1

Executive Summary

Stay the course in a global economy that bends but does not break

We expect continued elevated volatility from rising political and geopolitical risks with roughly 50% of the world's population voting in 2024 and multiple high-risk geopolitical conflicts including Ukraine and the Middle East with potentially another brewing in Taiwan. The economic resilience of 2023 will likely also be challenged by the delayed impact of monetary tightening, lower household excess savings, and reduced scope for fiscal stimulus given rising deficit levels. This context creates a complex environment for investing where binary outcomes of events can impact markets significantly over the short term. We advocate 'staying the course' and avoiding the temptation to time markets in anticipation of events. It has never been more important for long-term oriented portfolios to stay well diversified across multiple asset classes, with capital deployed via high-quality asset manager partnerships. The uncertain environment is likely to generate market dislocations that should present an additional source of return to investors able to allocate nimbly to exploit them.

Executive Summary

In Insights 2023, we highlighted the 'Paradigm Shift' taking place from the 'Great Moderation' of the last 20 years to a new regime characterised by significantly higher levels of macro volatility. 2023 provided ample evidence that we are indeed in such a new paradigm. After a series of rapid interest-rate rises by the Federal Reserve and other major central banks, the year began with a near-universal expert consensus on a recession being imminent. This fear was compounded by first-quarter banking stresses which ultimately resulted in five US regional bank failures, the most since 2017. However, as the dust settled on 2023, we were left with one of the strongest macro setups in recent history. Even as inflation appeared to moderate, economic growth not only held up, but ventured into almost boom territory in some regions. For example, US Q4 GDP rose at an above-consensus 3.3% annual rate (ar) following a strong Q3 at a 4.9% ar which took full-year 2023 growth up to 2.5%, well above the potential rate estimated at c. 1.5%. Although our baseline scenario precluded a recession, even we did not expect this degree of strong growth. This profession is nothing if not humbling.

We expect the new paradigm of elevated volatility to persist in 2024 and beyond. On the economic front, the resilient US growth of 2023 will likely be challenged by the delayed impact of monetary tightening, lower household excess savings, and reduced scope for fiscal stimulus given alarmingly high budget deficit levels, expected to remain above 6% of GDP at least through 2028. However, it is not all a bleak picture. We expect the rapid progress underway in disruptive technologies such as Artificial Intelligence to generate significant productivity gains over the medium term, particularly in the services sector. Rapid advances in lifesciences, notably in the area of weight loss, will also have positive repercussions including lower healthcare costs.

On the political front, roughly 50% of the world's population are voting in elections in 2024. The most consequential of these elections is likely to be that of the US in November. The outcome will have important implications both domestically and internationally. A Trump victory will have the greatest geopolitical consequences, particularly with respect to NATO and China. However, populist victories anywhere can contribute to inflationary pressures as they often boost aggregate demand through fiscal stimulus (e.g., tax cuts and/or spending) while simultaneously restricting aggregate supply (e.g., trade and immigration controls). Examples in the US include Trump proposals for renewed tax cuts and an across-the-board 20% tariff on all imported goods (with potentially a 60% rate levied on Chinese imports). From an investment perspective, this risk, combined with rising government debt levels, is likely to provide support for bond yields in the form of term (risk) premium.

From a geopolitical standpoint, there are at least three high-risk conflicts: two active in Ukraine and the Middle East and one brewing in Taiwan. For some time now, the war in Ukraine has been locked in a stalemate with a fading impact on commodity prices. While it could drag on for longer, the evolving consensus seems to be headed towards an eventual negotiated settlement. The tragic conflict in the Middle East has the potential to escalate to the wider region and we do not profess to have a crystal ball on how it will evolve. However, among the principal geopolitical risks for 2024, the experts we have consulted believe a US-China cold war ranks much lower. Both sides have strong reasons for keeping the relationship calm this year. President Biden does not need another foreign-policy crisis along with Ukraine and the Middle East in an election year; China's Xi Jinping has enough on his plate dealing with persistent economic malaise. As evidenced by the muted Chinese reaction to the election of a pro-independence activist as Taiwan's president, there is a shared desire in Beijing and Washington to minimize tensions over the island. However, after the November US election, regardless of who is elected, there will be intense pressure in the US to get tougher on China. With each of these three conflicts, we cannot exclude the possibility of extreme scenarios. However, from an investment perspective, our study of past geopolitical conflicts since WWII suggests their impact on global financial markets has tended to be inconsistent and for the most part, short-lived.

Against this complex and uncertain backdrop, it may be tempting to avoid investing until there is less uncertainty. However, we believe this new paradigm of higher volatility and uncertainty is likely to persist for extended periods. It also creates its own opportunities. Hence, our firm recommendation is for our clients to 'Stay the Course' and continue to deploy capital into well-diversified investment programs, while tactically leaning into areas that appear to have the best risk-reward characteristics

The most important investment highlights for 2024 are:

- We remain underweight fixed-income duration given the upward pressure on interest rates but aim to be nimble as markets may over- or under-correct. In the near term, we are likely to reduce this underweight if yields continue to rise.
- Given attractive base rates and spreads available, we continue to overweight contractual income-producing assets in Liquid Credit and Private Debt relative to Public Equities.
- Within Public Equities, we advocate remaining balanced across various strategies and sectors, although we retain our small overweight to lifesciences as we expect to see outperformance as the M&A environment improves along with the scientific advances noted above. The last few years served as a reminder of the challenges of generating outperformance from active long-only equity investing. We continue to believe in the case for active management but are paying much more attention to generating a more stable 'alpha' profile, with an increased focus on risk diversification and ensuring appropriate sizing for various strategies.
- We continue to retain an overweight to Absolute Return that we expect will provide an important source of uncorrelated returns in this volatile environment.
- Finally, we continue to advocate building highly targeted exposure to Private Equity. The sharp increase in interest rates has pressured Private Equity returns over the past 18 months and in this new higher-rate environment, we believe the contribution of leverage to Private Equity returns will decline, as will the rate of multiple expansion. Private Equity firms will, therefore, need to rely on increased earnings growth and lower entry price multiples to sustain their strong returns. These are teams with a lower middle market focus, sector specialists, and dedicated operating resources.

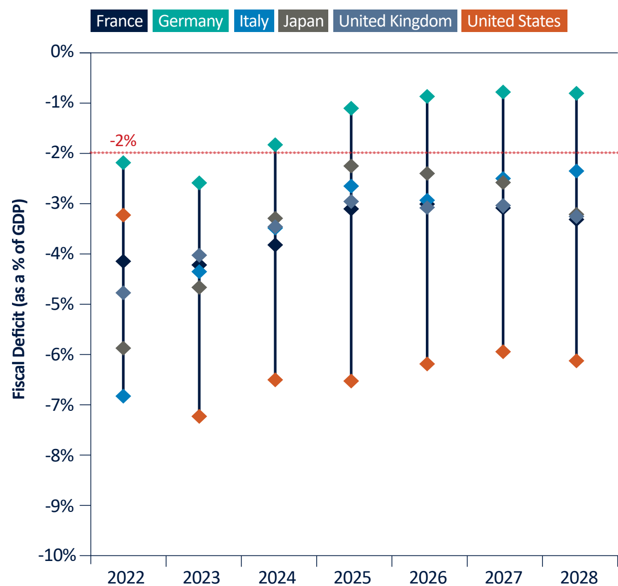
Macroeconomic Outlook

Below we provide a snapshot of a subset of our views on three key macro questions that are top of mind for many investors. Our full analysis of these and other important questions can be found in the macroeconomic chapter that follows.

Inflation: We believe the risks of a second wave of inflation are currently underappreciated by most investors. Although inflation levels are unlikely to return to the high single-digit peaks of 2022, fully converging to central bank targets of 2% may prove elusive. We note previous episodes in the 1970s and 1980s where the initial declines proved transitory. As supply chains have normalized, declining core goods prices have pulled down headline inflation readings. But these are now stabilizing if not rising and with near full employment and rising wages, the all-important services sector remains capacity-constrained. In addition, we see ongoing structural inflation pressures from the energy transition, the "reshoring" of global supply chains, and populist pressures for wealth distribution. Artificial Intelligence ("AI") has the potential to improve productivity and ease service sector inflation, but this impact may not be felt in the near to medium term. Inflation persistence will leave the Federal Reserve and other central banks that have guided towards significant rate cuts in a difficult predicament. On balance, we believe the Fed is biased to reduce rates if the all-important core-PCE rate drops below 2.5% on a quarterly basis. Readings close to 3.0% will likely cause them to delay the timing and reduce the extent of any easing.

Fiscal Risks: While inflation has been the driving force behind financial market performance, we believe investors will increasingly turn their attention to the rising challenge posed by ballooning fiscal debt and deficit levels in many major economies, particularly in the US (Exhibit 1). The UK 'Trussonomics' debacle of late 2022 provided an early warning of how easily bond investors can hold governments to account for unsustainable fiscal policies. We dedicate a special section on the US fiscal situation which is easily overlooked given the special status of US Treasuries as a safety asset. We expect to see a contest between the "Bond Vigilantes" and the politicians. The key outcome will be the level of the "term premium", or the added pay-off bond investors demand for the risk of holding long-term debt. While the macroeconomic scenarios will still determine the direction of travel of yields, the net impact of term premia will be relatively higher US yield levels in each scenario compared to those levels in the recent past.

Exhibit 1
The US stands out in an era of sustained fiscal deficits

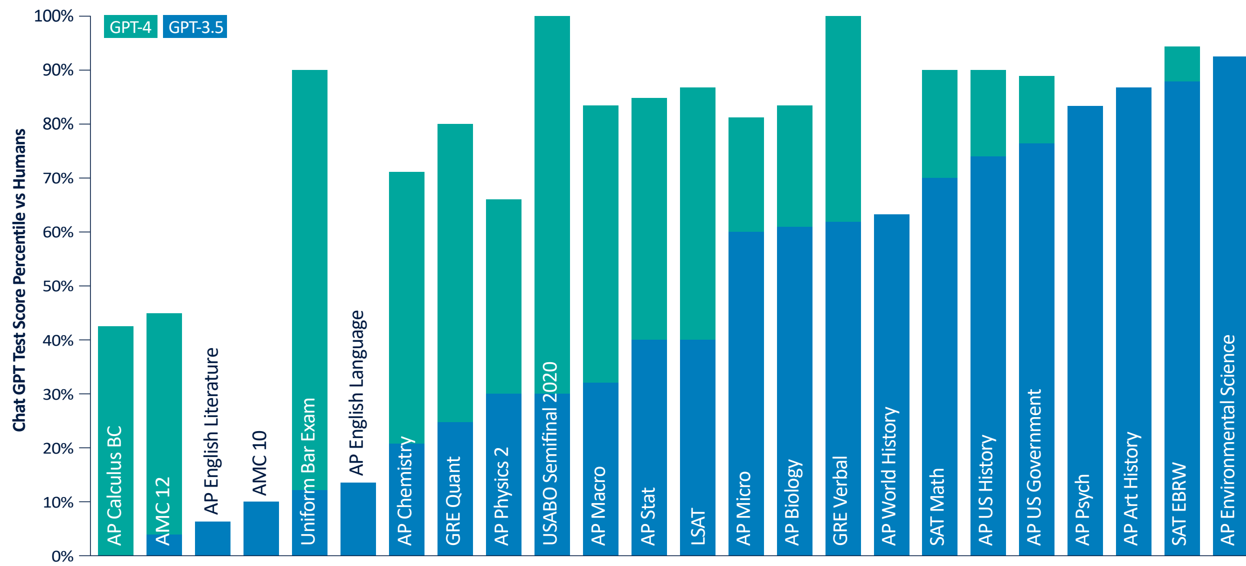


Source: *IMF*

AI Potential: Fortunately, the future holds more than just bad news and risks. As noted above, rapidly developing AI capabilities have the potential to dramatically increase services sector productivity, much in the same way industrial automation, the

Exhibit 2

Chat-GPT is excelling across a wide variety of fields



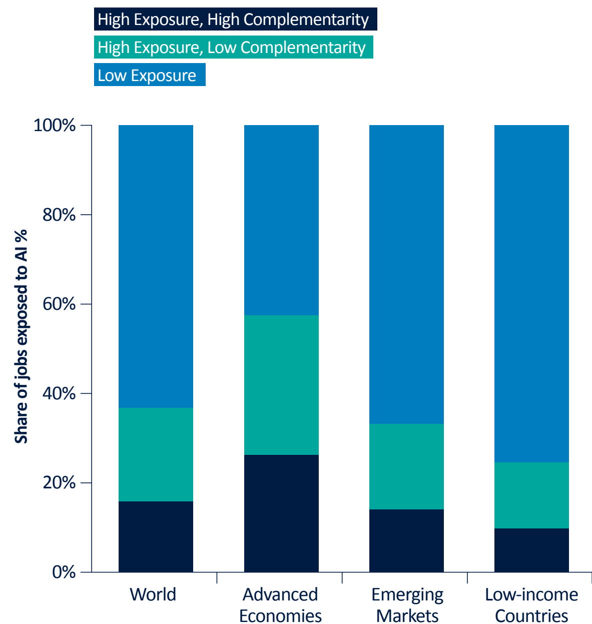
Source: *OpenAI*

internet and globalisation advances of previous decades improved the goods sector productivity. Experts believe that AI has the potential to boost global productivity by a c. 1.5%/annum over a 10-year period[1]. Exhibit 2 shows the potential impact across service sectors.

Clearly, any technological advance also creates risks of disruption to existing job structures. In a working paper, released this January, the IMF notes that "we are on the brink of a technological revolution that could jumpstart productivity, boost global growth and raise incomes around the world" before warning that "AI could also replace jobs and deepen inequality." Exhibit 3 shows analysis from the IMF suggesting that c. 40% of global jobs are exposed to AI; with 20% having high exposure to work being complemented/ augmented by AI while another 20% are at risk of outright replacement (high exposure, low complementarity). The term "complementarity" in this sense refers to AI models being used as a sort of assistant to help workers improve their productivity, rather than replacing them. With regard to the risk of worker displacement, experts are keen to highlight that the labour market will evolve and adapt, noting that 60% of workers today are employed in occupations that did not exist in 1940.

Exhibit 3

AI has the potential to be very disruptive for labour markets



Source: *IMF*

However, as with previous advances, and in light of the severe population growth challenges currently facing most advanced (services-based) economies, the net benefits could eventually outweigh the costs of reconfiguring labour forces. We delve deep into the impact of AI in our macro focus on equity markets. In addition to the macro implications above, our investment approach to Generative AI is outlined further below.

1 McKinsey, IMF