INVESTMENT OUTLOOK 2024

Coutts

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2023 – YEAR IN REVIEW

Investors and policymakers faced a challenging macroeconomic environment as we entered 2023, characterised by high inflation and sluggish economic growth. However, as we advanced through the year, central banks made good progress rebalancing the global economy, most noticeably in the US. This has created an attractive backdrop for investing.

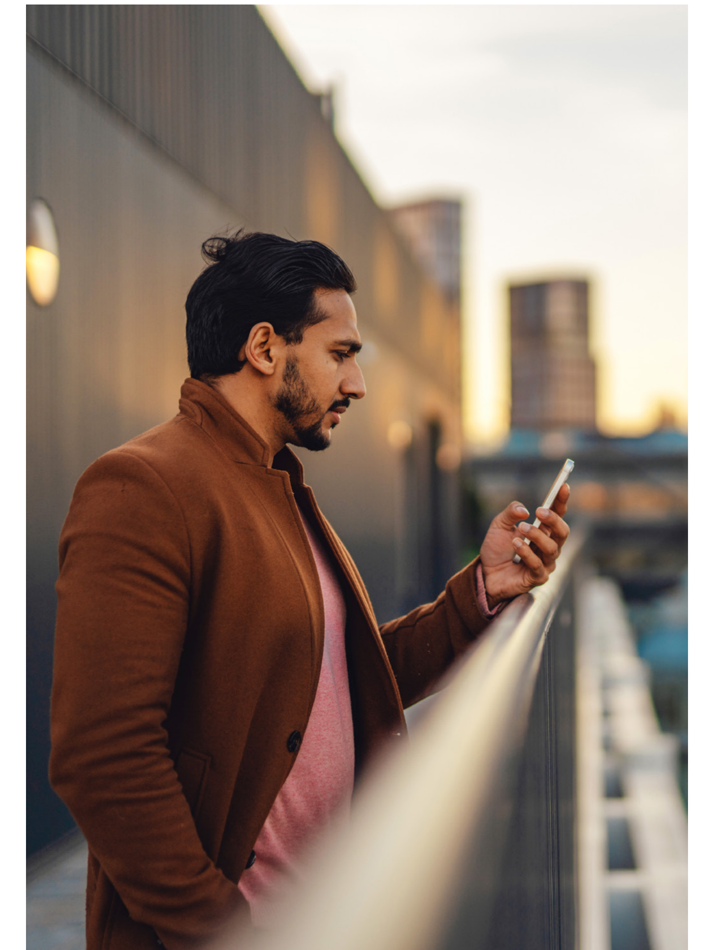
THE (RE)BALANCE OF GROWTH AND INFLATION

The US jobs market has undergone a (re)balancing act. There are fewer new jobs, while the number of people working has risen. In other words, the economy has seen people return to the labour force with the impact of a higher cost of living. This has moderated rising wage pressure without the need for job losses.

FED CAN STAY PATIENT

This is important because in 2022 the high level of new US jobs meant demand for workers far exceeded supply. It had the consequence of pushing up wages, and that pressure is now easing.

As we embark on 2024, the US economy is characterised by a healthier balance of resilient growth and lower inflation that's within the neighbourhood of the Federal Reserve's (Fed's) 2% target. The backdrop allows the Fed to remain patient with respect to interest rates, and it creates an attractive outlook for multi-asset portfolios.



US ECONOMY HOLDS FIRM

The Fed raised interest rates by 5.25% from March 2022 to July 2023, with the aim of moderating higher than expected post-lockdown inflation.

US economic growth has displayed resilience in the face of aggressive interest rate rises, which turned out to be one of the big surprises of last year.

US ECONOMY IS LESS INTEREST RATE SENSITIVE

Mortgages played a vital role in this. They are normally key for monetary policy to impact the economy – interest rates rise, mortgages cost more, people spend less, economic growth slows and inflation falls. In the US, this has not played out fully because the majority of home loans are long-dated 30-year fixed-rate mortgages. Most homeowners fixed their mortgages during the low interest rate era so it's new homebuyers being impacted by higher mortgage rates.

SLUGGISH ECONOMIC GROWTH IN UK

In contrast, the UK is a more interest rate-sensitive economy. Mortgages tend to be fixed for two to five years, and refinancing activity has progressively had an impact on consumer spending behaviour. This has contributed to the more sluggish economic growth experienced in the UK last year.

GROWTH CAN BEAT EXPECTATIONS

As we head into 2024, the global economy can outperform low consensus expectations. Regional divergences are likely and will create opportunities – specifically in the US, which could outperform given robust real income growth. Also, Japan will likely benefit from a looser monetary and fiscal backdrop relative to other developed economies. Disinflation is likely to continue, albeit at a slower pace than in 2023, as pandemic distortions continue to normalise and shelter inflation continues to slow.

The implications of this for multi-asset portfolios have been mixed, albeit leaning towards the positive. Equities have performed well, as better than expected growth fuelled expectations that company performance would improve. In contrast, government bond performance has been more muted, given resilient growth led central banks to increase interest rates more than was anticipated at the start of the year.

SECTION ONE

POST-PEAK INTEREST RATE ENVIRONMENT

Some central banks paused raising interest rates towards the end of 2023, confirming our view that they might have finally peaked. Before we look at what the world might look like when we're beyond this peak, let's look at why central banks raised rates in the first place.

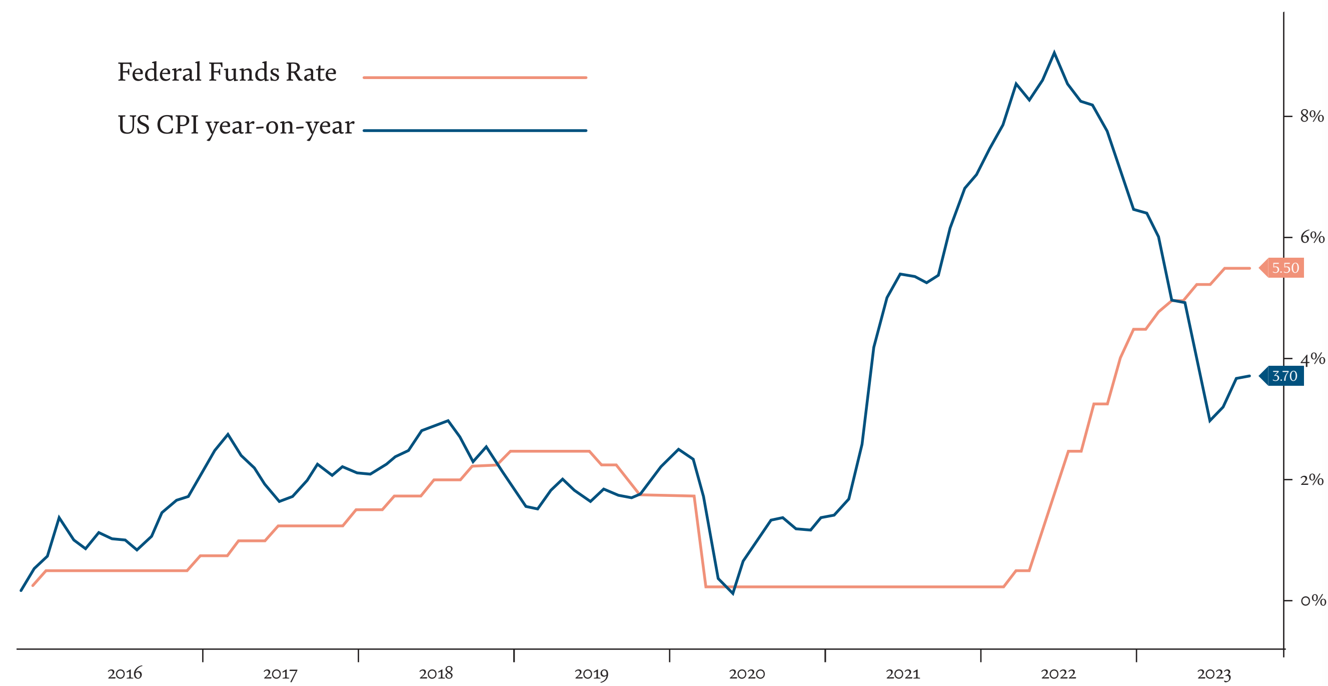
RISING INFLATION POST-PANDEMIC

The surge in rising costs that followed the Covid-19 pandemic emerged in Q1 2021. Year-on-year inflation in the US climbed steadily from 2.6% in March 2021 to 9.1% in the summer of 2022, according to the United States Department of Labor.

Inflation rose initially as a result of a mismatch between the supply and demand for goods during lockdown. This was later exacerbated when strong consumer demand and tight labour markets caused wages and the cost of services to rise.

RECORD INTEREST RATE INCREASE

With inflation shooting up to levels not seen since the early 1980s, central banks resorted to the fastest and largest monetary tightening cycle in the past 40 years. The Fed raised its Federal Fund Target Rate (FDTR) – interest rates – from 0.25% to 5.5% in just 24 months, as seen below. This is compared to the consumer price index (CPI) – inflation – over the same period.

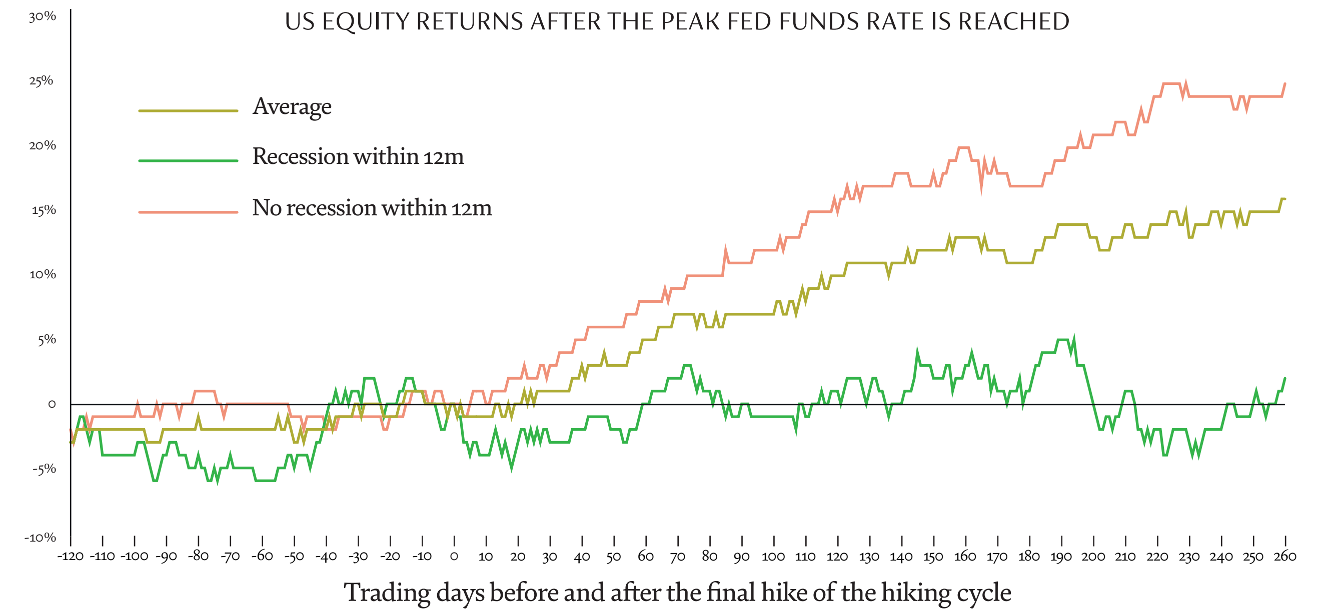


Source: Bloomberg.

THE AFTERMATH

Historically, periods of intense monetary tightening to fight rampant inflation have caused headwinds for risky assets. The negative impact on the economy tends to dampen the market mood and corporate profits.

The chart on the next page shows how US equities performed before and after the final rate hike by the Fed in the past. Ahead of the final hike, performance is mildly negative to flat. However, once the last hike is delivered, the outlook for equities improves dramatically, with stocks expected to rise roughly 15% on average a year later. We should point out, though, that this performance depends on whether the delayed impact of the rate hikes causes a US recession, as highlighted by the red line. On this occasion, we believe the US could avoid a recession or only have a reasonably mild one.



Source: Bloomberg, S&P 500.

THE YEAR FOR BOND YIELDS?

We believe bonds look increasingly attractive after two years of poor performance, and should be less sensitive to how the US economy performs in the coming year.

First of all, note that bond yields and prices have an inverse relationship. If yields go down, prices go up, and vice versa.

SECTION ONE

POTENTIAL DOUBLE-DIGIT BOND RETURNS

US government bond yields are roughly 5% at the time of writing. If yields remain unchanged, an investor will see a return of 5% over the next 12 months. However, if this yield was to change by 1-2%, in either direction, its returns would be appreciably different.

As highlighted in the table below, if yields go up by 1%, which we believe is highly unlikely, the 12-month return on the bond (including coupons) would be expected to be -2%. However, if yields fall by 1%, the 12-month return would be expected to be a considerable 12%.

10-YEAR BOND RETURNS OVER THE FOLLOWING 12 MONTHS

STARTING YIELD	CHANGE IN GOVERNMENT BOND YIELDS				
	-2%	-1%	0%	1%	2%
3%	17.0%	10.0%	3.0%	-4.0%	-11.0%
4%	18.0%	11.0%	4.0%	-3.0%	-10.0%
5%	**19.0%**	**12.0%**	**5.0%**	**-2.0%**	**-9.0%**
6%	20.0%	13.0%	6.0%	-1.0%	-8.0%
7%	21.0%	14.0%	7.0%	0.0%	-7.0%

Source: Bloomberg, Coutts.

Note: this assumes there would be a parallel move in bond yields and ignores second order effects.

We believe we've neared, or even reached, the peak in interest rates, and therefore expect yields to fall and prices to rise. Notably, a forecast return of 12% – should yields fall by 1% – would be greater than what cash rates are currently offering.

EARNINGS OUTLOOK

BRIGHTER OUTLOOK FOR US EARNINGS

Having faced a US earnings 'recession' in 2023 – when corporate profits fell for three straight quarters – US companies finally have an improving outlook for earnings growth. As mentioned before, the US economy has shown resilience despite rising interest rates. And, equally, companies are starting to show promising signs of growth for the year ahead.

HIGHER PROFITS ON THE HORIZON?

History tells us that, following earnings downturns like the one in 2022, profits tend to rebound. Typically, companies cut costs when they see their earnings fall. Hence, when economic conditions improve, they see higher profits.

CONSUMERS STILL FEEL THE SQUEEZE

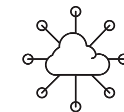
However, it may not all be smooth sailing as there are signs people are still feeling the pinch when it comes to their money. For example, the University of Michigan Consumer Survey shows consumer sentiment remains fragile. In November, 46% of the survey's respondents said they were worse off financially than a year ago, versus 28% saying they were better off, with the principal factor being higher prices.

KEY PERFORMERS

The investment side of the economy looks in better shape for some, however. After a year of recovery in 2023, there are high expectations for some sectors this year.

MEGA-CAP TECH

Large technology firms continued to spend heavily last year to keep up with the demand for artificial intelligence (AI). The so-called Magnificent Seven (Apple, Microsoft, Amazon, Nvidia, Alphabet, Meta and Tesla) did very well off the back of the excitement around AI, accounting for nearly all the positive investment performance of the S&P 500 in 2023.

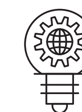


HEALTHCARE

This defensive sector is expected to be one of the major contributors to US earnings growth in 2024. Healthcare demand is beginning to normalise following the disruption of the Covid-19 pandemic. Excitement grew around new, injectable GLP-1 treatments for diabetes and obesity after successful clinical trials. This, along with several celebrity endorsements, drove growth expectations for next year.

FINANCIALS

At the other end of the performance spectrum, expectations are low for the financial sector. Having witnessed severe challenges in 2023, such as the collapse of Silicon Valley Bank, the sector faces further issues such as slowing loan growth, rising credit concerns and increased competition.



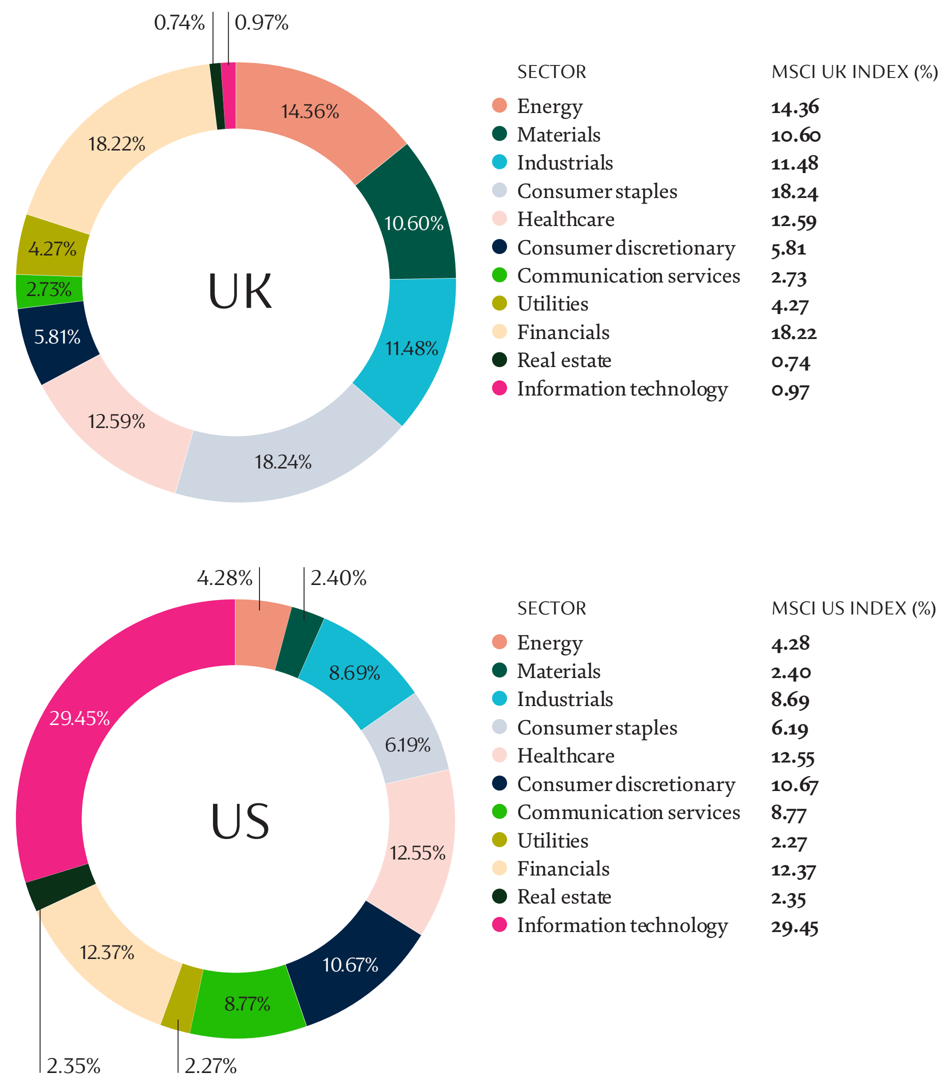
UK BEHIND THE CURVE

UK equities in a post-pandemic, higher-rate environment are falling behind their global peers. This may seem surprising given how much of the largest companies in the FTSE 100 and MSCI UK depend on international activity and overseas earnings. This could be down to the breakdown of sector dominance in the region.

SECTOR DIFFERENCES – US V UK

As you can see in the charts below, there are some significant differences in the weighting of sectors in the MSCI UK compared to its US counterpart.

Technology, for example, performed well in the US last year, but accounted for less than 1% of the MSCI UK. On the other hand, financials – including banks that had a tough 2023 and face low expectations this year – accounted for more than 18% of the MSCI UK.



Source: MSCI.

The ongoing absence of higher growth sectors, in particular technology, drives the disparity in performance. And as far as the make-up of the market is concerned, that position looks unlikely to change.

WHAT LIES AHEAD FOR UK INVESTORS?

A re-rating of the market is reliant on a move back to more value-style investing. The forward-looking investor will be more attracted to the US market compared to the UK. But opportunities will arise in the UK when confidence around the Bank of England's policies and the overall economic direction improve.

For now, investors will be focusing on locking-in above average dividend yields at cheap buy-in prices.

OUR ASSET ALLOCATION

In 2024, investors need to balance the risks of early signs of economic expansion against the delayed impacts of monetary policy.

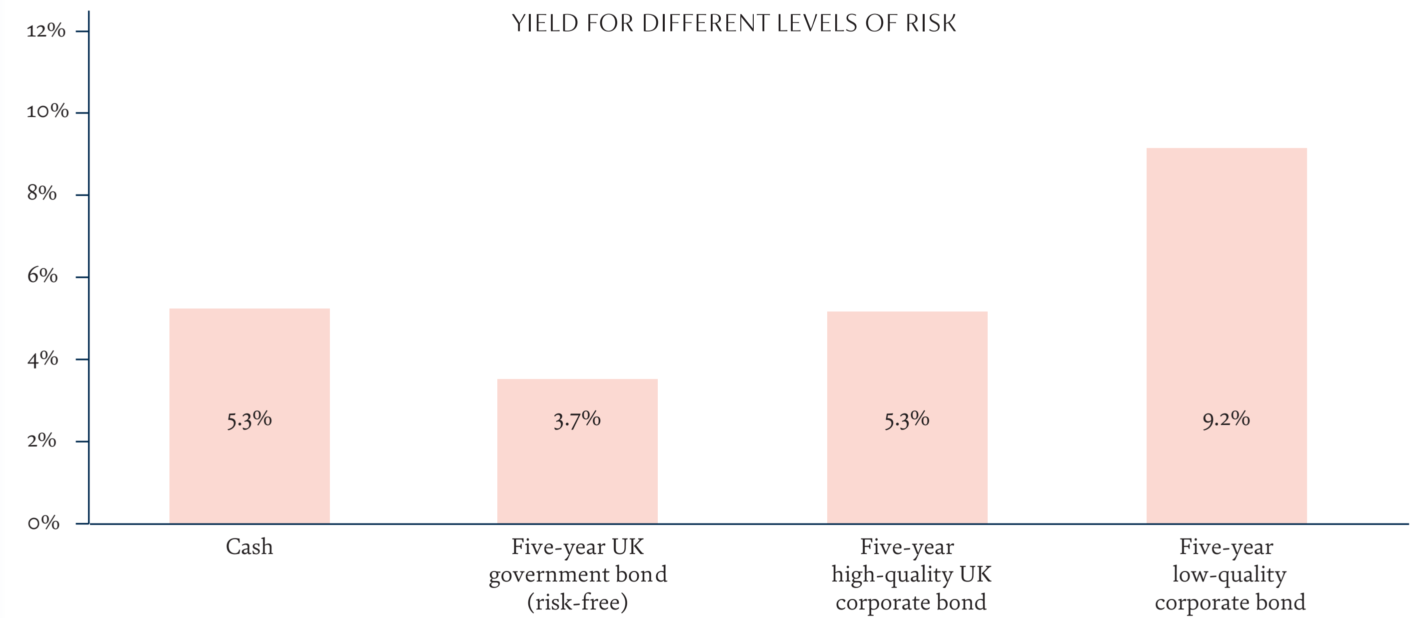
OUR PORTFOLIO POSITIONING

Against this backdrop, our portfolios are positioned to lean into the positive outcomes seen in the business cycle while earning the bond yields of a higher interest rate environment.

As such, our investments are weighted towards risky assets, more specifically global equities. For this exposure, we have chosen an active manager with a good track record of picking high quality, multinational companies that can best manoeuvre the current environment.

ATTRACTIVE BOND YIELDS

We're also earning 4% to 6% yields from the global government and corporate bond markets, where contractual income is attractive. Additionally, we have an allocation to global high yield, as prevailing high single-digit yield levels have led to attractive long-term returns.



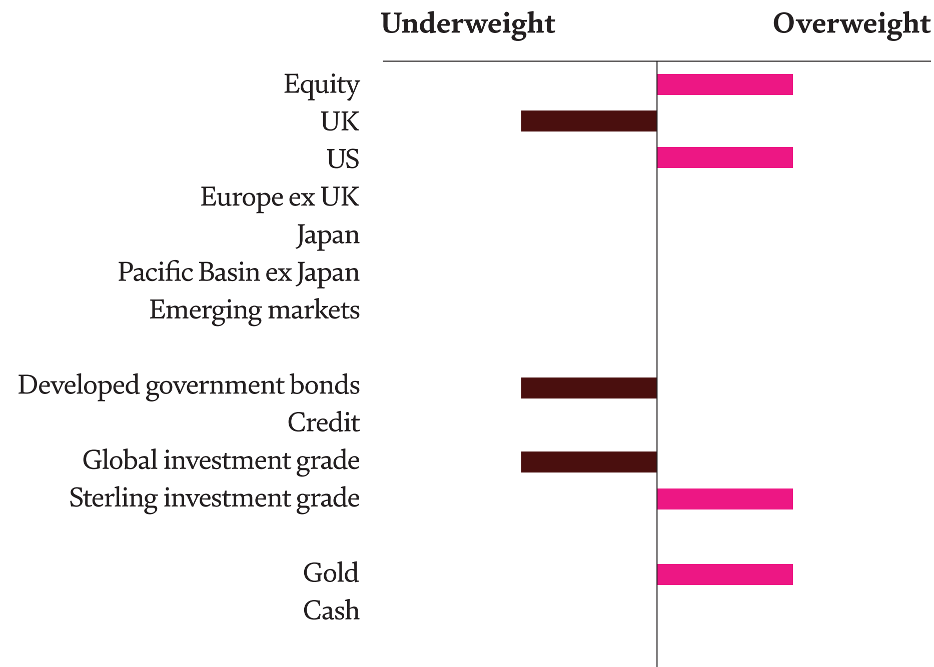
Source: Coutts, Bloomberg, Bank of America Merrill Lynch. As at 3 January 2024.

SECTION THREE

GOLD

We have an allocation to gold given various uncertainties associated with the lagged impact of higher interest rates, record government budget deficits and geopolitical tensions. In stressed market events, gold tends to be protective, and we blend it with our bond allocation for diversification.

OUR HOUSE VIEW:

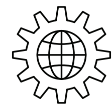


Source: Coutts. As at January 2024.

2024 OPPORTUNITIES

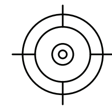
EUROPEAN BONDS

Europe is much closer to a recession than the US, which should support European bonds as yields are more likely to fall.



ACTIVE MANAGEMENT

Peak interest rates and the prospect of them staying higher for longer will see dispersion in stock outcomes. We lean towards active managers with expertise of picking companies that can best manoeuvre this environment.



SMALL CAPS

Smaller companies were on our watch list last year, but we didn't include them in our client portfolios and funds as rising interest rates created headwind challenges. But with those interest rate hikes ending, the outlook has improved for such firms. And smaller company valuations are at historically cheap levels, creating the chance to get good deals.

COUTTS INVESTMENT OUTLOOK 2024

ACTIVE V PASSIVE

THE HISTORY OF ACTIVE MANAGEMENT

Active management is much more challenging than passive investing when it comes to beating benchmarks, particularly through the volatile periods seen in the last few years. Active investment management involves manually selecting stocks or bonds that the fund manager thinks will perform best. This compares with passive investing, which replicates and tracks an index that is typically weighted by market capitalisation.

PRESSURE ON ACTIVE FUNDS

There is a lot of pressure on active funds to perform, and results can be pretty ruthless on the future of the fund. According to a study by SPIVA – a research arm of S&P Dow Jones Indices that studies active management versus benchmark – 20% of US equity funds have either been closed or merged since 2018 because of poor performance.

US EQUITY MANAGERS LEFT BEHIND?

The same study highlights that 89% of active US equity managers have underperformed over the past five years. This is largely down to a handful of companies excelling, like the previously mentioned Magnificent Seven. If active fund managers don't include a larger allocation to these few stocks, their fund performance will lag the broad index. This pattern is echoed in the big market regions across the world.

BETTER PROSPECTS GOING FORWARD?

While we've taken a positive stance towards passive investing for many years, we think the tide is turning and there are better prospects for active equity investing in the future.

Firstly, major stock indices have become very concentrated. For example, the Magnificent Seven stocks account for 30% of the S&P 500. These stocks have premium valuations that leave little margin of error on future earnings. In contrast, the remaining 493 stocks in the index are cheaply valued and should have a better opportunity to outperform. This is where active management could provide optimal returns by picking the stocks most likely to succeed.

Secondly, the fees associated with active management are usually more expensive than their passive counterparts. However, research shows that some institutional managers, like large pension plans and sovereign wealth funds, are beating benchmarks and at a lower fee. With active management falling out of favour for many asset management firms, fees are declining in order to maintain business.

In our eyes, this makes active management an appealing strategy in the current environment.

THE MATURITY OF RESPONSIBLE INVESTING

Responsible investing is defined as the integration of environmental, social and governance (ESG) factors into investment decisions. At Coutts, we follow a responsible investing approach across all our managed funds and core discretionary portfolios.

INVESTING IN SUSTAINABILITY IS STILL RELEVANT

It was widely reported in the media last year that ESG investing is going out of style and is being replaced with newer trends. However, there are credible grounds for believing that responsible investing isn't just a fly-by-night trend, and that we should be investing in sustainable opportunities.

Some examples include:

- the Intergovernmental Panel on Climate Change documenting how global temperatures continue to rise
- unacceptably high rates of biodiversity loss, according to the United Nations Environment Programme
- increased levels of extreme poverty found in research by the International Monetary Fund

These issues are unlikely to be resolved overnight and there's still a need for investing in change. Looking at the transition to sustainably sourced energy as an example, this could benefit both the environment and investors. The International Energy Agency estimates that $2.8 trillion will be invested into clean energy in 2023, across both fossil and sustainably sourced fuel.

MANAGING RISK

Asset managers have a fiduciary duty to clients to ensure that all investment decisions are made with their best interests in mind. A survey by The World Economic Forum found the leading risks for private-sector risk managers in their two and 10-year horizons are all ESG-related. Therefore, factoring ESG into investment decisions plays an important role when reducing downside risks within varying time frames.

REBUILDING TRUST

We are mindful there has been a loss of trust in recent years due to a lack of classification and transparency within sustainable investing, resulting in investors falling victim to greenwashing. Greenwashing is the marketing of sustainable activity where the ESG efforts have been overstated. The broader ESG investing space is evolving and there are efforts to address and rebuild investor trust.

Regulators are guiding the need for standardisation, classification, heightened transparency and parameters surrounding greenwashing, especially with regard to investment advice.

ADDRESSING GREENWASHING

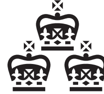
The UK's Financial Conduct Authority released its Sustainability Disclosure Requirements in November last year. One significant change will be evaluating which ESG-related labels, if any, are applicable to investment products.

This will benefit investors by cutting through the noise, rebuilding trust in responsible investing and enabling more informed investment decisions.

With this all in mind, we believe sustainable investing is very much alive and, as it matures, will undergo a necessary evolution to build trust. We continue to believe it's an important vehicle in mitigating downside risks and taking advantage of new opportunities.

IMPORTANT INFORMATION

The value of investments can go down as well as up.
Capital at risk. You must borrow or invest more than £1 million with Coutts to become a client.
Eligibility criteria, fees and charges apply.



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