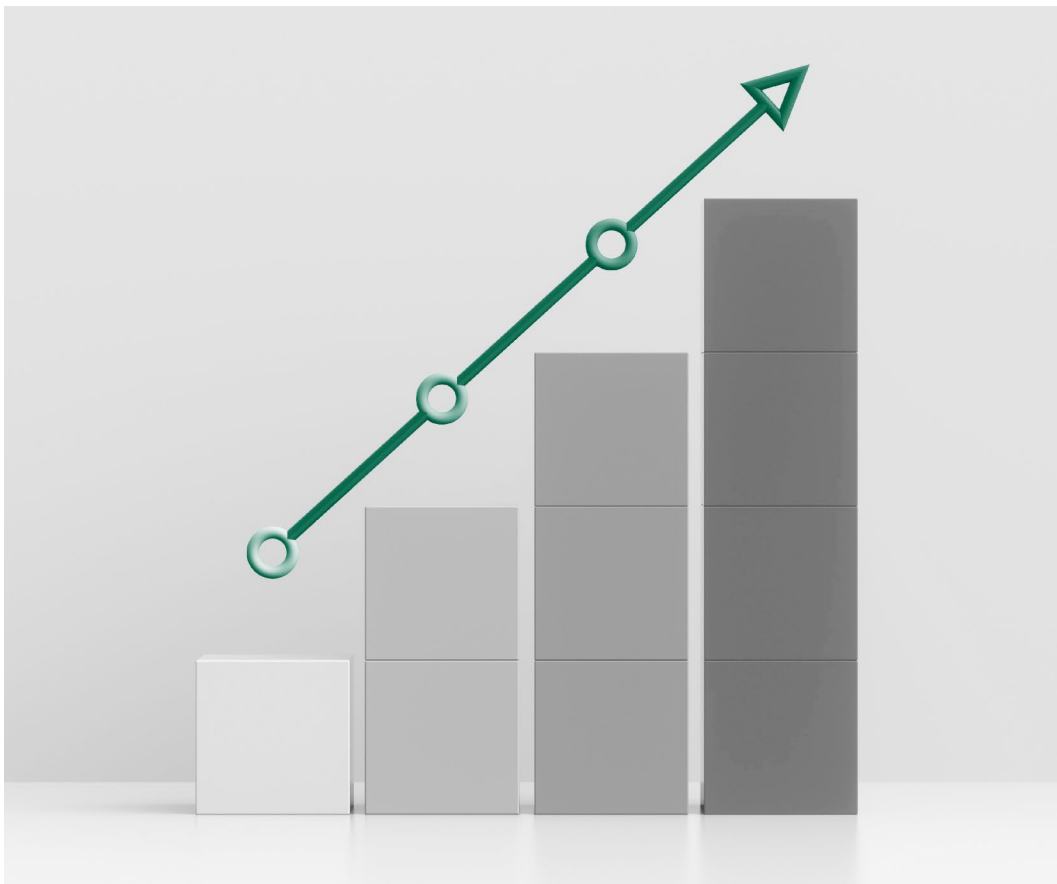




# CAN THE EQUITY RALLY CONTINUE?

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Dear Reader

Financial markets delivered strong returns across most asset classes in 2023 as the worldwide drive to normalize central bank policy rates came to an end. Our expectations for 2024 are positive, although equity markets in particular are unlikely to deliver another equally strong year.

Our constructive view is based on the assumption that lower inflation will allow central banks to start easing their restrictive policies, supporting growth and financial markets. As a result, the global economic cycle should pick up again by the second half of the year. As always, we could be wrong in one way or the other, but compared with the past fifteen years or so, one essential factor is different: The current yield on quality fixed-income assets is north of 5%, providing a solid buffer for diversified multi-asset portfolios to dampen unexpected shocks.

Surprises for markets could come from a record number of national elections scheduled to take place this year, with some 4 billion people set to cast their vote. We consider possible consequences in our Special Topic.

The current year is shaping up to be another eventful one, and we look forward to exchanging notes with you as 2024 progresses. Until then, we wish you success in all your endeavors.

Yours sincerely

A handwritten signature in black ink, consisting of stylized initials and a surname.

**Dr. David Wartenweiler**

Chief Investment Officer

# THE MACRO BACKDROP

## Soft patch at the start of the year

Growth will continue to slow into the first half before picking up once central banks are comfortable enough with inflation to lower policy rates to less restrictive levels. The cyclical rebound will, however, not eliminate the structural headwinds facing many economies, especially in the eurozone and China.



### Key points

- Decent US growth to limit room for Fed cuts
- Eurozone to emerge slowly from recession
- China victim of its outdated growth model

## US resilience confirmed

Following a stellar performance in the third quarter of 2023, US economic growth was bound to slow at the end of the year. Nevertheless, as consumers spent freely, supported by solid wage growth in a tight labor market, the economy continued to expand at a very respectable clip. Meanwhile, the inflation picture improved further. In 2023, headline inflation dropped from 6.5% to 3.4% year on year, prompting the Fed to take a dovish turn at its December meeting. Markets immediately seized on this decision, penciling in a slew of rate cuts as they had a year previously, but the bar for any Fed easing remains high. We don't expect any moderate easing before May. At any rate, two factors will constrain the US central bank. For one, as long as growth remains robust there will be only limited room – or need – for lower rates. Second, with the US presidential election campaign already under way, the window for policy changes will close fast if the Fed does not want to be seen as interfering with the political process. Unfortunately, government funding will remain a recurring concern in a deeply divided system, but a shutdown, never mind a protracted one, appears unlikely in an electoral year.

## Europe: stuck in a rut

The eurozone probably fell into recession once again at the end of 2023, with the economy held back by a number of cyclical and structural headwinds. The outlook remains challenging for the continent, as short-term leading indicators are stuck in contraction territory. Eventually, however, easier monetary policy – both the ECB and Bank of England are poised to loosen the reins from mid-year onwards – and robust wage settlements should create room for a modest re-acceleration in the second half of the year.

## China's painful transition

For some years now, China's leadership has been trying to rebalance the country's growth model away from investment and exports toward consumption. So far, it has little to show for its efforts, not least because the need to rightsize and deflate the property sector has depressed consumer confidence and willingness to spend. Moreover, instead of stimulating weak demand, the government has fallen back into its old habit of propping up growth through investment spending, which is only exacerbating the risk of deflation. Compared to China, India is in a much better place both cyclically and structurally, with its potential GDP growth rate rapidly rising.

**Table 1: Real GDP growth (y/y in %)**

	<b>2023E</b>	<b>2024F</b>	<b>2025F</b>	<b>Short-term trend</b>
United States	2.4	1.3	1.7	↘
Eurozone	0.5	0.5	1.4	→
Germany	-0.2	0.3	1.2	↘
United Kingdom	0.4	0.4	1.2	→
Japan	2.0	0.8	1.0	→
China	5.2	4.6	4.4	→
India	6.6	6.3	6.3	→
Russia	3.0	1.4	1.1	↘
Brazil	3.0	1.6	2.0	→

**Table 2: Consumer price inflation (y/y in %)**

	<b>2023E</b>	<b>2024F</b>	<b>2025F</b>	<b>Short-term trend</b>
United States	4.1	2.6	2.3	↘
Eurozone	5.4	2.3	2.1	↘
Germany	6.0	2.6	2.2	↘
United Kingdom	7.4	2.8	2.1	↘
Japan	3.2	2.3	1.7	↘
China	0.3	1.1	1.8	→
India	5.5	4.7	4.7	→
Russia	5.9	6.4	4.4	↗
Brazil	4.6	3.8	3.5	↘

Source: Bloomberg, HBZ



# INVESTMENT STRATEGY

The great easing? Not so fast!

Markets are primed for lower policy rates, which may well materialize, if not to the extent currently discounted. The entire yield curve could actually change shape, which could lead to unexpected outcomes, especially if US Treasury issuance overwhelms investor appetite.



## Key points

- Lower central bank rates – higher bond yields?
- Position for a cyclical acceleration later in the year
- Monitor US election campaign

## Market's rate positioning to come under scrutiny

Based on market-implied rates, major central banks should shortly be embarking on a major easing campaign extending into 2025 and beyond. Central bankers have been trying to counter such forecasts, only going as far as to admit that there is some room for easing later in the year. It looks almost like a repeat of 2023, when markets were also discounting large rate cuts only to be forced to price them out as central bankers stayed put. For 2024, however, the case for cutting rates is stronger. Inflation has continued to fall, removing the need to maintain an overly restrictive policy stance. In those economies where growth is unduly soft, such as the eurozone and the UK, inflation rates tend to have remained uncomfortably high for early cuts. In others, growth is robust, not warranting much easing at all. At the same time, markets are taking a more bearish view of long-term rates. Here the premises are that after years of quantitative easing, shrinking central bank balance sheets and ever-growing government budget deficits should re-establish a term premium - in other words, compensation for investors willing to hold longer-dated debt. The combined effect of some central bank easing and the return of the term premium could lead to a more normal, upward-sloping yield curve. Short term this would create volatility and possibly some pain for markets, but in the long run, investors should benefit from more realistically priced assets.

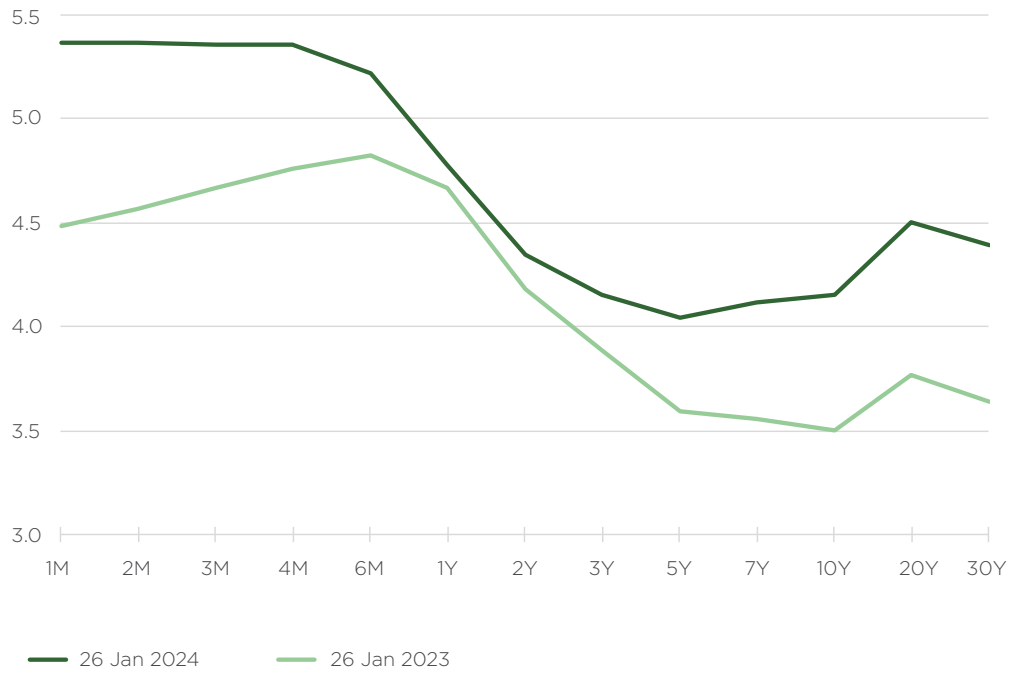
## Our positioning

Over the past months, we have increased our exposure to fixed income and in the process have extended our duration to lock in higher rates for longer. Similarly, we have reduced our underweight in equities, as we expect the global cycle to reaccelerate later this year. In particular, we have added to IT as a structural growth sector and Japan on valuations and policy normalization. At the same time, we have reduced our exposure to emerging market assets, which no longer look as attractive in risk-adjusted terms.

## What to watch

Near term, earnings will be of paramount importance for investors. Strong operational results may sustain the positive trend for equities even if valuations start to look stretched. In addition, we are paying attention to the shifting dynamics in the US Treasury market, where large new issuance could lead to a bout of indigestion. At all times, we will follow the US electoral campaign and its implications for policy from 2025 onward.

## The changing shape of the US Treasury yield curve (% p.a.)



Source: Bloomberg, HBZ

# FIXED INCOME

## New year, new risks

The current year already contrasts sharply with 2023, as attention has shifted to rate cuts thanks to receding inflation in many economies. It's time for investors to lock in rates for longer with bonds from quality issuers, both in developed and emerging markets (EM).



### Key points

- Favor carry and relative value trades
- Monitor technicals for corporates
- Fiscal balances to differentiate sovereigns

## Investment-grade yields compare favorably with equity premiums

The resilience of consumers and companies, bolstered by fiscal support, characterized many economies in 2023. However, with lower savings and tighter credit, a slowdown is inevitable in early 2024. Despite receding inflation, interest rates will remain elevated until policymakers are confident of reaching their targets. The ensuing easing will be moderate, especially if growth remains positive, as central banks do not want to trigger a new bout of inflation amid lingering supply concerns. The times of ultra-low interest rates are definitely over. Higher funding costs have not yet translated into materially higher default rates, even among lower-quality issuers, but as more and more companies have to refinance their maturing debt, the pain will become more evident. For this reason, in the current context we favor high-quality investment-grade issuers with sound balance sheets and moderate leverage. Falling inflation, lower growth, and ultimately lower policy rates will stabilize longer-term rates, arguing for gradually longer duration as well.

## EM: cautiously optimistic and tactically opportunistic

Following a significant rally at the end of 2023, EM sovereign spreads have widened owing to heavy new issuance. Coupled with weak fund inflows and tight valuations, this will probably result in a less favorable environment in the first quarter. However, we anticipate improving market conditions as the year progresses thanks to decreasing supply and rate cuts by the US Fed. For now, we recommend a cautious stance and suggest a combination of carry and relative value trades in both investment grade and high yield. We are extending our neutral stance on EM sovereign debt, which we adopted over a year ago; the spreads are still too tight given the overall macroeconomic backdrop. This perspective mirrors our position at the beginning of 2023, but we must avoid becoming complacent. Despite a higher-rate environment leading to increased yields and persistent fiscal challenges, markets are not recognizing increased credit risk beyond the distressed space. We also maintain a neutral stance on corporates. As the primary market springs to life, as it does at the start of every year, we expect investors to transition from old bonds to new ones rather than expanding their existing positions. The focus therefore should be on relative value rather than increasing risk outright in existing bond portfolios.

## Low risk compensation for higher credit risk (in bps)



Source: Bloomberg, HBZ

# EQUITIES

## Can the rally continue?

Global equities posted strong returns last year as the feared recession failed to materialize and markets cheered up on prospects of lower interest rates in 2024. While economic and geopolitical uncertainty will remain high, equities should perform well in what is still a favorable macro situation.



### Key points

- Risky assets rallied after shift in Fed rhetoric
- US soft landing and lower rates favorable for equities
- Geopolitical and economic uncertainties remain elevated

## Expected rate cuts raise risk appetite

The fourth quarter of 2023 was a strong period for global equity markets, with the US Federal Reserve signaling from mid-November that interest rate cuts might be on the way in 2024. Both equities and treasuries rallied after the announcement. Developed markets outperformed emerging markets amid ongoing worries over China's real estate sector, shrinking population, and uncertainty regarding the government's long-term objectives. Crude oil prices fell despite the OPEC output cuts, reflecting weaker demand from China and record supply coming from the US. Aided by lower energy prices, inflation continued to decline markedly in the US throughout the year. Meanwhile, initial data indicate US real growth of 3.3% quarter on quarter (seasonally adjusted annual rate) in the fourth quarter. The combination of more moderate but still healthy growth and declining inflation makes a so-called soft landing of the US economy increasingly likely. By now, this outcome represents the base case for most economists after a widely predicted recession failed to materialize in 2023. The S&P 500 index ended the year just shy of its record high of early 2022. While megacap technology stocks benefited significantly from declining discount rates, stocks of companies with weak fundamentals also rallied in anticipation of improved profitability amid lower funding costs and sustained growth. Eurozone shares, meanwhile, were boosted by expectations that the ECB would also start cutting, possibly as early as April 2024. In Europe, the top-performing sectors included real estate and technology, both of which profited from the aggressive repricing of the yield curve, while healthcare and energy were the main laggards.

## Big tech and small caps set to do well

Moving into 2024, we would expect large technology stocks to continue to perform well given their positioning and ability to capture AI-related trends and the technological transformation of society in general. After some potential weakness in the first quarter due to a period of softer growth, we expect smaller companies with weaker fundamentals to start catching up as the new business cycle picks up and profitability improves. At the same time, volatility could rise, especially around economic and earnings releases in the context of normalizing interest rates, the rebalancing of labor markets, and geopolitical tensions, which remain elevated.



## IT and small-cap stocks to move higher provided no surge in long-term rates and growth holds up



Source: Bloomberg, HBZ

# COMMODITIES AND FX

## Still expecting a weaker USD

Geopolitics can knock commodity prices around, but given that the fundamentals of supply and demand tend to dominate over the longer run, the effects often don't last. Gold is therefore highly sensitive to non-market events, but generally, interest rates and the US dollar drive the price action. This year will not be any different.



### Key points

- Oil range bound for now
- Dollar with more downside
- Gold as a USD portfolio hedge

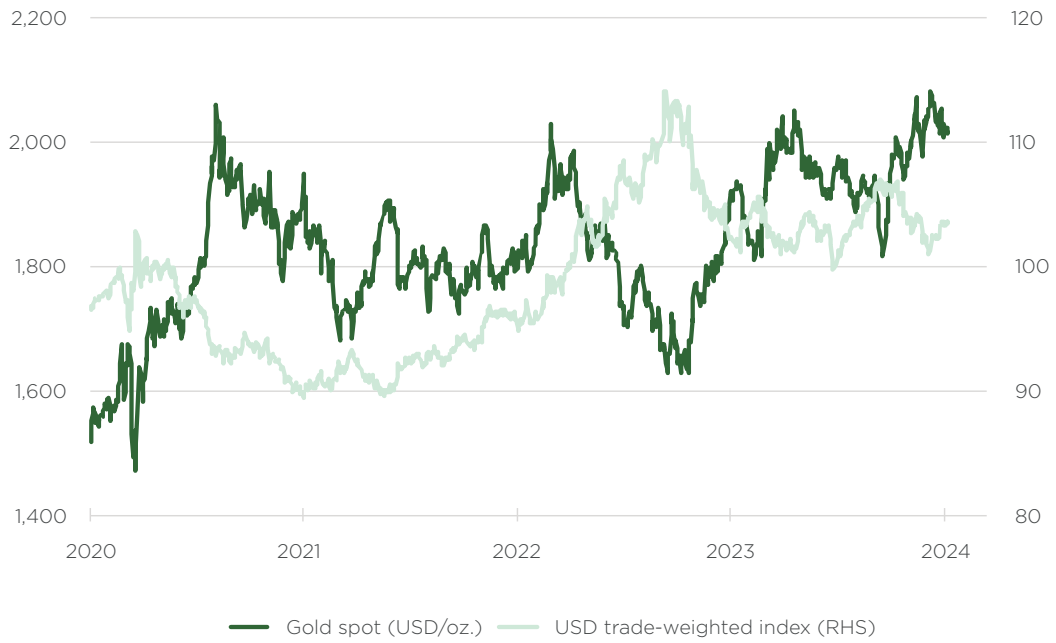
## Crude oil is for trading, not investing

According to the International Energy Agency, global oil demand is projected to remain elevated in 2024. Despite a series of output cuts by the OPEC+ alliance since late 2022, the market has remained well balanced, as non-OPEC output from countries like the US and Brazil has grown at a fast clip. With the futures market firmly in backwardation, there is currently no serious concern about longer-term supply. Looking at the priorities of key players can help outline medium-term oil price scenarios. Saudi Arabia thus requires an oil price of some USD 80/bbl. to finance its budget, and this level gives an indication of the floor of the current trading range. Similarly, China's demand and price sensitivity probably represent a ceiling in the vicinity of USD 90-95/bbl. This suggests that crude oil will be range-trading for the foreseeable future, limiting its attractiveness as an investment asset. Trading in inherent volatility, on the other hand, can and should be quite rewarding.

## Gold vs. the US dollar

With the expected Fed rate cuts and a probable cyclical upturn of the global economy later in the year, the USD could once again experience a period of weakness. However, similar expectations of an end to the tightening cycle in the eurozone, as well as favorable growth differentials, could limit the depreciation of the USD. More downside could materialize against the Japanese yen, which is trading close to its weakest level against the USD in more than 25 years. Attention is now shifting to the position of the Bank of Japan (BoJ). The BoJ ended its controversial yield curve control in late 2023, but so far has maintained a negative policy rate. With inflation once again above 2%, the bank now appears more confident of achieving its price stability target, and negative rates may end in 2024. A stronger JPY should be the result. During the run-up to the global rate normalization campaign in 2021, gold came under pressure. Since then, however, the metal has held its own thanks to its properties as a hedge against inflation, geopolitical tensions, and the weakness of fiat currencies. The weaker dollar boosted the gold price last year, and lower USD rates should do the same this year. In our view, the prospects are actually better for gold than for most major currencies. Given its low correlation to other assets and the current global environment, gold certainly has its place in any diversified portfolio.

## When USD goes down, gold goes up (usually)

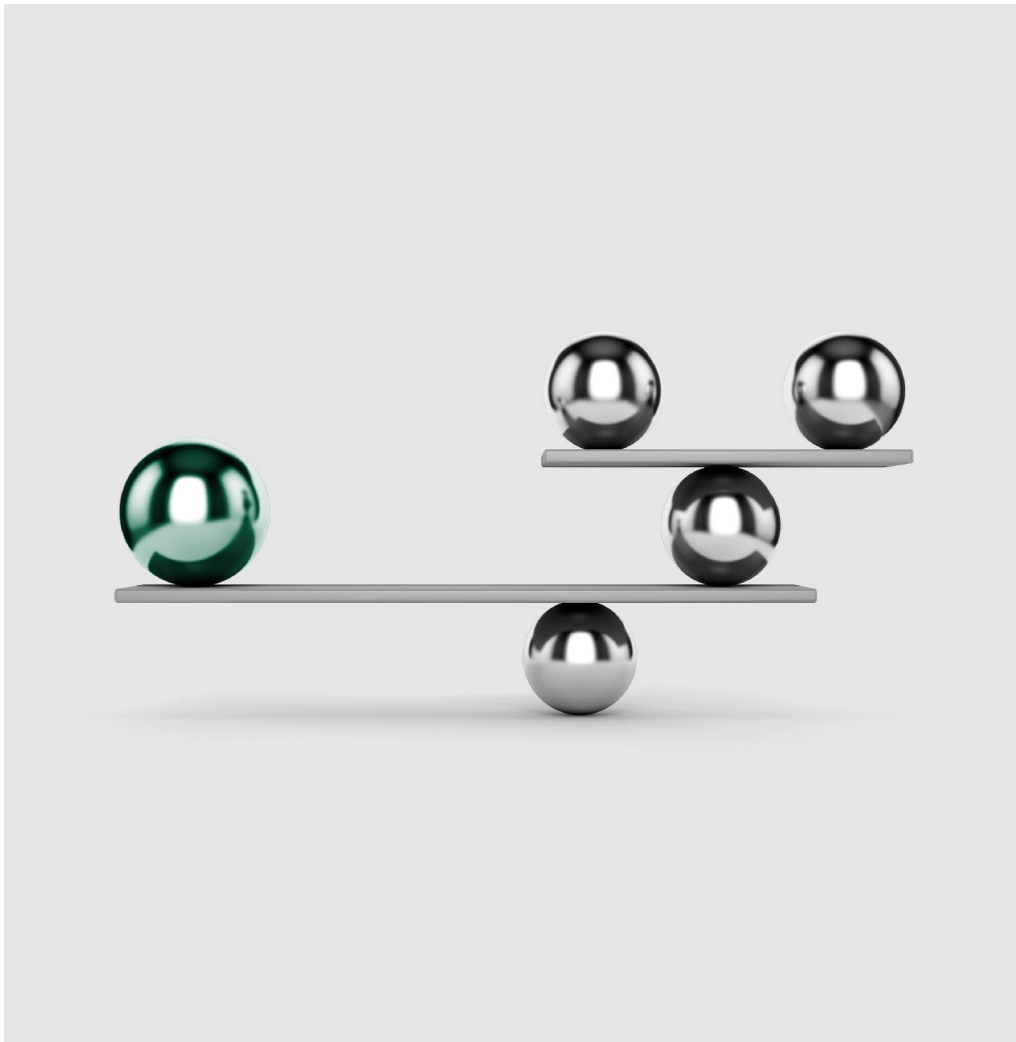


Source: Bloomberg, HBZ

# KEY MARKETS

## To each their own

As the markets look for the Fed to pivot, policies and cycles are starting to diverge across the globe. Such divergences are also apparent in our key markets, with Pakistan entering a bumpy election period, the UAE shining as a paragon of stability, and the UK standing still.



### Key points

- Pakistan bracing for a bumpy election period
- Non-oil sector carries UAE economy
- High bar for Bank of England rate cuts

## Pakistan: turbulence ahead

Inheriting a crisis defined by a lack of confidence among businesses and the public, the caretaker government has managed to find some economic stability. The key steps taken to support the economy include the setting up of a Special Investment Facilitation Council (SIFC) focusing on FDI deals in specific sectors, and increases in electricity and gas tariffs - despite the latter's contribution to inflation. However, some relief in the form of a strong agricultural season and lower oil prices was reason enough for the central bank to hold rates steady at the end of the year. With the rollover of a multi-billion Chinese loan earlier last year and the disbursement of another tranche by the IMF early this year, pressure on the country's external accounts has eased for the time being. The PKR came off its lows in late 2023, and the KSE-100 index rallied more than 40% to mark an all-time high. Nevertheless, the new year brings a new set of challenges, starting with the long-delayed election: a weak government may not be able to take the tough steps the caretakers took.

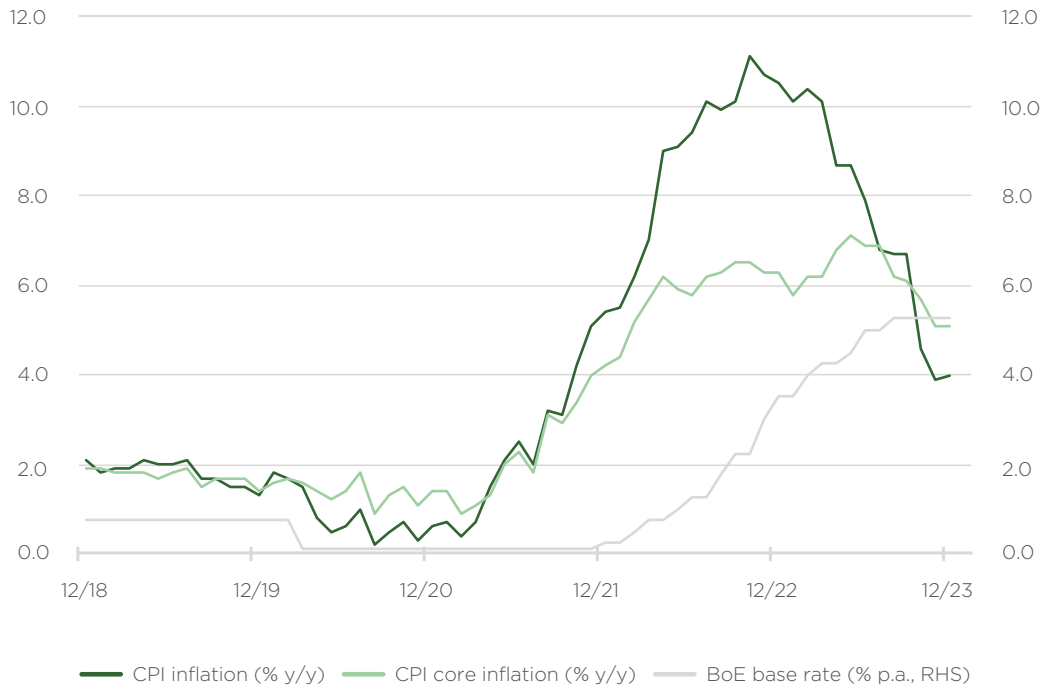
## UAE: robust and steady

A solid economic performance in 2023 was clear evidence that diversification away from oil is paying off for the Gulf state, as non-oil GDP probably grew some 6% over the year. Key contributors were the property sector, which showed resilience in the face of peaking interest rates with steadily rising prices and rents, and tourism, which surpassed pre-pandemic levels with a 22% increase in visitors to Dubai in the first ten months of the year alone. The UAE has also been largely immune to the tensions in Gaza. With leading indicators close to a four-year high, the positive momentum is set to continue.

## UK: a lackluster year

In a year of very meager growth, a continuing decline in inflation was one of the few bright spots for the country's economy. The drop in prices allowed the Bank of England to end its tightening cycle after having lifted the base rate to the highest level since 2008. Nevertheless, inflation remains at unpalatable levels, especially considering the structural tightness of the labor and housing markets. The Bank of England will therefore tread very carefully before starting to ease policy.

## UK: room for the Bank of England to cut?



Source: Bloomberg, HBZ

# SPECIAL TOPIC

## A year of elections: what to expect

An unusual number of national elections will take place this year in countries including India, Indonesia, Mexico, Pakistan, Russia, South Africa, the UK, and, of course, the US. While some of the outcomes are foregone conclusions, some may create more than their share of market-moving news.



### Key points

- High number of important elections in 2024
- US presidential election potentially game-changing
- Greater geopolitical turmoil possible



## Elections are not created equal

Not all elections are about choice. Some are more akin to rituals to confirm a leader or a party who is uncontested or cannot be challenged. Here Russia comes to mind. Some have outcomes that are well anticipated even in otherwise competitive, open electoral systems by virtue of the track record of the incumbent leader or party. Think India, where Modi and his BJP party are heading for another five-year mandate. Finally, some have limited impact, as well-balanced institutional frameworks assure a great deal of continuity even after a change of government. Most such elections are often non-events for markets.

## Market-moving contests in 2024

However, there will be elections with potentially significant market implications. These include the elections likely to take place later in Q2 in South Africa, where the absolute majority of the ruling ANC is at stake. Possible coalitions could tip the country further away from market-friendly policies. The vote in Indonesia in mid-February is wide open but of huge relevance given the country's size and strategic location at the heart of Southeast Asia. The UK general elections, most likely to take place in October or November, are widely anticipated to lead to a change of government. The ambitions of the Labour Party are considerable, but the country's means are more limited than ever. The impact on the economy and markets could therefore be similarly limited. Most investors will, however, focus on the US, where a change in control of the White House could indeed have momentous consequences.

## What is at stake in the US?

Depending on whom you listen to, this year's US presidential elections have the potential for tectonic shifts at the national and international level if Donald Trump wins a second mandate. Since the events of 6 January 2020, many fear that Trump could hollow out the entire institutional framework of the US and force a political alignment within the federal government administration. Importantly, he intends to extend tax cuts adopted during his first presidency, which would greatly widen the US budget deficit if left unfunded. The bond market could take this very badly. Trump also wants to impose a 10% across-the-board tariff, which could affect Europe more than China already hit by high levies. Finally, his "America first" stance could greatly undermine long-established international security arrangements, leading to even greater geopolitical turmoil.

## Trump 2 would face a different economic reality

<b>Economic/market indicators</b>	<b>2016</b>	<b>2024</b>
Government debt (% GDP)	105	124
Federal deficit (% GDP)	2.7	6.4
Real GDP growth (q/q % saar)	2.2	3.3
Inflation (CPI, % y/y)	1.7	3.4
S&P 500 P/E forward	16.7	20.8
Equity market volatility (%)	17.1	13.9
10-year Treasury yield, %	1.78	4.10
Fed funds rate, % p.a.	0.375	5.375
Oil price (WTI, USD/bbl.)	44.1	77.3

Source: Bloomberg, UBS, HBZ

# MARKET SUMMARY DATA

As of 29 January 2024



<b>Equity indices</b>	<b>Last</b>	<b>-3M</b> %	<b>YTD</b> %	<b>-3Y</b> %
BBG World USD	1,707.2	16.8	1.0	21.7
S&P 500	4,891.0	18.8	2.5	31.7
EuroStoxx 50	4,625.5	15.2	2.3	32.9
FTSE 100	7,653.3	5.0	-1.0	19.4
SMI	11,397.8	10.4	2.3	7.6
Nikkei	36,026.9	16.2	7.7	30.2
BBG EM USD	1,108.4	7.3	-3.1	-23.5
Sensex 30	71,920.8	13.9	-0.4	48.8
KSE 100	62,948.4	23.5	0.9	35.7
Hang Seng	16,077.2	-7.6	-5.7	-43.2
Russia RTS	1,118.8	3.7	3.3	-18.2
Brazil Bovespa	128,967.3	13.8	-3.9	12.1

<b>Bond indices</b>	<b>Last</b>	<b>-3M</b> %	<b>YTD</b> %	<b>-3Y</b> %
FTSE US Gov	1,511.35	5.1	-1.3	-10.9
FTSE US Corp	2,412.44	8.9	-1.0	-9.1
FTSE US HY	1,256.80	8.8	0.1	6.2
FTSE Euro gov	215.64	5.6	-1.3	-16.3
FTSE Euro Corp	236.00	4.9	-0.5	-8.2
FTSE EM Sov	837.99	10.5	-2.1	-11.6
DB EM Local USD	163.82	7.3	-1.3	-9.0

<b>Currencies vs. USD</b>	<b>Last</b>	<b>-3M</b> %	<b>YTD</b> %	<b>-3Y</b> %
DXY	103.43	-2.8	2.2	14.3
EUR	1.09	2.1	-1.9	-10.8
CHF	0.86	4.7	-2.4	3.3
GBP	1.27	4.6	-0.2	-7.3
JPY	148.15	0.9	-4.6	-29.2
AUD	0.66	3.5	-3.2	-13.7
CAD	1.35	2.9	-1.5	-4.9
ZAR	18.79	0.2	-2.3	-19.3
INR	83.12	0.1	0.1	-12.3
PKR	279.63	0.3	0.7	-42.7
Gold oz.	2,018.52	1.1	-1.6	9.8

<b>Interest rates</b>	<b>3M interbank</b>	<b>10Y government</b>
	%	%
USD	5.58	4.10
EUR	3.89	2.24
GBP	5.33	3.91
CHF	1.72	0.87
JPY	0.05	0.72
AUD	4.35	4.22
CAD	5.41	3.52
ZAR	8.39	11.44

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