1Q24 Capital Markets Update

Time to lock in the high yields on US fixed income

As central banks are expected to cut rates throughout 2024, yields are likely to decline. Investors can benefit from locking in opportunities available in the US fixed income market

Focus on high quality stocks

Companies with strong balance sheets, stable cash flows, and healthy profit margins are positioned well for weak economic growth environment - a baseline scenario for 2024 in DMs

Stay invested in AI & other disruptive technologies

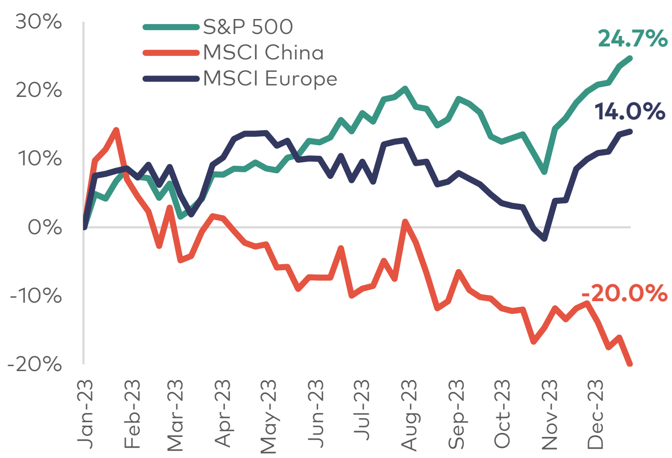
Companies involved in artificial intelligence, chip-making, fintech, cybersecurity, and healthcare technologies are expected to benefit considerably in mid to long-term

2023 Recap

The US and European stocks rallied, while China lagged. 2023 was contrasting to a year before. Equity markets in the West rebounded sharply from 2022 losses, primarily catalyzed by investor excitement around the new AI technologies as well as central banks' noteworthy success in combating inflation. Importantly, the major sources of growth in US equities were the seven largest S&P 500 companies that promise to leverage heavily on AI and disruptive technologies in the near future. In contrast, the Chinese economy underperformed expectations, a result closely mirrored by the country's equity market that declined 20.0% in 2023.

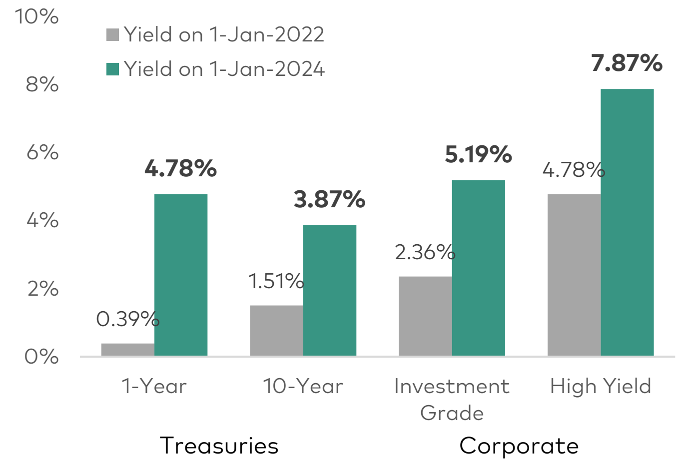
Yields have declined, but remain elevated compared to the pre-pandemic period. As inflation kept moderating, markets have priced in rate cuts from the US Fed and European Central Bank as early as in the first half of 2024. As a result, yields have fallen considerably. The 1-year and 10-year US Treasuries, that currently yield 4.8% and 3.9%, offered 5.5% and 5.0%, respectively in October 2023. Nevertheless, the US fixed income has not been so attractive since 2008. Hence our first theme for 2024: locking in the high yields currently available in the markets.

Performance of major regional equity markets in 2023



Source: Bloomberg

Yields on major US fixed income classes in 2022 and 2024



Source: Bloomberg

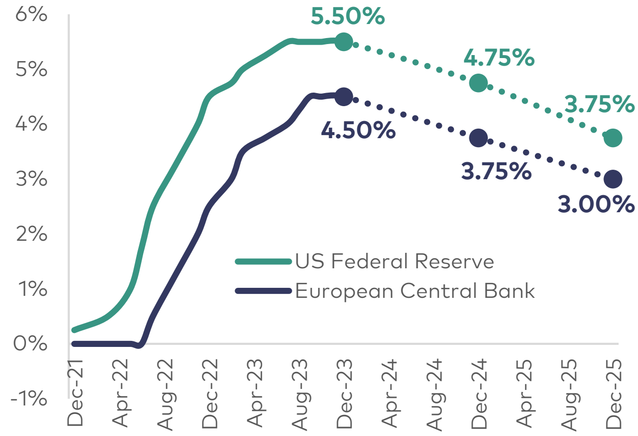
Main Investment Themes for 2024

1. Lock in the high yields

The Fed and the ECB are expected to start cutting rates as early as in the first half of 2024 and, according to forecasts, should reach 4.75% and 3.75% by the year-end, respectively. Any reduction in interest rates will translate into lower yields on debt securities, making it a good time now to lock in the high yields currently offered by markets.

Importantly, however, interest rates are unlikely to return to the pre-pandemic lows in coming years, as inflationary pressures are expected to remain elevated. In terms of the economy, this implies a lower demand for credit, lower consumer and business spending, and an overall weaker economic activity.

US Fed and ECB interest rates (realized and expected)

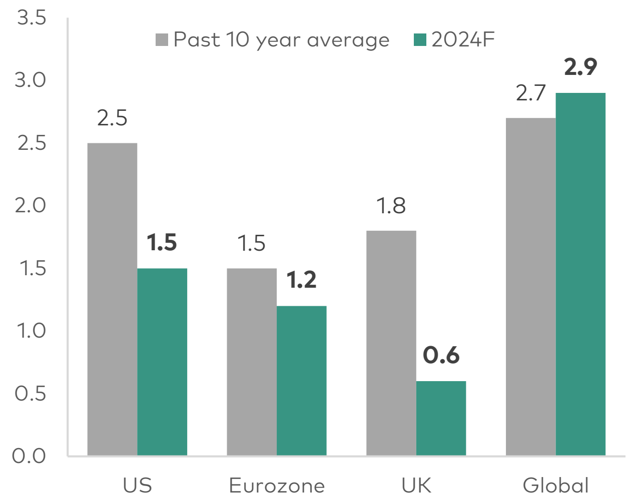


Source: Bloomberg, US Federal Reserve, European Central Bank

2. Position for weak growth in developed markets…

In 2024, developed markets are expected to grow by less than their historical trends, as tight monetary policy is likely to discourage economic activity. This is an unfavorable scenario for growth assets. However, high quality stocks are well positioned to withstand such economic environments. These companies are characterized by experienced management teams, strong balance sheets, high return on capital employed, strong and stable cash flows, and healthy profit margins. Examples of high quality stocks are Apple (AAPL), MasterCard (MA), Eli Lilly and Company (LLY), UnitedHealth Group (UNH), Adobe (ADBE), and Merck & Co. (MRK). Lastly, consider FTSE 100, an index of mature and stable companies, paying a near 4% dividend yield.

IMF GDP growth forecasts for major economies (%)



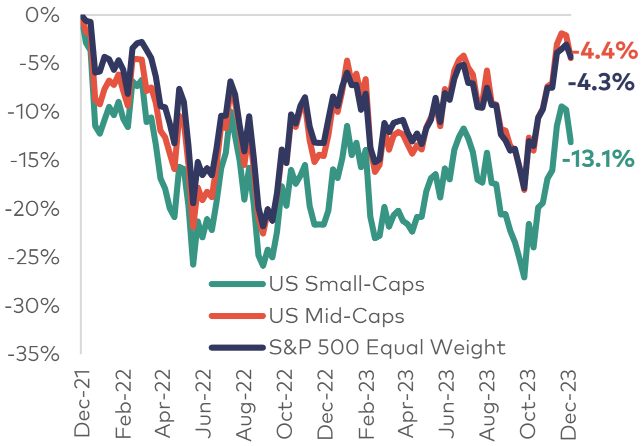
Source: Bloomberg, IMF

3. … but leave room for positive surprises

Macroeconomic developments are hard to forecast. Given that global economic growth surprises on the upside while inflation continues to fall, high beta stocks are expected to outperform the broader market. Such companies are usually of small size and are found in highly cyclical industries, such as ecommerce and travel (e.g., cruise lines).

Currently undervalued equity segments are also likely to outperform under such a scenario. Small (IWJ) and medium-sized US stocks (IJH) as well as the equal-weighted S&P 500 index (RSP) are examples of the US equity segments that remain below their 2022 peaks.

Performance of US equities since 1-Jan-2022



Source: Bloomberg

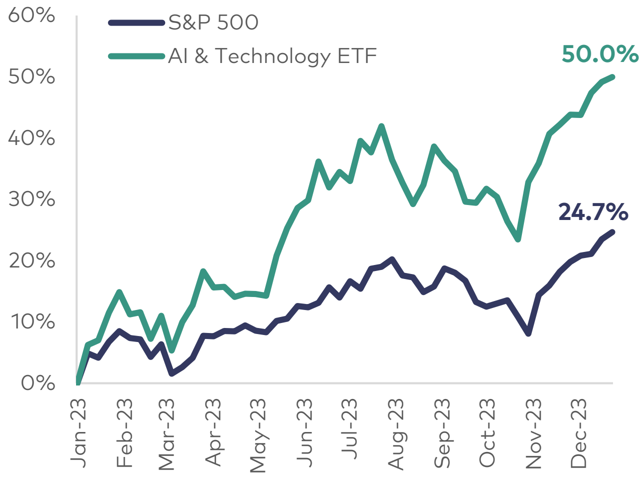
Main Investment Themes for 2024

4. Be invested in AI & other technology megatrends

Technology megatrends are expected to reshape the economies in mid to long-term period. While the early signs of productivity gains are already seen from adopting new AI technologies, the impact is expected grow considerably, with mature economies with aging populations benefitting the most.

The industries most likely to be impacted positively in the short run from technological disruptions are healthcare (potential for drug development and digital healthcare), semiconductors (increasing demand for AI-tailored chips), cybersecurity (rising need in response to more sophisticated cyber threats), and fintech (growth of digital payments).

Performance of AI ETF and S&P 500 in 2023

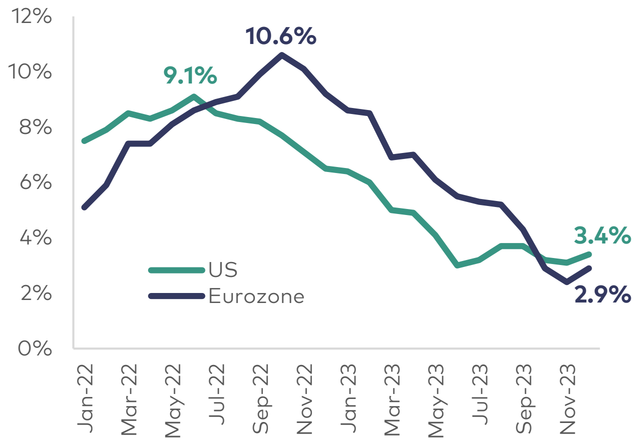


Source: Bloomberg

5. Insure against persistent inflation...

Inflation has moderated considerably in both the US and Eurozone. However, upside risks remain to be seen on the horizon. If inflation reaccelerates/stops falling, central banks will likely have to delay rate cuts, which would be an unfavorable scenario for both stocks and bonds. To insure against this risk, investors can add inflation-hedges in their portfolios, such as commodity futures and ETFs as well as energy stocks. For instance, in 2022, when inflation peaked in the West, GSCI commodity-indexed ETF (GSG) and S&P 500 Energy Select Sector ETF (XLE) returned roughly 24% and 58%, respectively.

Headline CPI inflation in the US and Eurozone



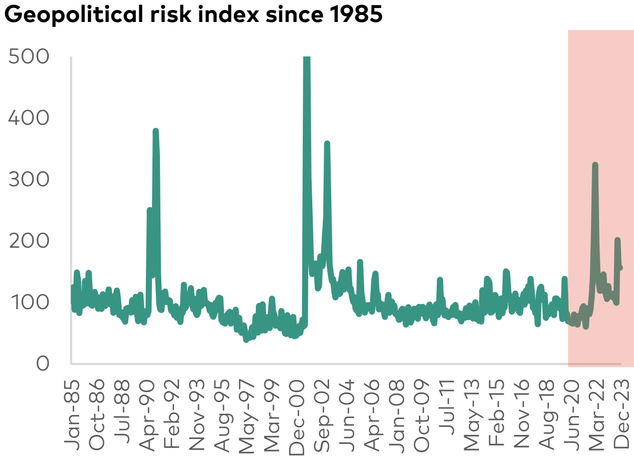
Source: Respective national statistical offices

6. ... as well as geopolitical risks

Worries on existing and potential geopolitical conflicts have been a key investment theme in past year and the situation is not expected to change meaningfully in 2024. This year has a heavy political calendar, with major elections scheduled in the US, the UK, Taiwan, India and Russia.

While global trade and cooperation is challenged by deeper geopolitical fragmentation, one way investors can hedge against such risks is by adding exposure to the strategic industries, such as aerospace and defense as well as safe haven assets, such as precious metals. Historically, gold, silver, and oil have been the most resistant assets to geopolitical risk fluctuations.

Geopolitical risk index since 1985



Source: US Federal Reserve Board

2024 Forecasts

Fixed income yields are expected to decline in 2024. As inflation retreats in developed economies and monetary authorities start gradually cutting rates, yields on sovereign as well as corporate credit will very likely follow and decline. Therefore, it may be a good time for investors to lock in the high yields currently available in the market.

Analysts favor cyclical sectors, despite dim economic outlook in developed markets. Cyclical US sectors of Communications, Consumer Discretionary, Financials, Energy, and Materials have positive consensus growth forecasts over the next 12 months. In terms of broader markets, Japan and AI-fueled developed markets equities have the most positive outlook. Meanwhile, the US and European markets are expected to be challenged by unfavorable macroeconomic environments.

FIXED INCOME

Bloomberg Consensus Forecasts for Yields, %

Rate	Latest	1Q24F	2Q24F	3Q24F	4Q24
US treasuries					
30-year	4.20	4.27	4.16	4.06	4.05
10-year	3.95	4.07	3.95	3.84	3.8
5-year	3.83	4.08	3.9	3.73	3.62
2-year	4.14	4.42	4.14	3.87	3.68
SOFR*	5.31	5.28	4.99	4.6	4.27
German bunds					
10-year	2.14	2.53	2.41	2.32	2.24
2-year	2.52	2.8	2.64	2.43	2.26
EURIBOR*	3.93	3.94	3.84	3.65	3.38

Source: Bloomberg
*SOFR and EURIBOR are given in 3 month maturities

EQUITIES

12 Month Consensus Analyst Forecasts*

S&P Sectors	ETF	Outlook
Communications	XLC	Positive
Discretionary	XLY	Positive
Financials	XLF	Positive
Energy	XLE	Positive
Materials	XLB	Positive
Technology	XLK	Neutral
Healthcare	XLV	Neutral
Staples	XLP	Neutral
Real Estate	XLRE	Negative
Industrials	XLI	Negative
Utilities	XLU	Negative

Source: S&P Capital IQ

6-12 Month Market Views

Markets	ETF	Outlook
Japan	EWJ	Positive
DM AI mega force	BOTZ	Positive
UK	EWU	Neutral
Emerging Markets	EEM	Neutral
China	MCHI	Neutral
US	SPY	Negative
Europe	IEUR	Negative

Source: BlackRock Investment Institute

Positive Neutral Negative

*12 month consensus analyst forecasts correspond to average growth forecasts from the best performing financial analysts (mainly from the Wall Street). Outlook mark is determined with respect to the overall growth forecast for S&P 500 (i.e., if the sector has a higher growth forecast than S&P 500, then it is assigned a positive outlook mark and vice versa).

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