Global multi-asset outlook 2024

Focusing on key features of a world in transition

By the Multi-Asset Team
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A world in transition

As we look back over the past year, many predictions about 2023 in the investment world turned out to be wrong. As 2023 began, China appeared to be on the cusp of a recovery, supported by government stimulus efforts and the re-opening of the economy. Instead growth continued to disappoint. The US was expected to slow, and many even predicted a recession. Instead, demand and the labour market in the world's largest economy held up, partly on the back of continued generous fiscal support and new opportunities in technology (tech). Japan was a positive surprise and served as a beacon of investment hope in Asia. The country finally lifted itself from decades of deflation while showing credible resolve to reform and improve productivity and profits. The key feature for Japan is its hard push to make productive use of capital, which is dictated by reforms but is also a functional requirement for it to survive in an inflationary environment.

Inflation ebbed in 2023 as policymakers had hoped, seemingly paving the way for central banks to cut rates in 2024. However, despite what many currently project, central banks could find achieving target inflation rates more challenging than expected. The deeper rate cuts some markets are pricing may prove less plausible as 2024 unfolds.

The US fiscal impulse will likely remain supportive into 2024. Coupled with healthy private sector balance sheets and supportive corporate cash flows, the economy could well continue to absorb the pain of higher rates for a while longer. Outside of a recession, there appears to be no clear catalyst to slow down demand and provide a sufficient counter to the structural tightness seen in energy, materials and the labour market. Now deeply entrenched, deglobalisation will continue to underpin inflationary dynamics that will prove challenging to overcome through rates alone.

To date, investments in new production capacity for energy and materials do not appear sufficient to meet normal growth in demand. On the other hand, generative artificial intelligence (AI) and other technologies offer new possibilities to boost productivity. This could ease pressures in the labour market, but it will take time and is unlikely to ease inflationary dynamics any time soon. In the meantime, massive investments continue to pour into AI and other technologies—industries which consume large amounts of energy.

Investment themes for 2024

Our investment themes for 2024 focus on key features of a world in transition. They include higher-for-longer rates, production shortages in natural resources and the search for new sources of productivity. Transitions are never easy, and features of the old world accustomed to low rates may not make it. We believe that some of these old-world features could pose systemic risks as "creative destruction" does not always run smoothly.

The following are the key features and themes we are focusing on for 2024:

- **Easing inflation (but 2% targets may prove challenging)**: Inflation has continued to moderate through 2023, but sticky services inflation (in light of a still-tight labour market) has made reaching targeted levels of inflation more challenging for central banks. Prices of commodities including energy have been softer on pockets of weak demand, but limited supply will curtail the downside. We see inflation continuing to slow into 2024, particularly in regions such as Europe, where growth is slowing quite rapidly. However, short of an unlikely plunge in demand, inflation will likely remain stubbornly above targeted levels and force central banks to keep rates higher for even longer than the market currently expects.

- **Nuanced view on duration**: Yield curves remain inverted on the premise that deep rate cuts will ultimately reward owners of long-dated yields. However, central banks of some countries such as the US may not be able to deliver the expected magnitude of rate cuts. Considering the above-described inflation dynamics and strongly inverted yield curves, we see little value in long-dated bonds. While duration—from a portfolio context—continues to serve a defensive role against slowing growth, it is important to stay selective (curve inversions come at a cost) when adding such exposures. We currently favour Australia, Japan and China—markets where aggressive rate cuts may not be necessary for investors to achieve capital gains in order to offset the cost of carry.

- **Positive on carry**: Short-dated credit provides the highest level of yield seen in nearly 20 years. On a relative value basis, yields are more attractive than growth opportunities in many pockets of the equity market, particularly those whose earnings depend on the economic cycle and are exposed to the higher cost of capital. While there are some concerns over higher rates negatively impacting corporates, balance sheets have so far remained strong and growth has been more positive than expected. We favour short-dated exposures to reduce the risk of poor performance should a credit event occur, and we favour markets where growth has been stronger such as Australia, Canada and those in Asia. Other opportunities could emerge depending on the degree of rate cuts ahead.

- **Commodities as an inflation hedge**: Over the near term, weak pockets of demand could tame commodity inflation. Production capacity, however, appears structurally insufficient to supply new investment to build ostensibly redundant production capacity (inflationary) and support ongoing war efforts. Short of a global recession, which is not our base case, commodities offer value and a natural hedge to inflation (and duration exposure) where energy and materials are key inputs with strong cash flows. As AI solutions gather momentum, demand for the enormous amounts of energy needed to power AI-related technology could increase, lifting resources such as uranium amid a scramble for cheap energy.

- **Tech and AI as new defensive growth assets**: Some still see generative AI as a fancy auto-complete functionality, but we see it as a fundamental breakthrough in making sense of large quantities of vital data to facilitate the processes of businesses and replace pockets of expensive labour. All industries will be disrupted, and the biggest tech companies in the world (mainly in the US) are financing the transition with unprecedented quantities of capital financed out of strong balance sheets and cash flow instead of debt. A sharp decline in demand could impede the pace of investments into generative AI, but only temporarily. We expect tech and AI to become new defensive high-growth assets over the long term.

- **Japan in midst of structural transition**: Japan is pushing through with reforms, and the country's corporates are hard at work reconfiguring their balance sheets and business models to expand profitability. There are regulatory incentives to do so, such as the Tokyo Stock Exchange issuing directives that require listed companies to maintain price-to-book ratios above 1.0 times. More importantly, as inflation takes hold in Japan, Japanese companies must put their large cash balances and capital to work after sitting effectively idle during 30 years of deflation. We also expect Japan to benefit from geopolitical developments. Japan gives its Western allies one of the few open access points to Asia and is an important alternative to China where the Western world continues to wean from its dependency on the country. The key risk, in our view,

is the Bank of Japan (BOJ)'s course for normalising policy, which remains extremely easy and out of step with inflation dynamics and very tight policy elsewhere. The BOJ is gradually stepping away from yield curve control and the next step is likely to end negative interest rates and perhaps lift rates into positive territory. The means of transition will add to volatility, but we are assured in the sense that the BOJ is strongly incentivised not to tighten so much as to risk the economy re-entering deflation.

- **Gold as a multi-purpose hedge**: Gold continues to work as a risk hedge, providing protection against geopolitical risks and systemic risks such as those stemming from the Russia-Ukraine war in 2022 and the banking crisis early in 2023. Gold also provides a safe haven against poor government policy and a combination of policies that effectuate currency debasement. In Japan, for example, the BOJ's easy policy is deemed necessary to free the economy from deflation. The side effects of such a policy are a weak currency and higher inflation, and gold has served as a powerful store of value for the Japanese. Governments around the world are building gold reserves, perhaps aware of the risks that the stretched financial system poses. Gold is a preferred defensive asset which offers portfolio protection, and it is currently less driven by interest rates as it has been historically.

Conviction views and strategy into 2024

Strategy overview: Our chief objective is to source and combine both income and growth to achieve real returns above inflation and cash rates. Given the amount of yield that is capable of being generated from the bond markets, we currently favour fixed income, which can generate a consistent yield and return, over equity alternatives that are more vulnerable to the economic cycle. Our preferred fixed income exposure includes short-dated credit markets for their strong levels of carry and longer-dated sovereign bonds which are not facing extreme hedging costs from curve inversion. In the equity space, we are focused on secular growth opportunities that exceed the high yield hurdle.

Equities: We favour Japan equities for the country's structural reforms that support earnings and better profitability for the months and potentially years ahead. A value tilt is sensible, in our view, as banks and other historically low-profitability industries may have the most to gain from reforms.

Our value tilt in Japan dovetails with our secular growth theme derived from big tech that is driving AI development principally located in the US. The tech hardware cycle is also turning to the upside, having drained most of the excess inventory from the post-COVID overhang. While our focus is on secular growth themes, we remain opportunistic on potential cyclical opportunities such as pockets in emerging markets and perhaps Europe depending on how the cycle unfolds.

Commodities are facing supply constraints while limited capital expenditure in production capacity has resulted in enormous cash flow, especially in energy, that is boosting buybacks. There is natural support for commodity prices given the limits on production capacity and investment needs for raw goods and energy. Importantly, we see commodity-linked equities being a natural hedge to inflation and duration risk.

Sovereign bonds: Developed market sovereigns look expensive relative to the US Federal Reserve's cash rate, as 10-year Treasury yields sit some 100 plus basis points (bps) below the cash rate. This reflects the markets pricing significant cuts over the next 12 months. We see slowing inflation and growth being a tailwind for sovereign bonds in 2024. However, highly inverted yield curves make such a position expensive for investors not based in the US and perhaps not offer the capital gain payoff investors expect. Accordingly, we are constructive on (1) countries that offer better-hedged yields such as Australia and China, (2) short-dated bonds where the curve inversion is not as extreme, and (3) emerging market bonds which could see their currencies perform well if Treasury yields decline.

Credit: We have become more constructive on credit over the past six months and continue to have a favourable view of short-dated credit spreads. While economic growth has been slowing sharply across Europe, certain economies such as the US and Australia have so far shown resilience. Investment-grade issuers termed their debt out during the COVID crisis, and this has meant the higher interest rate costs have been slow to bite. We think that the combination of high short-end government rates and credit spreads which are around their historic averages point to carry-adding opportunities.

Gold: In addition to a selective sovereign duration that hedges mainly against slowing growth, gold serves as a key defensive asset in our portfolios to hedge against plentiful geopolitical and systemic risks as well as policy mistakes that may emerge in 2024.

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