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MARKET OVERVIEW Q4 2023

Projections and outlook for 2024

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Market Overview Q4 2023 – projections and outlook for 2024

Executive Summary

The global economy has shown resilience throughout 2023 thanks to strong labor market, consumer sentiment, and business capital spending. This path proved more challenging for investors as central banks aggressively raised interest rates and tightened monetary policy to fight inflation.

The main consequence of the historically fastest interest rate hike cycle is the lagged effect - the effects on the economy and consumers that will begin to take hold as the new calendar begins.

Stock indices have proven to be more resilient to macro risks, but everything has a price: investors had to pay for absolute returns with record low diversification, where the share of the 7 largest companies exceeded a quarter of the index. And while nothing is more important to the retail investor than absolute return, professional and institutional investors take the structure of portfolios very seriously, where the distribution of returns and the concentration of risk and return play an important role.

We believe that 2024 will be an important turning point for the global economy and capital markets, and we are convinced that the recipe for an investment successful 2024 lies in the right mix of patience, diversification and quantification of institutional capital flows.

These 4 key investment themes for the coming year, will deliver balanced returns:

Diversification with alternative assets
The accumulating geopolitical and economic risks are a good reason to pay attention not only to alternative asset classes, but also to investment strategies.

Liquidity management
Trend towards lower interest rates - opportunity for optimization of debt instruments portfolio in order to form free active liquidity with fixed income.

High-quality investment assets
The market rally at the end of the outgoing year is not a reason for a complete rotation into high-risk assets, as the current economic situation is not sufficient to form a long-term rising trend and may be a source of risk.

Volatility of currencies and commodities
Both the dollar and commodity assets (along with metals) have been starting to form volatile trends.

Have a question for the team? CONTACT US

Key events and expectations in 2023:

- The banking crisis didn't happen, and neither did the U.S. default
- There has been no global collapse of the real estate market
- The recession has not happened because of a more resilient economy than it appeared to be
- The U.S. has lost its AAA credit rating from Fitch
- U.S. inflation slowed before the labor market worsened, averting the worst economic situation for the markets
- Contrary to pessimistic expectations, the Bank of England did not raise the rate to 6.5%, and is very likely to stop at 5.25%
- China's economy hasn't collapsed, but it hasn't had a growth boom either.

Key risks in 2024:

- High valuation and market concentration: the share of the technology sector in stock indices is at 1999 levels
- Excessive optimism: the number of mentions of "soft landing" in news stories is at 1995, 1999, and 2008 levels
- Estimating the trajectory of interest rates: historically, the market almost always misses in its consensus estimate of future interest rates
- Politicization of the economy: the upcoming elections may create artificial incentives for the private and corporate sector, which will subsequently burden the real economy even more heavily
- Geopolitical risk: the war in Ukraine, the war between Israel and Hamas, and the general escalation in the Middle East have again brought the risk of geopolitical tension to a new level.

Unlikely, but possible in 2024:

- **Pharmaceutical sector may be strengthened by new innovations.** Given the low multiple valuations and the high proportion of cash liquidity held by large pharmaceutical companies, there is an increasing likelihood of new products and new M&A deals in this sector
- **Amazon is starting to show ads.** Amazon Prime Video is very likely to start showing ads starting in late January, which will structurally change the company's advertising revenues
- **Cannabis surge.** President Biden is close to enacting significant easing on the cannabis market, which has caused thematic stocks and ETFs to boom
- **Institutionalization of cryptocurrencies.** Bitcoin represents an asset of nearly 800 billion, close to the market capitalization of Tesla, larger than Visa (523 billion), J.P. Morgan (490 billion) and Exxon Mobil (400 billion). A historic event is expected in the new year - the approval of a spot bitcoin-ETF by the SEC, which will change the industry forever.

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STRATEGY

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Strategy

Last year was full of unpredictable events that impacted the political-economic and business landscape in significant ways.
The economic and market downturn following the COVID-induced stimulus measures has not fully materialized; China continues to struggle with deflation in an effort to restart the credit cycle, and some countries in Europe are heading into recession faster than other regions. As for the US, credit is expensive, and the housing affordability index is near historic lows with savings rates near record lows.

Key events in 2023

Despite the temporary decline in the banking sector, globally it did not cause crisis effects

Banking crisis at the beginning of the year: in both Europe and the US, the spring of 2023 was marked by a crisis of bank liquidity reassessment, the bankruptcy of Silicon Valley Bank and the first alarm bell for investors' concerns about the reliability of the banking system. Subsequently, this theme evolved into the historic deal between Credit Suisse and UBS that changed the Swiss and European banking landscape forever.

With the introduction of ChatGPT, Bard, etc., the market has adjusted the valuation of most IT companies in a positive direction quite quickly

The banking theme has been replaced by artificial intelligence, which has flooded the information space and has become a strong driver of a significant part of the IT market. AI has consolidated the leadership of the largest US companies and renewed interest in the technology sector of a wide range of investors.

The cost of error for the Fed is high, as the market could be back in the 1970s due to a possible rapid interest rate cut

The decline in inflation towards the Fed's preferred 2% level and the Fed's subsequent rhetoric of willingness to cut interest rates is a key theme for the rest of the year. Although risks of a new wave of inflation remain, the market is optimistic about its assessment in the coming quarters.

The current unemployment rate of 3.5% is not recessionary, but recent figures suggest it is rising

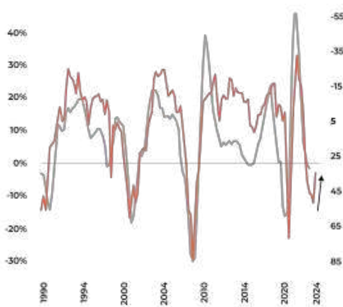
In the second half of 2023, for the first time there was a noticeable increase in unemployment, including in certain categories of employment (temporary, contract, and seasonal employment, employment in certain sectors of health care and services). Since unemployment remains the only key indicator that has not exceeded the recessionary triggers, we believe that this topic will soon return to the media spotlight.

Despite the aggressive pre-New Year's rally, we believe markets are underestimating the synchronization of the economic slowdown among global economies, and this macro pattern looks more like the final stage of a business cycle decline than the start of a new supertrend.

That said, we are optimistic about 2024 as the upcoming election as well as hidden liquidity injections can provide significant support for any bear market, similar to what we saw in the middle of 2020.

Asset prices and sentiment have ranged from euphoric to catastrophic over the past 2 years, and a whole suite of political-economic factors have contributed to this.

The level of lending to large companies has increased



S&P 500 EPS Y/Y (LS)
Sr. Loan Officer Survey: Banks Tightening C&I Loans to Large Firms (%, Leading 6M, Inverted, RS)

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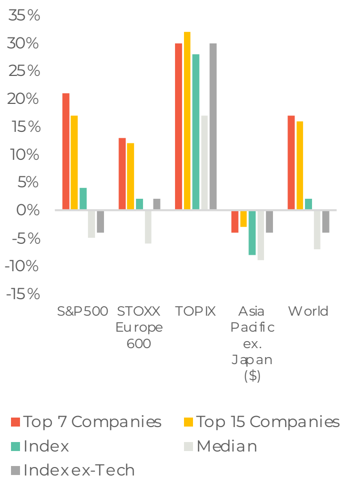
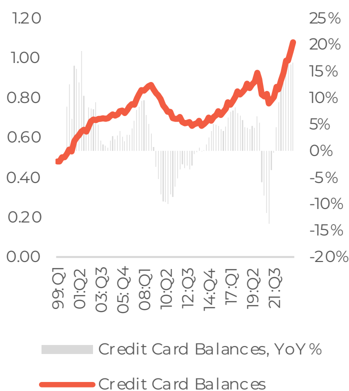
The slow progression of the economy toward the end of the cycle is somewhat reminiscent of the 1990-1991 period, when interest rate policy was slow to penetrate various areas and did not cause a recession similar to 2008

Equities dynamics in different markets



High interest rates are severely impacting consumers: interest rates on credit cards have risen to a shocking 20%, whilst delinquencies on money and car loans are on the rise

Consumer credit balance



Strategy

The combination of inflation and high interest rates usually leads to tighter credit, but this factor is gradually dissipating.

If the economy continues to grow, this will cause wages to rise and could put pressure on core inflation. The only organic way out of this situation is if the economy slows further, as this would break the nexus of stable inflation, high interest rates and tightening credit. But in that case, the likelihood of recession rises, and that is a process that is difficult to control.

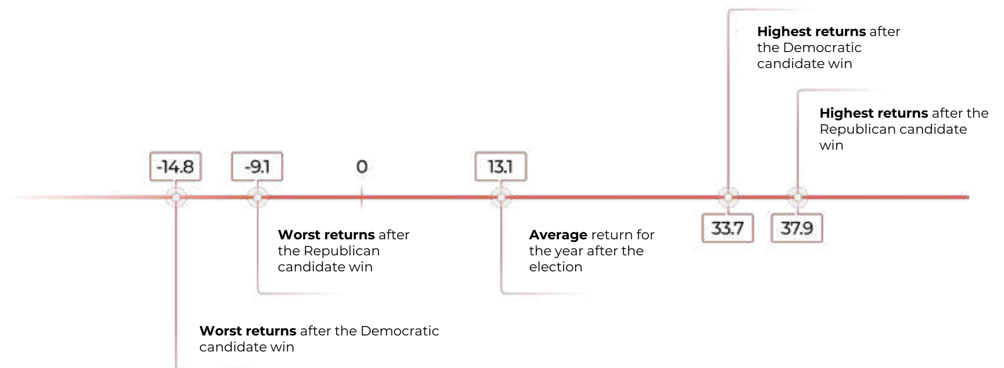
If inflation declines gradually, the Fed is likely to keep interest rates high for longer than the market estimates. We see that despite the political profile of next year, the Fed is watchful of its price stability goals.

For most of the past year, we have been focusing on high-quality, low-risk products to protect investors from likely but poorly predictable events. Based on previous experience, we have made some adjustments to model portfolios in order to better exploit probable price rallies.

The main risk to uncompromising investment growth is the general economic downturn, and in particular the gradual cascading slowdown in various sectors of the US economy.

Over a longer time horizon, the situation looks like this: the first disruptive processes began in the form of a contraction in housing construction (December 2021), followed by a contraction in manufacturing activity (mid-2022) and credit (2023).

Consumer spending and services, which usually follow the dynamics of the labor market, remain constant factors. At the same time, political factors will act as a significant counterbalance to economic factors - next year is an election year not only for the US, but also for a number of other developed economies, so various kinds of explicit and implicit stimulus and financial support are likely, which may act as a mitigating factor.



While 2022 was a bad year for almost all financial assets, 2023 was good primarily for stock indices, and to a lesser extent for individual company stocks. This can be attributed primarily to stronger nominal GDP and increased market confidence in a soft landing and no visible sources of risk.

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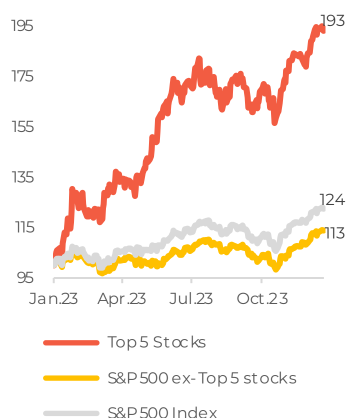
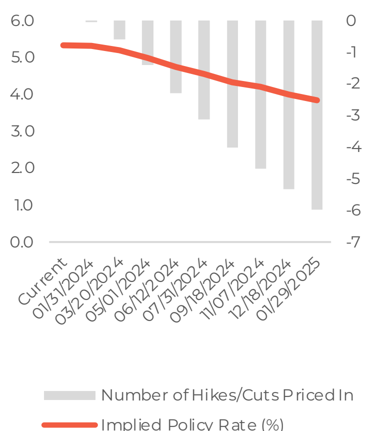
Market and individual stock categories returns



Rate cut expectations



Strategy

However, the performance of stock indices is less corroborated by net cash flow and the long-term growth prospects of businesses. The seven largest US companies have gained 21% since the start of the Fed's interest rate tightening cycle, while the average technology company has fallen 4% in real terms (market median) over the same period.

Our baseline scenario is that the Fed has completed raising interest rates amid a combination of lower economic growth and lower inflation, leading to an eventual reduction in interest rates in 2024.
While inflation is likely to remain above the 2% target, there are a number of circumstances in which inflation could fall more slowly than expected. Today, markets are pricing in about a 1% cut in interest rates by the end of next year at a fairly aggressive pace. However, this is where we see the main risk that markets may be pricing in more fundamental optimism than the economy will be able to sustain without disruptive developments.

Now that yields on short-term debt securities are at their highest since 2001 and long-term bond yields are declining, investors are wondering which assets can offer a more balanced return to the risk taken. And just as importantly, whether different asset classes (stocks of different sizes and profiles, bonds of different duration and risk) can provide sufficient diversification, and whether they will not decline as synchronously as they have been rising.

We believe that next year will be favorable for debt and commodity instruments, bring a lot of volatility in currencies and alternative assets, and be a real stress test for stock indices. This is the main reason why selecting specific companies and businesses will play a critical role in generating returns for investment portfolios. From an equity perspective, companies with high margins and robust revenue streams are still able to increase profits despite a more challenging operating environment.
Below are the key projections for next year by major asset class and investment themes:

Theme	YTD'23 Rates and bond yields peak	1H (2024) Economic slowdown in focus	2H (2024) US recession/rate cut hopes
	Macro conditions		
Demand and GDP	Demand remained strong	Economy starts to slow	Mild recession
Inflation	Core inflation stabilized above Fed target	Inflation remains sticky	Disinflation back in play
Rate hikes	Rates peak at 5.25-5.5%	No change	Rate cut likely
Yield curve	Became less inverted	Remains inverted	Yield curve steepening
Oil prices	US$72	US$75-90	US$70-80
US-dollar	Rangebound	Rangebound	Weakens
	Risks		
Main risks	Geopolitical volatility; US-China, Middle East War, Ukraine-Russia Credit risks big enough to induce immediate rate cuts		
	Equities		
Market	Up more than 15%	Rangebound	Rangebound
Earnings forecast	EPS cuts stabilized in 2H23	Stable revisions	Mild downgrades
	Sector preference		
Overweight	Communication Services, Infotech, Discretionary	Communication Services, Infotech, Healthcare and Consumer Staples	
Neutral	Industrial, Materials, Energy	Energy, Consumer Discretionary and Financials	
Underweight	Utilities, Healthcare, Staples	Materials, Property, Industrials and Utilities	

Strategy

Next year promises to be favorable for stable and alternative returns. Despite the increasing likelihood of rising asset volatility (from currencies to equities), we expect risk premiums to rise and asset valuations to normalize.
Among the security classes, we separately emphasize high quality assets (bonds and individual stocks instead of stock indices, as well as commodities and alternative assets).

Equities

In the equities market, we strategically favor businesses with quality/defensive profiles. Rising debt loads across a broad spectrum of the corporate sector are causing some capital inflows into those stocks whose businesses have excess cash flows. We believe that the excessive concentration of stock indices last year will prompt institutional capital to seek sources of diversification.

Bonds

Relatively low historical yields on a wide range of government and corporate bonds for the third year in a row have attracted the interest of market participants to increase the proportion of fixed-income instruments. The recent rally in debt instruments has convinced investors of the ability of bonds to generate high yields with minimal risks. We see next year as an opportunity to build a long-term diversified bond portfolio.

Commodities

The baseline scenario assumes growth in asset prices of the mining and energy sectors, as well as growth in the prices of gold and platinum group metals. The latter are more dependent on the dynamics of real yields and the dollar index, which promise to be volatile. Strategic investment themes (electric vehicles, investments in infrastructure, etc.) do not lose relevance, but real pricing depends more on supply and demand.

Europe

In the baseline scenario of insignificant GDP growth, we are less confident in the growth of stock indices in Europe. Significant dependence on the absence of an economic boom in China, as well as a number of geopolitical and domestic factors limit the macro environment for equity market growth. That said, central bank policies are deeply synchronized with global interest rate policy.

China

China's stock indices fully reflect economic sentiment. The lack of credit impulse growth is coupled with significant economic easing. Meanwhile, a deep real estate downturn is combined with a lack of regional reforms and uneven fiscal policy. The number of multidirectional forces is growing, so a series of economic stimulus from the government could at any time be enough of an argument for global capital to drive stock indices.

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