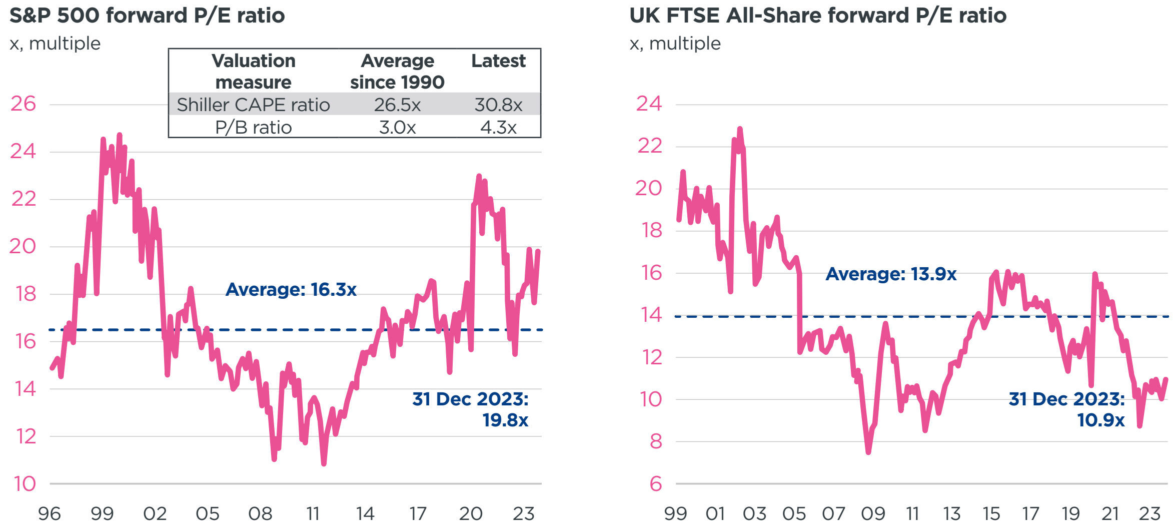
Source: LSEG Dataroom

In emerging markets, whilst operating performances generally improved, the impact of market sentiment in China continued to weigh on this sector, to produce another year of relative underperformance, even if absolute returns were still positive (EM sterling return was 4.0% over the year).

Looking forward, in the USA the 'Trump show' is set to dominate the news wires over 2024, and could cause some fluctuations in the already pricy US market, however in aggregate, we see some potential for a broader based rally to continue if the Fed can engineer a safe (non-inflationary) landing for the US economy.

Back in the domestic market, we see a real opportunity for countries like the UK, which could benefit from some pre-election fiscal stimulus to bolster the economy prior to the anticipated Autumn election, and hence market performance. The UK FTSE All Share Index at the end of 2023 trades on a multiple of around 10.9 times earnings (over 20% below its average level since 1999) compared with the US market figure of around 20, (over 20% above its long-term average[1]).

Chart 6: **US and UK P/E ratios versus recent history**



Source: JP Morgan Asset Management Guide to the Markets, Q1 2024

Emerging Markets also continue to trade at similar levels to the UK, so for clients with material equity exposures, there could be scope to re-introduce a domestic bias, as well as a discrete emerging market allocation. Whilst China remains a risk, there are other markets around Asia and Latin America better positioned for growth, and an active approach in this area could help mitigate some of the downside country and stock-specific risks.

In summary, the current bull market is relatively young and has potential to broaden out to markets outside the US large cap to more attractively priced markets such as the UK and certain emerging markets.

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[1] Source: JP Morgan Guide to the Markets, q4, 2023

Other market opportunities — how about crypto?

One area that divides opinion starkly is the outlook for crypto currencies, which had a resurgence in 2023. Many consider them as purely speculative tools, and certainly they are no replacement for cash given their volatile capital value and no real intrinsic value. Prices crashed in 2022, and multiple scandals, such as the collapse of Sam Bankman-Fried's FTX exchange, have tarnished their image. They also continue to frustrate authorities due to their place in criminal enterprises and money-laundering.

Chart 7: Bitcoin (spot price, USD)

Source: Google

However, there are some signs of a re-birth: Bitcoin has been testing recent highs in mid January 2024 as the US authorities have finally approved the first spot Bitcoin ETF. This has led to many large asset managers competing to launch low cost Bitcoin based ETFs. Could crypto become a more legitimised portfolio diversifier, alongside other non-yielding assets such as gold, to add to institutional portfolios? A weight of money into ETFs in 2024 could help improve liquidity and popularity of this asset class beyond its traditional advocates, and there is already a huge industry built up around this which has survived a number of scandals and challenges.

However, at XPS we continue to view this as a speculative investment at this stage, with no discernible 'risk premium'. Whilst the technology behind crypto assets such as distributed ledger technology (e.g. Blockchain) has the potential to revolutionise investment markets, the purchase of crypto assets at this stage is of very limited value to the institutional market, even as a diversifier in multi-asset institutional portfolios.

At XPS we continue to view crypto as a speculative investment with no discernible 'risk premium'.

Summary

Market risks remain as politics takes centre stage in 2024. Whilst we may have seen the worst of the inflation blip, there are still risks to the economy if pre-election tax stimuli result in growth and employment outperforming the consensus forecasts.

However, market opportunities remain for those investors with a risk appetite, and we believe that:

- **Whilst traditional bond markets continue to offer a reasonable yield, spreads have contracted and so are less compelling value than recent history. The preponderance of elections over 2024 give rise to the potential for yields to move in either direction from here.**
- **Non-US equities (such as UK and emerging markets) now offer better value than the US 'mega caps' that dominated equity returns in 2023, and so could help continue the positive momentum in the equity markets.**
- **Other diversifiers are starting to emerge, and crypto advocates will be championing its increasing adoption in 2024 – this is an asset class we would urge institutional investors to resist.**

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