The Investment Podcast

Episode 34: The Investment Podcast
CIO perspectives on what lies ahead in 2024

13 December 2023

[music]

Speaker 1: *The Investment Podcast* brought to you by M&G.

Speaker 2: This podcast is for investment professionals only.

David Parsons: Hello, and welcome to this CIO edition of *The Investment Podcast*. I'm your host, David Parsons, and today we're joined by two very special guests, as we look to the year ahead. With me today are Fabiana Fedeli, Chief Investment Officer for Equities and Multi Asset and Sustainability, and Jim Leaviss, CIO for Public Fixed Income at M&G Investments.

Pleasure to have you both here. Our last podcast of 2023 indeed. I wonder if we can move, perhaps, to the key issues of the day. Of course, inflation and the path of interest rates have remained the dominant themes of 2023. It's been a year of shifting narratives, as markets reacted to the latest economic data points and comments from policymakers, but as we enter 2024, what are likely to be the big drivers of your respective asset classes, do you think?

Jim Leaviss: Well, I think that 2023 was a year of surprises in many respects. Remember, I'm a bond investor. 2022 was awful for fixed income, and I think that most people have looked at the bond markets and the yield curve, and its inversion i.e. long-dated yields being below short-dated yields, and thought to themselves that this year would be a year of a US recession, and the fed would be ready to cut rates.

People were expecting a good year for bonds, and a weak year for US economic growth. In fact, the US has had a really strong 2023, and bond yields have had another disappointing year. We've reached over 5% in yields at the long end of the US bond market this year, for instance. Things didn't go according to plan. Interest rates have stayed high from the fed, but next year, I think we are going to get a different story.

We probably will get that recession, that the yield curve that bond markets have been predicting for over a year now. That's because interest rates have gone up so much. We've had 5% and more of interest rate hikes from the fed, that's probably taken longer than most people had expected to feed through, in terms of putting a break on the global economy. It is starting to come through now.

We're seeing the signs of that in inflation starting to come down in the US. It's not far away from the fed's target on some measures now. Some signs economic growth slowing too. In particular, I'd say the US housing market is starting to slow down, again, as a result of all those interest rate hikes. Next year will be a year where the fed can cut interest rates, and the market thinks, at the moment, that we're going to get over 1% worth of rate cuts from the fed, so effectively, four rate cuts in 2024.

There's always a risk that inflation makes a comeback. There's always a risk of another geopolitical event that causes bond markets to go up or down. I think the biggest event for me will probably be the sheer volume of elections we have around the world in 2024. There's a big one in the United States as we all know. I think that will be perhaps the biggest driver of bond yields in 2024.

David: Fabiana, what do you think might be the equity take on these types of factors, and where do you think the equity markets might be heading next year?

Fabiana Fedeli: David, inflation in particular, core inflation is going to be key for equities in 2024. Not only that, but obviously, the reaction of central banks to such inflation, and the pressure that higher interest rates will put on global economy. Equities like lower rates, they like a healthier economic environment. For now, with inflation

coming down, but still high versus central bank targets, central banks really don't have a reason to cut, as long as the economy is still resilient.

Should the economy worsen significantly from here, then cuts might come, but it might be coming for the wrong reasons. Equities will be reacting to that. What happens to core inflation, and what happens overall to the macroeconomic background.

David: As global inflation gradually cools, expectations there could be rate cuts next year have increased, but policymakers have signaled that interest rates may remain elevated for some time to come. What are your thoughts on this, and what impact could a higher-for-longer environment have, do you think?

Jim: What's the reason why interest rates will stay high? Well, it's a good news story, generally. The kind of theme that people put with, what they call table mountain profile of rates i.e. the fed or the Bank of England or whoever hikes aggressively, and then keeps rates at a high level for a year or so, before they're cut, is that we get a soft landing in the global economy. It's something we should all hope for.

The problem is really, that when you look back at history, it never happens. There are very, very few examples of a soft landing. We all think that central banks are getting to that point where they've managed to engineer one, but then you get a sudden slowdown in growth. I mean, it is the archetypal steering an oil tanker around, and very big changes in interest rates are going to have a very big impact, but you don't know when the turn happens.

It looks likely that will be next year now. The chances of a soft landing, as I say, history doesn't bear that out. History also shows that, you don't get a tabletop mount in formation in interest rates. Generally, the fed and other central banks cut interest rates around eight months after they reach the peak, and it's possible we are at the peak. I think that's why we're seeing, as we go into the end of 2023, we are seeing bonds start to perform really quite well.

The reason for that is that the bond markets think that maybe the fed is done, that the Bank of England is done, and the ECB isn't going to be hiking rates either anymore. Within eight months i.e. by the middle of 2024, we'll see central banks cutting rates again. Unfortunately, the soft landing narrative, I think, will probably go out of the window at that point.

David: What impact do you think that higher-for-longer might have, or an elevated period of interest rates on equity markets, Fabiana?

Fabiana: Well, David, in the end, equities are driven by earnings, and by the outlook for those earnings. Higher rates are not conducive to higher earnings. Let's not forget also that, the higher rate environment hasn't really affected all markets in the same way. Think about the US, where households really are still having long-term mortgages at relatively low rates.

Companies have already taken on that at times during COVID when that rates were very low. We're still not seeing that impact of rates, particularly, in the US economy. We started to see some cracks even in the US. We actually just spoke to a few credit card companies earlier this week, and they have told us that, while it is true that the higher-end consumer still continues to spend, the lower-end consumer, the lower-income consumer, we had already seen a decline in spending on credit card balances.

Now, that same decline is coming from one tier up of income of consumer income. You're starting to see a little bit more concern also from households about the higher rates, about slowing economic environment. Overall, this means that a higher rate environment, if it continues, could affect equity markets negatively.

David: I think we're all agreed the market's direction is by no means clear. Do you foresee more uncertain terrain ahead?

Jim: I mentioned that we've got a lot of elections next year, and we've got Trump on the horizon. I was speaking to some colleagues the other day, and we're asking ourselves, if someone told you, "It's definitely going to be Donald Trump, president on the start of 2025, the election's November 24," what would you do in terms of your portfolio? I think that it's going to be a case of him thinking about unfinished business.

Unfortunately, that means some personal revenge on politicians, judges, and other people he perceives to have wronged him. Political instability and social instability is something I think you've got to be nervous about. Economically, for risky assets like equities and corporate bonds and high yield, it may be quite good for US assets,

because I think that if you look back at the tax cuts he was hoping to put through when he was last president, he didn't manage to really move the dial to a significant degree.

He's a pro-business president. I think he'll want to do more this time round. I imagine, we'll see big tax cuts, good news initially, a sugar rush for rich people, for corporates. It probably, also means lots more government bond borrowing. I think government bonds, and particularly long-dated government bonds will probably suffer in that environment. They'll also start thinking, do these tax cuts produce a bit more inflation?

Does he put taxes on imports as he's threatened to do? Does that that also generate some US inflation? Then, finally, and most worryingly, I think geopolitically, does it mean that Trump decides to leave NATO, abandon Ukraine, leave Taiwan to its fate, et cetera? A ramping up of geopolitical uncertainty that could cause some really big moves in asset prices around the world.

David: D1o we see a similar potential for uncertainty ahead in equities?

Fabiana: Well, David, yes. Clearly, we expect uncertainty ahead in equities. Let's not forget that, for equity markets, what really counts is the health of the global economy, and the impact that the geopolitical risk and government policies that Jim speaks of will have on the direction of such global economy, but let's also not forget that, uncertainty brings opportunity for active investors.

When we see the cycle being uncertain, the best course of action for active investors is, really to look at structural themes, rather than cyclical exposure. There are a number of structural themes that are seeing capital flowing in independently from the macro backdrop. I am thinking of innovation including AI, infrastructure, and also the low-carbon economy. There is uncertainty, but there are also opportunities.

David: We've seen in the past how volatile markets can create opportunities for disciplined selective investors in both equities and bonds. How might investors be able to drive returns in the year ahead, considering all the factors in play that you've outlined?

Jim: Well, I think it'll be really important to think about what a slowdown in growth means for the assets that you own. So far, if you look at corporate bond markets, which is the thing that I'm most interested in really, we haven haven't seen a really significant rise in defaults. It's been a world where companies borrowed lots of money during the pandemic, so they're not short of cash.

They can survive a downturn, and if you look at their fundamentals, how much borrowing they've got relative to their earnings, I think we're quite happy that we are not going to see investment-grade companies, at least, experience a significant default wave. They're well-funded and should be able to survive an economic downturn. When you look at the riskier end of corporate bond markets, and I'm talking about high yield, which people call junk bonds, or speculative grade bonds, I think the story's a little bit different.

There are some very weak companies at the bottom of there that pay you a very high yield. We're talking 10%, 11%, 12%, but we are starting to see default rates edge up for those companies. They have borrowed a lot of money, and I think it's yet to be seen whether, when those bonds mature, whether the market is willing to give them more money, and so I think we'll see defaults start to edge up in the lower rated bonds.

I think quality is going to be quite important, and I think doing your credit homework is going to be ever more important in a downturn. We've had a few years now where economic growth has been unspectacular, but steady, and in some areas like the US, pretty good, and so I think there's a danger that people in the market have got a bit lazy, and haven't discriminated between the good companies, and the bad companies.

At times like this, you need a strong fundamental credit team doing your own independent credit research, and producing credit ratings yourself, rather than just looking and buying the stuff with the highest yield. Discrimination, credit research, and I think a move up in quality are the things that I'd be looking at in 2024.

David: Thank you, and some thoughts on, perhaps, the key points in equity markets. What do you think is going to drive return there?

Fabiana: Well, David, we have seen two interesting phenomena during 2023 that have affected equities. The first one is, during the earning seasons. We have seen companies even in the same sectors, faring very differently in terms of fundamental results. This has been due to stronger product line up, better intellectual property, better cost control, better balance sheets, and ultimately, better management.

This differential in results has had an impact on the performance of companies even within the same sectors. If you look at the dispersion among companies-- Among stocks in the MSCI ACWI since 2020, it has been consistently above its 10-year median. Now, something has, however, happened in the summer during the sell-off that we have seen between August and October, and that is that such dispersion has been compressed.

This has created some significant opportunities that we can take advantage of, because many companies have seen price declines that, frankly, were not warranted by fundamentals.

One example that comes to mind is the so-called bond proxies. Many companies, so price declines because investors thought they were exposed negatively to a higher-for-longer interest rate environment. However, some of the companies had very long-term maturities for their debt. They had fixed rate debt, many of them actually had very strong balance sheets, and also cost passed through on their revenues.

There are opportunities in this area, particularly, in infrastructure and in the low carbon ecosystem, where companies with long-term structural tailwinds are currently at very attractive prices. I agree with Jim, it is really important to do your homework, to make sure that the companies you invest in, particularly, because of the uncertain economic environment, are higher quality, have solid balance sheets, have strong products, and again, where there is a solid management.

Let me maybe conclude with an interesting data point. Many investors believe that the US market has trounced all other markets in performance in 2023. Well, if you look actually at the top 10 stocks in the MSCI All Country World, among these ones, the top performing stock was not a US stock. It was actually a Chinese stock. A stock from a market that this year has been unloved by investors.

Actually, among those top 10 companies that have outperformed in the MSCI All Countries World, only four were listed in the US. Most of the others were Asian stocks, and one actually was a UK listed stock. To me, this means that there are still plenty of opportunities out there in equities for investors that are willing to go deeper in research in stocks, and who remain selective in their choices.

[music]

David: Unfortunately, that's all we have time for on this occasion. I'd like to thank both Jim and Fabiana for your insights and your time today, and thanks to you, our audience for tuning in once again.

[music]

Speaker 2: For further information, please view the notes which accompany this episode. This podcast is for investment professionals only. The value of investments will fluctuate, which will cause prices to fall, as well as rise, and investors may not get back the original amount they invested. Past performance is not a guide to future performance. The information and views expressed should not be taken as a recommendation, advice, or forecast.

[00:18:54] [END OF AUDIO]

For Investment Professionals only. Not for onward distribution. No other persons should rely on any information contained within. This guide reflects M&G's present opinions reflecting current market conditions. They are subject to change without notice and involve a number of assumptions which may not prove valid. The distribution of this guide does not constitute an offer of, or solicitation for, a purchase or sale of any investment product or class of investment products, or to provide discretionary investment management services. These materials are not, and under no circumstances are to be construed as, an advertisement or a public offering of any securities or a solicitation of any offer to buy securities. It has been written for informational and educational purposes only and should not be considered as investment advice, a forecast or guarantee of future results, or as a recommendation of any security, strategy or investment product. Reference in this document to individual companies is included solely for the purpose of illustration and should not be construed as a recommendation to buy or sell the same. Information is derived from proprietary and non-proprietary sources which have not been independently verified for accuracy or completeness. While M&G Investments believes the information to be accurate and reliable, we do not claim or have responsibility for its completeness, accuracy, or reliability. Statements of future expectations, estimates, projections, and other forward-looking statements are based on available information and management's view as of the time of these statements. Accordingly, such statements are inherently speculative as they are based on assumptions which may involve known and unknown risks and uncertainties. Actual results, performance or events may differ materially from those expressed or implied in such statements. All

forms of investments carry risks. Such investments may not be suitable for everyone. **United States**: M&G Investment Management Limited is registered as an investment adviser with the Securities and Exchange Commission of the United States of America under US laws, which differ from UK and FCA laws. **Canada**: upon receipt of these materials, each Canadian recipient will be deemed to have represented to M&G Investment Management Limited, that the investor is a 'permitted client' as such term is defined in National Instrument 31-103 Registration Requirements, Exemptions and Ongoing Registrant Obligations. **Australia**: M&G Investment Management Limited (MAGIM) and M&G Alternatives Investment Management Limited (MAGAIM) have received notification from the Australian Securities & Investments Commission that they can rely on the ASIC Class Order [CO 03/1099] exemption and are therefore permitted to market their investment strategies (including the offering and provision of discretionary investment management services) to wholesale clients in Australia without the requirement to hold an Australian financial services licence under the Corporations Act 2001 (Cth). MAGIM and MAGAIM are authorised and regulated by the Financial Conduct Authority under laws of the United Kingdom, which differ from Australian laws. **Singapore**: For Institutional Investors and Accredited Investors only. In Singapore, this financial promotion is issued by M&G Real Estate Asia Pte. Ltd. (Co. Reg. No. 200610218G) and/or M&G Investments (Singapore) Pte. Ltd. (Co. Reg. No. 201131425R), both regulated by the Monetary Authority of Singapore. **Hong Kong**: For Professional Investors only. In Hong Kong, this financial promotion is issued by M&G Investments (Hong Kong) Limited. Office: Unit 1002, LHT Tower, 31 Queen's Road Central, Hong Kong. **South Korea**: For Qualified Professional Investors. **China**: on a cross-border basis only. **Japan: M&G Investments Japan Co., Ltd., Investment Management Business Operator, Investment Advisory and Agency Business Operator, Type II Financial Instruments Business Operator, Director-General of the Kanto Local Finance Bureau (Kinsho) No. 2942, Membership to Associations: Japan Investment Advisers Association, Type II Financial Instruments Firms Association.** This document is provided to you for the purpose of providing information with respect to investment management by Company's offshore group affiliates and neither provided for the purpose of solicitation of any securities nor intended for such solicitation of any securities. Pursuant to such the registrations above, the Company may: (1) provide agency and intermediary services for clients to enter into a discretionary investment management agreement or investment advisory agreement with any of the Offshore Group Affiliates; (2) directly enter into a discretionary investment management agreement with clients; or (3) solicit clients for investment into offshore collective investment scheme(s) managed by the Offshore Group Affiliate. Please refer to materials separately provided to you for specific risks and any fees relating to the discretionary investment management agreement and the investment into the offshore collective investment scheme(s). The Company will not charge any fees to clients with respect to '(1) and '(3) above. M&G Investments is a direct subsidiary of M&G plc, a company incorporated in the United Kingdom. M&G plc and its affiliated companies are not affiliated in any manner with Prudential Financial, Inc, a company whose principal place of business is in the United States of America or Prudential Plc, an international group incorporated in the United Kingdom. This financial promotion is issued by M&G Luxembourg S.A. in the EU and M&G Investment Management Limited elsewhere (unless otherwise stated). The registered office of M&G Luxembourg S.A. is 16, boulevard Royal, L-2449, Luxembourg. M&G Investment Management Limited is registered in England and Wales under number 936683, registered office 10 Fenchurch Avenue, London EC3M 5AG. M&G Investment Management Limited is authorised and regulated by the Financial Conduct Authority. M&G Real Estate Limited is registered in England and Wales under number 3852763 and is not authorised or regulated by the Financial Conduct Authority. M&G Real Estate Limited forms part of the M&G Group of companies.