Monthly Investment Update

2024 Outlook: Key Themes Shaping the Path Ahead

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In 2023, one of the biggest surprises was the combination of high growth and falling inflation in the US, which had a huge impact on all risky assets. In Europe, on the other hand, inflation fell even faster – but at the cost of stagnating growth. As a result of this largely positive environment, we are starting the new year with a moderately constructive positioning in our asset allocation. But while it's interesting to see that things have turned out to be much better than expected, in terms of growth and inflation, it's also vital to identify the primary causes – in order to understand if these trends may continue in the year ahead.

Highlights

▪ Our outlook is positive for the US equity market and neutral for Europe, while our portfolios are neutral on Emerging Markets and China for the time being.

▪ In terms of bonds, following the very strong rally in the last two months of 2023, we believe that yields seem to be at fair value – and therefore returns should be in line with current prevailing yields.

▪ In the currencies space, we maintain our overweight exposure to the US dollar.

▪ Within commodities, we have small positions in oil and gold as a hedge against geopolitical risks and if the US dollar dynamic turns out to be weaker than we expect.

2024 Outlook

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Looking ahead in 2024, our outlook is positive for the US equity market and neutral for Europe, while our portfolios are neutral on Emerging Markets and China for the time being.

In terms of bonds, following the very strong rally in the last two months of 2023, we believe that yields seem to be at fair value – and therefore returns should be in line with current prevailing yields, especially on long maturities. In fact, the market is already discounting 150 basis points (bps) to 160 bps in rate cuts by the Federal Reserve (Fed) and the European Central Bank (ECB) over the year – which is achievable given the trend in inflation is lower, and growth is decelerating in the US while already very low in Europe. But a nasty recession would need to materialize in order to justify a more aggressive rates dynamic, and consequently fixed income returns higher than current yields. For this reason, we remain neutral on bonds, as keeping durations longer than benchmarks represents an unnecessary risk that we prefer to avoid. We prefer to increase portfolios' yields with selective quality corporates and a marginal exposure in bank subordinated debt.

In the currencies space, we maintain our overweight exposure to the US dollar (USD). We recognize that the valuation of the USD is currently on the rich side, and the US Treasury's hefty issuance (due to high deficits) could attract speculators' interest. Yet, our view is that the ECB could actually anticipate the Fed in cutting rates, despite their rhetoric: economic conditions warrant an easier monetary policy in Europe before the US.

Within commodities, we have small positions in oil and gold as a hedge against geopolitical risks and a weaker dynamic in the US dollar than we currently expect.

Figure 1: 2023 Market Performance

Equity Indices	Last Value	Last Year
MSCI World	3,115.68	24.44%
Nasdaq	14,592.21	44.70%
S&P 500	4,704.81	26.26%
S&P Equal Weighted	6,308.09	13.84%
DJ Industrial	37,430.19	16.18%
Nikkei	33,288.29	30.90%
Eurostoxx	4,462.18	23.22%
Swiss SMI	11,176.77	7.06%
FTSE 100	7,693.81	7.68%
Canada	20,818.58	11.83%
Shenzen	3,347.05	-9.14%
Hong Kong	16,645.98	-10.46%
MSCI EM	1,003.13	10.12%

Equity Sectors	Last Value	
S&P value	173.50	22.09%
S&P Growth	73.29	29.84%
S&P Defensives	1,585.14	3.43%
ARK Fund	48.52	67.64%
Fangs	8,410.27	96.45%
S&P Banks	95.03	-0.89%
Euro Stoxx Banks	86.12	31.53%
S&P Energy	86.12	-0.64%
Gold Miners	29.76	9.96%

Commodities	Last Value	Last Year
BBG Commodities	98.60	21.77%
BBG Agriculture	61.62	43.42%
BBG Energy	31.85	24.23%
BBG Precious Metals	220.48	11.56%
BBG Industrial Metals	138.62	13.70%
Gold	2,047.45	13.10%
BBG Brent Crude TR	1,079.17	-0.92%
BBG WTI Crude Oil TR	192.39	-1.97%

FX	Last Value	
DXY Index	1,223.55	-2.70%
EUR/CHF	0.9316	-6.13%
GBP Index	649.50	4.03%
EM FX Index	1,728.02	4.80%
USD/JPY	144.23	7.57%
USD/CNY	7.15	2.92%
Bitcoin	43,180.32	153.55%

Bond Indices	Last Value	
US Inv Grade	109.66	9.40%
US High Yield	76.92	11.53%
Euro Corps	245.52	8.19%
JPM Europe Govies	10,452.24	13.43%
US Treasuries	2,271.48	4.05%
China Aggregate	260.28	2.71%
EMBI Global	836.60	10.45%
EMBI Local	135.35	10.90%

Source: Bloomberg, as of December 31, 2023.

The big surprise of 2023 was the combination of high growth and falling inflation in the US, which had a huge impact on all risky assets, starting with those that have the longest duration (i.e. greater sensitivity to interest rate declines, such as the technology sector, led by the US Big Tech names). In fact, US inflation declined from 6.5% year-over-year at the beginning of 2023 to 3.1% at the end of November, while GDP growth should be around 2.5% for the whole year (data is due to be published at the end of January).

In Europe, on the other hand, inflation fell even faster, from 9.2% to 2.4%, but at the cost of stagnating GDP growth. The first major difference between the two continents is that the tightening of monetary policy in Europe has already impacted economic activity, but in the US it has not. Growth forecasts for 2024 see the consensus for US GDP more than double (1.30%) European GDP (0.50%). But despite this, the ECB has been far more hawkish than the Fed in recent weeks!

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Looking at the US, which is by choice our reference market, we were all (too) obsessed with the arrival of a hard landing – which seemed all too obvious, to miss many other favorable trends that have occurred, starting with artificial intelligence (AI). The typical slogans of the beginning of the year ('rising rates = recession', 'higher-for-longer until something breaks', 'the post-Covid supply curve has changed, worsening the growth-inflation mix') have, at least for the moment, proved unfounded.

Regarding the two key variables, growth and inflation, why have things turned out much better than expected?

It is important to identify the causes, in order to understand the potential persistence of these trends in the year ahead. **As far as growth is concerned, four dynamics developed in a very unexpected way: 1) fiscal spending, 2) productivity, 3) the (very) delayed impact of monetary policy, 4) sustained private consumption thanks to the labor market, the availability of a large pool of excess savings accumulated during the pandemic, and excellent consumer balance sheets in the post-Covid era.** Let us analyze these factors in detail, some of which are probably exceptional – and therefore unlikely to be repeated in 2024 – while others should last for longer.

Government spending has had a very strong impact on growth, estimated at over one percentage point of real GDP. The US budget deficit is expected to settle at over -7% in 2023, a very high level for a year of full economic expansion with the unemployment rate at an all-time low, below 4%. It is

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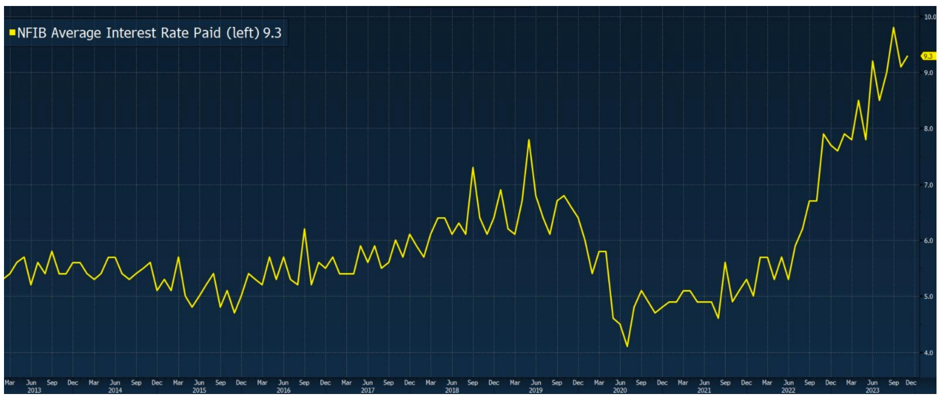
hard to imagine that in an election year like 2024 the government will pull the reins in the boat; indeed, it will do what it can to spend, but it does not have control of both Houses. It is therefore difficult to think of another positive net contribution to growth.

"The labor market started to show signs of weakness, with job openings and temporary jobs falling sharply..."

The labor market started to show signs of weakness, with job openings and temporary jobs falling sharply, and the unemployment rate itself already rising from its April low of 3.5% to 3.8% today. This trend is likely to continue, as the Fed continued to raise rates until July, and yields on the long end of the curve only stopped rising in September – so the effects of these hikes are being felt with a lag on companies' income statements. We also know that the cost of capital for SMEs – which by number of employees are the largest 'employer' in the US economy – has almost doubled from 5% to 9% in the last two years, and has only started to fall in the last month. It is unlikely that the last 2 or 3 percentage points of increase will not be felt until rates fall more sharply. In addition, consumption has benefited from about USD1 trillion extra savings during 2023, which have been deployed at a rate of almost USD100 billion per month to meet the needs of households. The most reliable estimates say that this pool does not exceed USD200-300 billion to date (from a starting point of more than USD2 trillion in 2021).

Figure 2: NFIB Average Interest Rate Paid



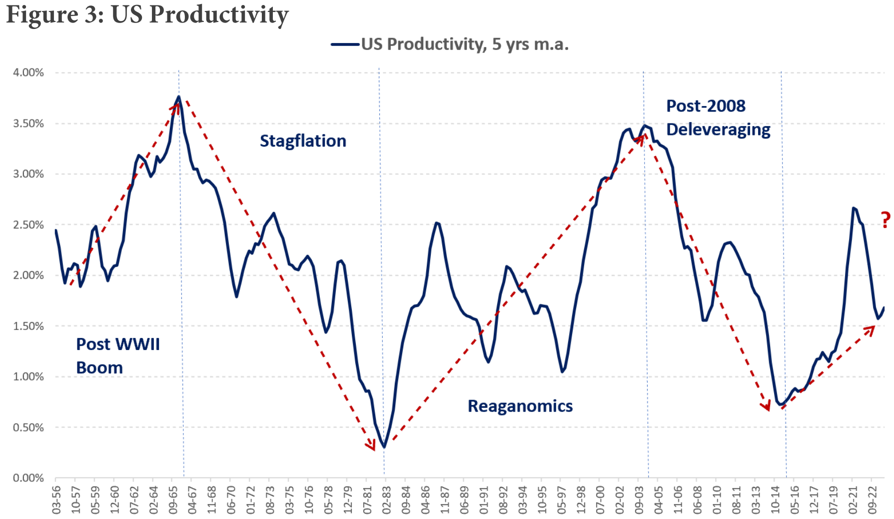
Source: Bloomberg, as of January 5, 2024.

"The positive factors that should support the economy in the coming year and beyond are productivity and the consumer balance sheet."

Instead, the positive factors that should support the economy in the coming year and beyond are productivity and the consumer balance sheet. An increase in productivity could prevent the economy from entering a recession even with some softness in consumption, while the health of the balance sheet should prevent any recession from becoming too severe (more than 0.5% GDP contraction for a couple of quarters).

Productivity is, in our view, the most important element, and the basis for our constructive positioning for risky assets (at least US ones – as we will see below in more detail) in 2024. As Figure 3 shows, productivity, which has been hovering around 2% in the US for the past 70 years (twice as much as in Europe), seems to have entered an acceleration phase.

Figure 3: US Productivity



Source: Bloomberg, as of January 5, 2024.

Productivity is closely linked to direct investments, and these are accelerating in this cycle. Investments are favorably affected by three factors: AI, post-Covid supply chain disruption, and geopolitics.

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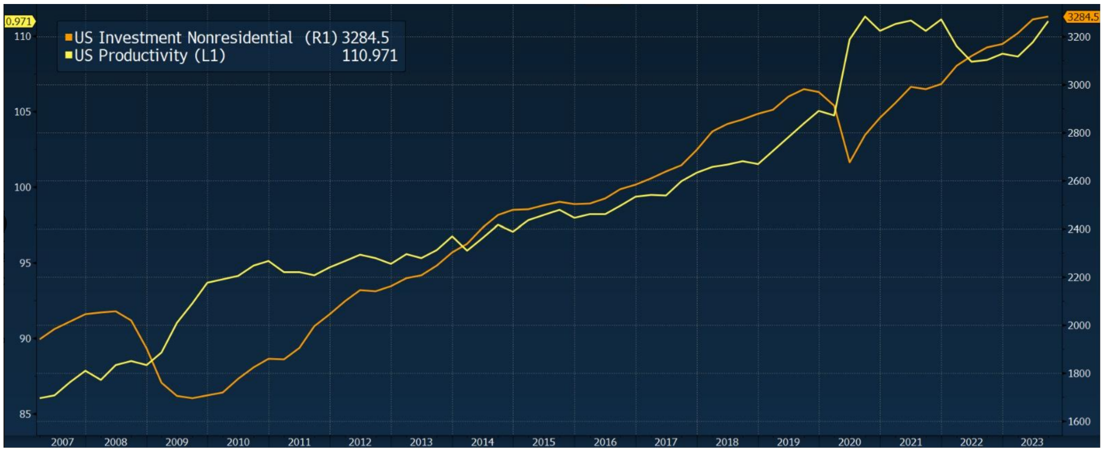
Figure 4: US Investment vs. Productivity



Source: Bloomberg, as of January 5, 2024.

On AI, it is all too clear that the need for companies to invest in order to keep up with the ongoing technological revolution is a priority. The other two factors are somewhat counterintuitive. The pandemic has taught companies, and purchase managers in particular, that bringing manufacturing closer to home (hence to the US, and the Biden administration's various 'investment act' programs) is important.

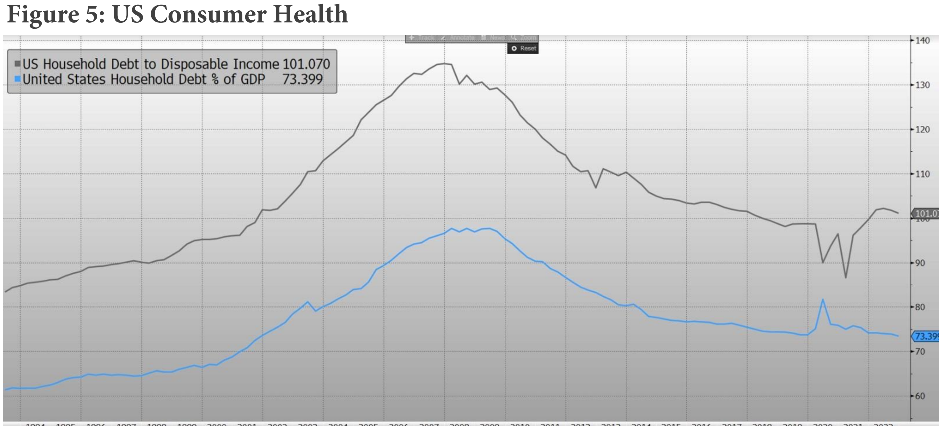
Geopolitics is also helping investments, with US-China tensions that we believe will continue to manifest themselves on the level of economic competition rather than direct military confrontation (we are referring to concerns over Taiwan). US politicians are already doing everything to favor domestic production (reshoring), or at best, friend-shoring. This trend is unlikely to change any time soon. In detail, three government programs went into full swing in the second half of 2023: the IRA (Inflation Reduction Act), the Chips Act, and the Infrastructure Investment and Jobs Act, totaling at least USD1.6 trillion.

Productivity is also getting a boost from the long post-Covid wave. The penetration of technology into our working lives has increased, as has hyper-connectivity, perhaps at the expense of stress, but certainly favorable to output per hour. Technology is also making the labor market more elastic and efficient, with companies being able to draw from a larger labor pool thanks to working-from-home, benefiting efficiency.

“Productivity is also getting a boost from the long post-Covid wave.”

For the health of the consumer, we use the graph below which needs no further comments: despite the rate hikes of the last two years, interest expenditure as a share of income is rather low in historical terms. This is due to two aspects: 1) the amount of debt on consumers' shoulders has decreased after the restructurings during the GFC, and 2) the whole economy (and thus incomes) has exploded in nominal terms due to the post-Covid inflation shock.

Figure 5: US Consumer Health



Source: Bloomberg, as of January 5, 2024.

“...the system in aggregate has cleaned itself up a lot thanks to the inflation level of the last two years...”

Moreover, Personal Consumption Expenditures, which make up 70% of GDP, and GDP itself, have grown by 33% since the end of 2018, contributing a great deal to rebalancing the debt ratios in relative terms, for both the private and public sectors. It is a bit like saying that the system in aggregate has cleaned itself up a lot thanks to the inflation level of the last two years, even though the imbalances between debtors and creditors, rich and poor, have increased internally. **The Fed's dovish turn at the end of November is interesting in this respect, as it seems to be a confirmation of the American pro-growth mentality, which has perhaps interrupted a phase of internal redistribution to the detriment of asset holders.**

With regard to inflation, however, the normalization is mainly due to labor costs, which have fallen significantly despite a strong labor market, and to the supply side, which has regained its elasticity and thus its ability to cope with sustained demand without generating price pressure. **Moreover, let us remember that this expansionary cycle, which began after the pandemic lockdowns, has been very atypical. In fact, the collapse of economic activity was due to the forced closure of the economy and the inability to produce goods and offer services.** Therefore, once companies were left to operate, and the psychological effect of the reopening that altered consumption choices had worn off, supply and demand quickly rebalanced, reducing pressure on prices.

“The moment the economy fully reopened and normalized, inflation started to fall, despite sustained demand.”

In practice, the moment the economy fully reopened and normalized, inflation started to fall, despite sustained demand. This would seem to confirm the thesis that it was a supply side problem. Consequently, it seems reasonable to us to stick to this trend; after all, if the risk to the economy is downwards, this should lead to a further weakening of the labor market and thus to a further decline in labor costs. It is easier to think that inflation could rear its head in the face of a new energy shock, but this is part of the geopolitical tail scenarios, which we can defend against with natural hedges in the energy sector.

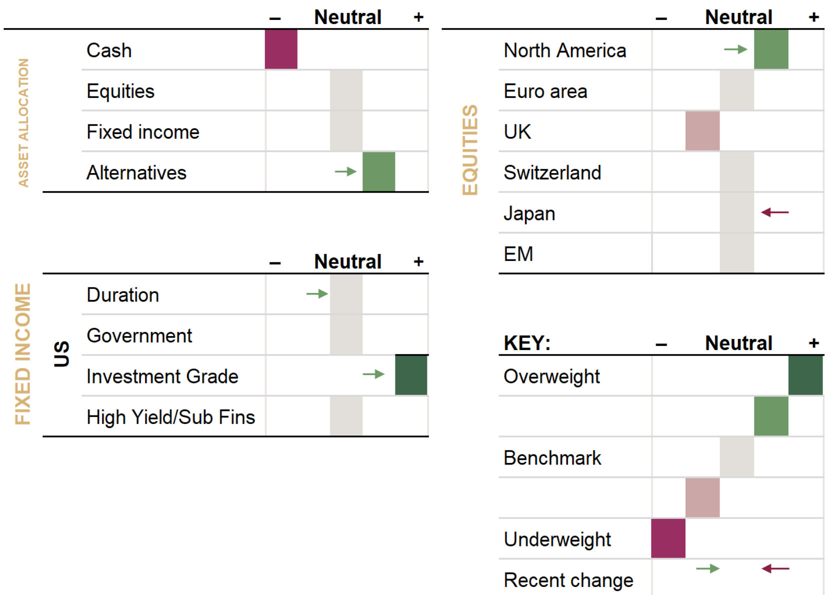
Figure 6: US Labor vs. Core CPI

Source: Bloomberg, as of January 5, 2024.

"In terms of asset allocation, we are starting 2024 with a moderately constructive positioning."

In terms of asset allocation, we are starting 2024 with a moderately constructive positioning. Our bets are a synthesis of three possible scenarios we have identified for the US economy, combined with our structural view, which has never changed in Novum's history, of the supremacy of the US capital markets over Europe and the emerging markets.

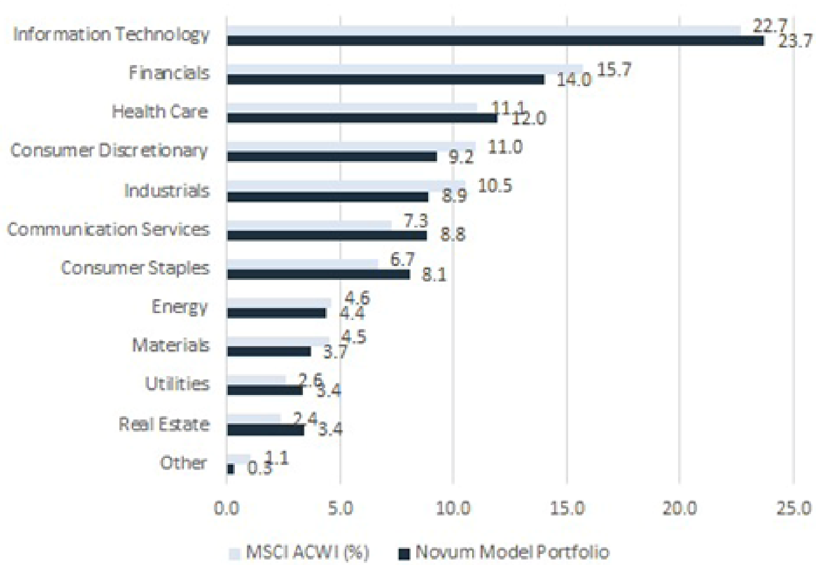
Figure 7: Our Asset Allocation



In terms of sectors, the biggest bet is an overweight in the technology sector, which weighs more than 20% of equity books, and a slight overweight in sectors linked to falling rates, namely utilities and real estate.

"In terms of sectors, the biggest bet is an overweight in the technology sector..."

Figure 8: Our Sector Positioning



The three scenarios we have identified are as follows: at a methodological level, the Investment Team has assigned a probability score to the three (US) economic scenarios, and we have constructed our outlook accordingly, which we comment on briefly below.

Scenario	Key Variables	Probabilities
Soft Landing	GDP slows to 1% from 2,5%, inflation softens, Fed cuts rates slowly	70.0%
Recession	GDP falls to -0,5% on the full Year, inflation collapses, Fed cuts aggressively	22.7%
Stagflation	GDP slows to 1% or below, but recession remains sticky, Fed cannot cut rates	7.3%
		100.0%

The 'soft landing' scenario seems the most likely, and is fully endorsed by the market. **It must be said that had we not witnessed the Fed's change of stance in mid-November, this scenario would have been far more unlikely for us.** But the rate movement we witnessed was significant, with a drop of over 100 bps in 10-year rates, a tightening of credit spreads, a 16% rally in the S&P 500 from its lows, and a drop in the Dollar Index of over 3%. All this has enabled an easing of financial conditions comparable to Powell's famous U-turn at the end of 2018. We therefore think it possible that this U-turn (or perhaps a too early declared victory on inflation, which we will find out next year) could really allow the economy to make a perfect soft landing, since we know how sensitive Americans are to the wealth effect on portfolios, and thus compensate for the tightening that was materializing until a few months ago.

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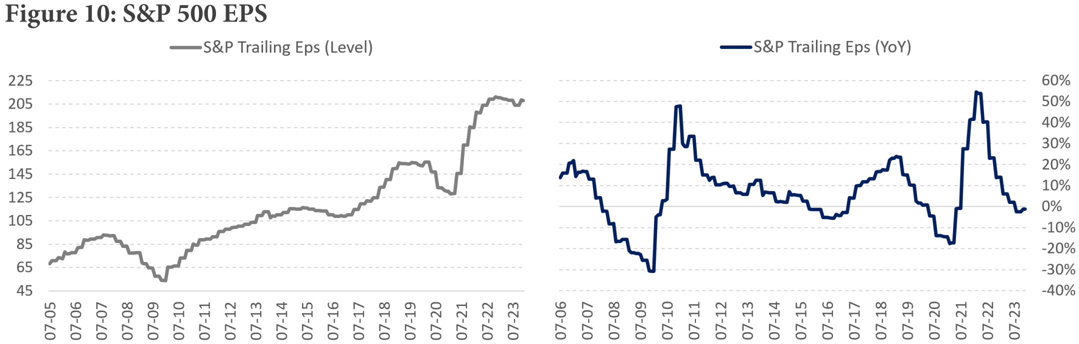
Figure 9: US Financial Conditions

Source: Bloomberg, as of January 5, 2023.

In this scenario, market expectations for the S&P 500, with expected earnings growth of 10% for the year, could be met, or even beaten. The graphs below, showing the S&P 500's earnings (the absolute level on the left and year-over-year change on the right), reminds us of another paradox in this economic cycle. As we see from the chart on the right, earnings exploded after the post-Covid reopening, while in 2023, despite solid economic growth, they have been stagnant year-over-year (since production costs caught up with the rise in sales, and consequently market gains have come from expanding multiples). Next year, on the other hand, with the Fed ready to cut rates, we should start to see earnings rebound as early as January (Q4 2023 earnings), and then continue to grow in subsequent quarters for the aforementioned total of 10%, year-over-year.

"Next year, on the other hand, with the Fed ready to cut rates, we should start to see earnings rebound as early as January..."

Figure 10: S&P 500 EPS



Source: Bloomberg, as of January 5, 2023.

As far as multiples are concerned, it is true that after the recent rally, the one-year forward P/E has moved towards the upper end of its range (Figure 12), but if inflation were to fall without a recession, these levels can be sustainable. The multiple we see of the S&P 500 is very much influenced by the "Mag 7", whose multiple is certainly very high (34), but also justified by the operating margins (double the aggregate S&P, at 26%) and earnings growth expected in the coming years. Let's also not forget that the "Mag 7" collect an average of 55% of their revenues abroad, compared to around 40% for the rest of the market. Consequently, the recent decline of the USD, which could continue if the US economy slows down more than expected, would act as an implicit hedge for the sector.

The last element, supporting the thesis of not excessive multiples, is that the "S&P 493" (which is obtained by subtraction of the Mag 7), trades at a more acceptable 15/16 forward P/E ratio.

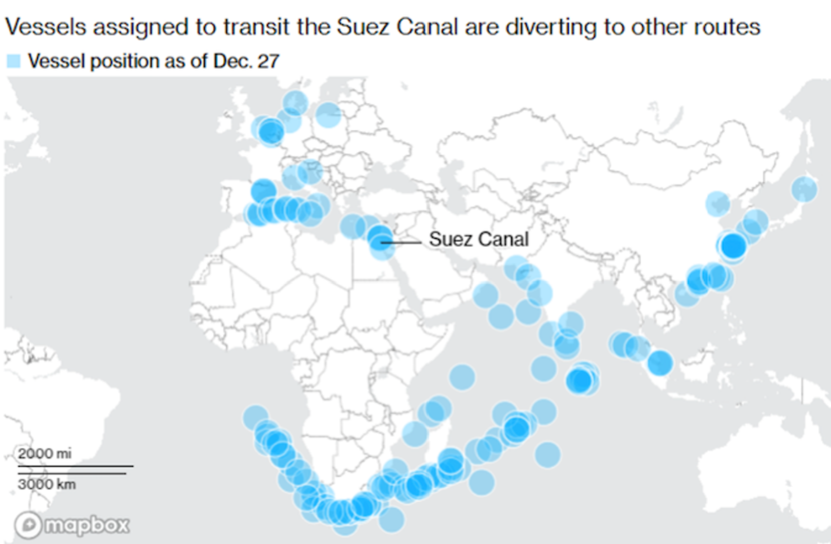
Figure 11: S&P 500 P/E Ratio

"In our central scenario, we have considered the possibility that our overweight on the USD will penalize us..."

Source: Bloomberg, as of January 5, 2023.

In our central scenario (70% probability), we have considered the possibility that our overweight on the USD will penalize us (the Fed cutting rates is historically a negative for the USD – in the context of high deficits). This is a risk we are willing to take, since the strong USD should also materialize in the third scenario, the most unlikely one for us, related to stagflation. We consider this scenario quite unlikely (7%), because as mentioned there is a contradiction between economic slowdown – declining labor market – and interruption of the disinflationary trend. An energy price shock could alter this picture (and this is why we want to be fairly protected with our overweight positions in the sector), and could bring us back to a new inflationary wave. Related to this topic is also the supply chain disruption led by geopolitical tensions, e.g. Red Sea, illustrated by the below map of ships going through the Cape of Good Hope.

Figure 12: Suez Disruptions

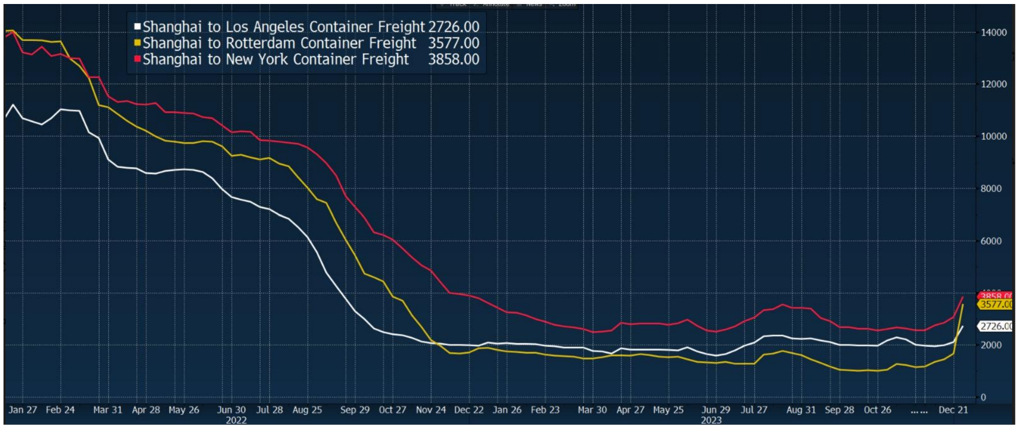


"Indeed, if the economy were to enter recession, it is clear that US equities would suffer."

Source: Flexport.

The second scenario, the hard landing scenario, is the one that is most difficult to hedge against. Indeed, if the economy were to enter recession, it is clear that US equities would suffer. But the USD would also fall, with the twin deficits difficult to finance with an aggressive Fed cutting rates. **It's hard to find a good hedge for this scenario, probably gold (of which we have small positions); indeed, even rates are already discounting 140-150 bps of cuts by 2024, almost double what the Fed's Dot Plots predict. Consequently, it does not make sense to bet on a marked drop in rates to justify an overweight in fixed income, especially on long maturities. Indeed, we remain neutral in the area, having bought bonds during 2023, and extended durations around September 2023.**

Figure 13: Freight Costs From Shanghai to the West



Source: Bloomberg, as of January 5, 2023.

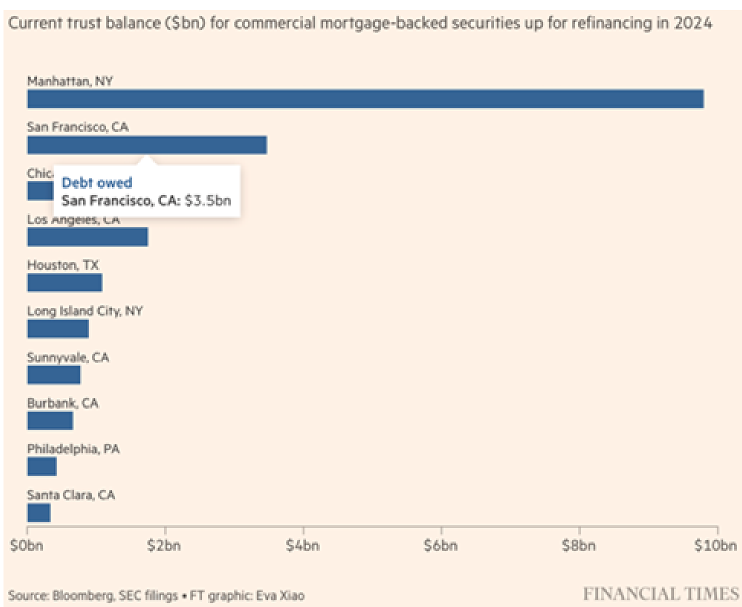
“This is why we will be monitoring the labor market, which would be the transmission mechanism between the corporate world...”

We will be paying close attention to this scenario. This is why we will be monitoring the labor market, which would be the transmission mechanism between the corporate world – which is subject to the downside of rate hikes and the consumer world. **As mentioned, this scenario is something of a race against time – on the one hand, the previous rises that are starting to hurt (as seen by the defaults on credit cards or loans of the most fragile borrowers) – and on the other hand, the easing of the last two months that can certainly come to the rescue.**

Another potential black swan related to the lagged effects of monetary tightening: a refinancing wall for CMBS/RMBS in the US, topping USD30 billion, will hit the market in 2024 (Figure 15). Should the refinancing process prove uneven, cracks could rapidly appear in the banking system, similar to what we saw with the regional banking crisis and the collapse of long-duration assets in their balance sheet.

One just has to hope that it is not too late!

Figure 14: CMBS/RMBS Refinancing Wall



Source: FT.