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GLOVISTA INVESTMENTS

Glovista Global Perspectives

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2023 Review and 2024 Outlook: *YTD Rally in Risk Markets, Largely Risk Premium-led; '24 Outlook likely to Entail US Recession and Resumption of Bond Term Premium Pressure*

As is customary in December, in this commentary we aim to review major global macro and market developments retrospectively for the closing year and prospectively for the incoming year, with an emphasis on resulting portfolio strategy implications.

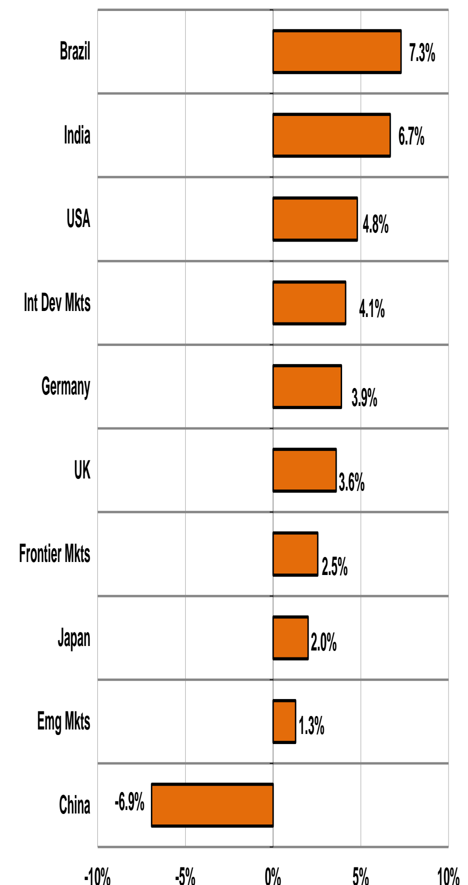
The 2023 review section discusses our views on the driving factors underlying the 2023 rally in risk markets. In short, we identify this year's risk market rally as largely the result of a sizable decline in risk premium across a number of factors, ranging from geopolitical, inflation, bond term premia and economic growth, along with the arguable one-off cost-savings driven boost to US profit margin dynamics. As we discuss in the outlook section below, in 2024 we expect mean-reverting dynamics of such factors to pose a challenging backdrop for risk markets. Consequently, our portfolio strategy stance in 2024 will continue to emphasize quality factor tilts at the currency, style, geographic and sector levels.

2023 Review: *Risk Markets Rally on Sizable Decline in Geopolitical/Interest Rate/Equity/Inflation/Bond Term Premia along with Liquidity Spike from FED's Response to March US Regional Banking Crisis*

Risk asset indices have posted positive returns in 2023, albeit with almost unprecedentedly narrow breadth across geographic regions, industries and capitalization groups (Figure 1).

We attribute much of this year's returns to a considerable reduction in risk premium levels across the geopolitical, interest rate, equity, inflation and bond term premium domains. As an example of said risk premia reduction dynamics at play in 2023, it is illustrative to look at global equities' return performance decomposition (Figure 2).

Country-wise Monthly Performance in USD terms (Dec 2023)*



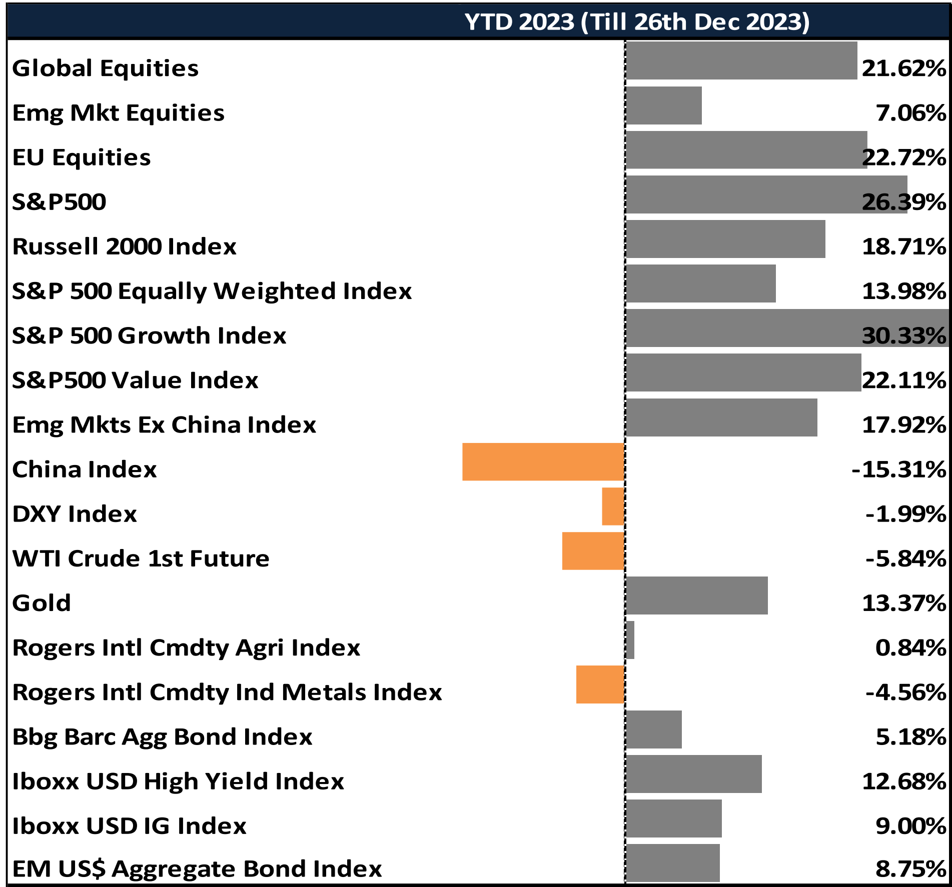
Source: Glovista Calculations
**As of Dec 26th, 2023*

Monthly US Sector Performance – Dec MTD 2023*		
Sectors	**% Change**	**FY1 PE Ratio**
Energy	2.07%	11.2
Materials	4.96%	20.4
Industrials	6.86%	22.2
Cons Disc	6.90%	26.7
Cons Stap	1.78%	20.2
Technology	3.93%	33.0
Healthcare	3.38%	21.1
Financials	4.93%	15.6
Utilities	1.19%	17.0
Telecom	5.44%	19.9
Real Estate	8.17%	38.7
S&P500	4.53%	22.2

*as of Dec 26th 2023

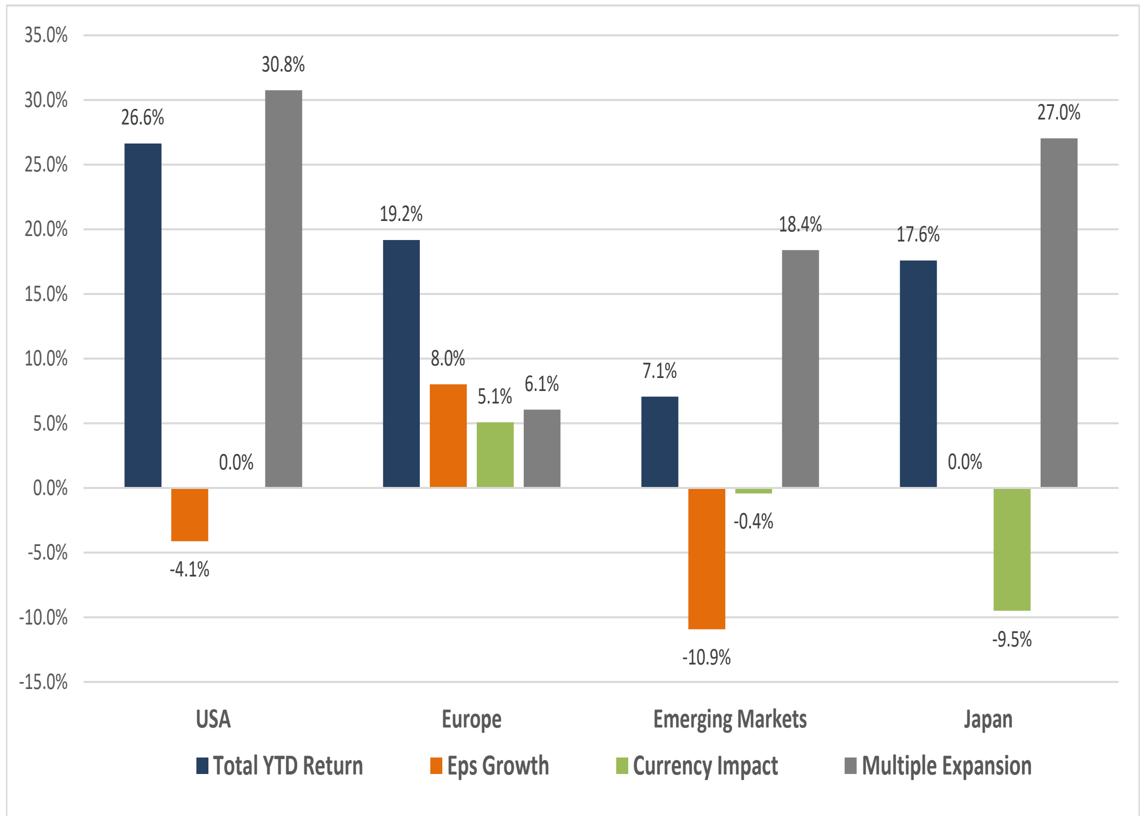
Source: Glovista Calculations

Figure 1. Risk Markets Post Solid Gains in 2023 Albeit with Unprecedented Narrow Breadth



Source: Bloomberg & Glovista Calculations

Figure 2. 2023 Gains in Global Equities Fueled Primarily by Risk Premium Compression



Source: MSCI & Glovista Calculations

A quick rundown of this past year's major macro developments includes the following:

- ***Weaker than expected economic growth.*** Several large developed economies have surprised to the downside in activity, bordering on recession level performance (e.g. Germany, Sweden, Australia, Canada) while others (e.g. China) have grown well below expectations. Likewise, while the world's largest economy – the USA – has surprised with its resilience, when measured against the traditional GDP metric, other measures of economic activity (most notably GDI, Gross Domestic Income) have posted year-on-year contraction as of the earlier part of the fourth quarter. It is quite likely that the US economy's longer lags with which monetary policy impacts activity - courtesy of the American economy's larger reliance on capital markets financing channels and US households' privileged financing via long-dated fixed rate mortgages - account for the US economy's vast outperformance of developed peers in 2023. As we look ahead to 2024, we expect a reversal of such performance.

- ***Weaker than expected inflationary pressures:*** China's weakened economy has set off powerful goods sector disinflationary dynamics globally throughout the course of the year. Likewise, the close to recession conditions in Germany, Sweden, Australia, Canada and other major economies have fueled a loosening of labor market conditions. In the USA, labor market conditions have weakened considerably over the course of the year's second half, particularly as reflected in the household survey. As a result, service sector inflation pressures have abated considerably these past several months, at a global level.

- ***Geopolitical risk premium decline:*** during the year's fourth quarter, the German and US governments exerted pressure on Ukraine to enter into peace negotiations with Russia, thus fueling a decline in geopolitical risk premium. Similarly, also during the fourth quarter, the US government's unambiguous support of Israel has contained risks of a broadening of hostilities in the Middle East.

- ***March US regional banking crisis:*** the US Federal Reserve responded to the banking crisis with the introduction of new liquidity facilities, discussed in prior monthly columns. As a result, the then ongoing quantitative tightening process came to a temporary halt while investor attention switched away from value oriented to growth-oriented sectors, especially mega-cap technology sector names. Thus, the combination of massive loosening of liquidity conditions along with sharp investor rebalancing interests away from value sectors set off a massive re-rating of mega-cap tech sector valuations that stand at exceedingly expensive levels versus historical norms.

- ***Improved Tech Sector Profit Margin:*** Outsized 2023 and 2022 beneficial impact on US mega-cap tech corporate earnings growth tied to large cost cuts, and hefty interest rate margins harvested on their massive surplus cash balances, boosted corporate profit margins for tech sector dominated US Indices. As we look ahead to 2024, such dynamics are unlikely to recur and quite likely to reverse meaningfully.

The above-mentioned dynamics – weakening growth though with continued expansion, along with declining inflation – have led to an expansion in risk asset valuation multiples, further reinforced by declining geopolitical risk premium levels, especially during the fourth quarter. At the end of 2023, risk asset valuation multiples do not discount material risks of US recession or considerable slowdown in 2024. For example, Figure-3 illustrates multiple market based measures showing exceedingly high optimism.

As we look ahead to 2024, it follows that any additional upside return potential for equities and other risk asset groups are unlikely to derive from further compression in risk premium levels but rather from carry factors that take the form of sales/margin/currency/earnings sector dynamics. We discuss some of those factors in the context of our 2024 outlook immediately below.

Figure 3. Market Discounts Exceedingly Blue Sky 2024 Macro Outlook: Equities, Credit, Bond Term, Fixed Income

Source: Bloomberg & Glovista Calculations

***2024 Outlook:** Glovista Enters 2024 favoring Defensive Portfolio Tilts against US Recession Potential: Overweight Quality/Value/International, Underweight US$ into Q2 and Underweight Bond Duration on Bond Term Premium Reset Risks*

Our 2024 outlook reflects the following macro baseline case: material risks of US recession, weaker US Dollar during the first half of the year; widening credit spreads; bond term premium upward pressures, and; likely Republican Party victory at the upcoming November 2024 presidential elections. Our expectation for a mild US recession in 2024 reflects a number of considerations, including:

- The timing of lags between monetary policy tightening and impact on economic activity. Historically, such lags begin to bite around 18 months following the first rate hike (early in 2022). The quantum of hikes applied in this cycle has been especially large while the US economy's indebtedness level is also above historical average levels;

- Ongoing domestic economic weakness in Europe and China is likely to impact the visibility of US net export growth;

- Weaker fiscal impulse following the expiry of multiple pandemic era federal government programs as well as the reinstatement of student loan debt servicing.

Our macro financial baseline case, if proven correct even in a narrow sense, should result in a period far more fertile for alpha generation than 2023, a year in which the US market has recorded the narrowest stock group leadership in decades.

A weak 2024 US economic outlook is likely to be accompanied by a compression of equity multiples. Likewise, a period of further US$ weakness should extend at least into the second quarter of 2024 as the US Federal Reserve responds to the economic deceleration and inflation decline with multiple policy rate cuts. In addition, credit spreads are likely to widen under such scenario even though the scheduled profile of expiring corporate debt maturities is not massive next year.

As we enter 2024, we favor overweight allocations to US value stocks and international equities. Moreover, we favor overweight quality factor exposures across equities and fixed income portfolios given elevated US recession risks and lagged effects from 2022/2023 monetary policy tightening. Within fixed income, we favor short- to intermediate- maturities given the sharp decline recorded in bond term premium levels during the fourth quarter of 2023. The US government's monumental budget deficits – the largest in peacetime history – are likely to surprise significantly to the upside in 2024 and 2025 should the US economy weaken more than expected. Current bond term premium levels are exceedingly vulnerable to reset higher under such macro scenario, in our view. Consequently, we do not favor long dated maturities.

At a global level, we favor US value sector as well as international equities owing to their attractive relative valuations versus their currently much favored US mega-cap growth peers. Our bearish US Dollar outlook, especially through the second quarter of 2024, along with our thesis calling for US economic underperformance versus international peers next year should propel foreign markets' strong outperformance, especially given prevailing massive underweight investor allocations.

Insofar as principal risk factors conditioning the outlook in 2024, we believe the following are likely to be most relevant: supply-driven energy price rises; resurfacing of inflationary pressures; mercantilist trade policy agenda under a second Trump administration; China-Taiwan tensions following Taiwan's upcoming presidential elections.

Global Emerging Market Perspectives

China Market De-Rating Hides Broadening '23 Emerging Equity Markets' Outperformance versus Developed Peers; '24 Outlook Sustained by Potential for Real Rate Declines, Cycle Outperformance and Re-Rating

As we look back to 2023, a cadre of adverse China economic, geopolitical, financial and policy developments stand out as the driving factor set accounting for emerging market equities' relative underperformance versus developed peers. A number of such developments include:

- Sustained price declines in Chinese households' largest asset – primary homes – as the property market corrects following years of excess supply and price escalations;

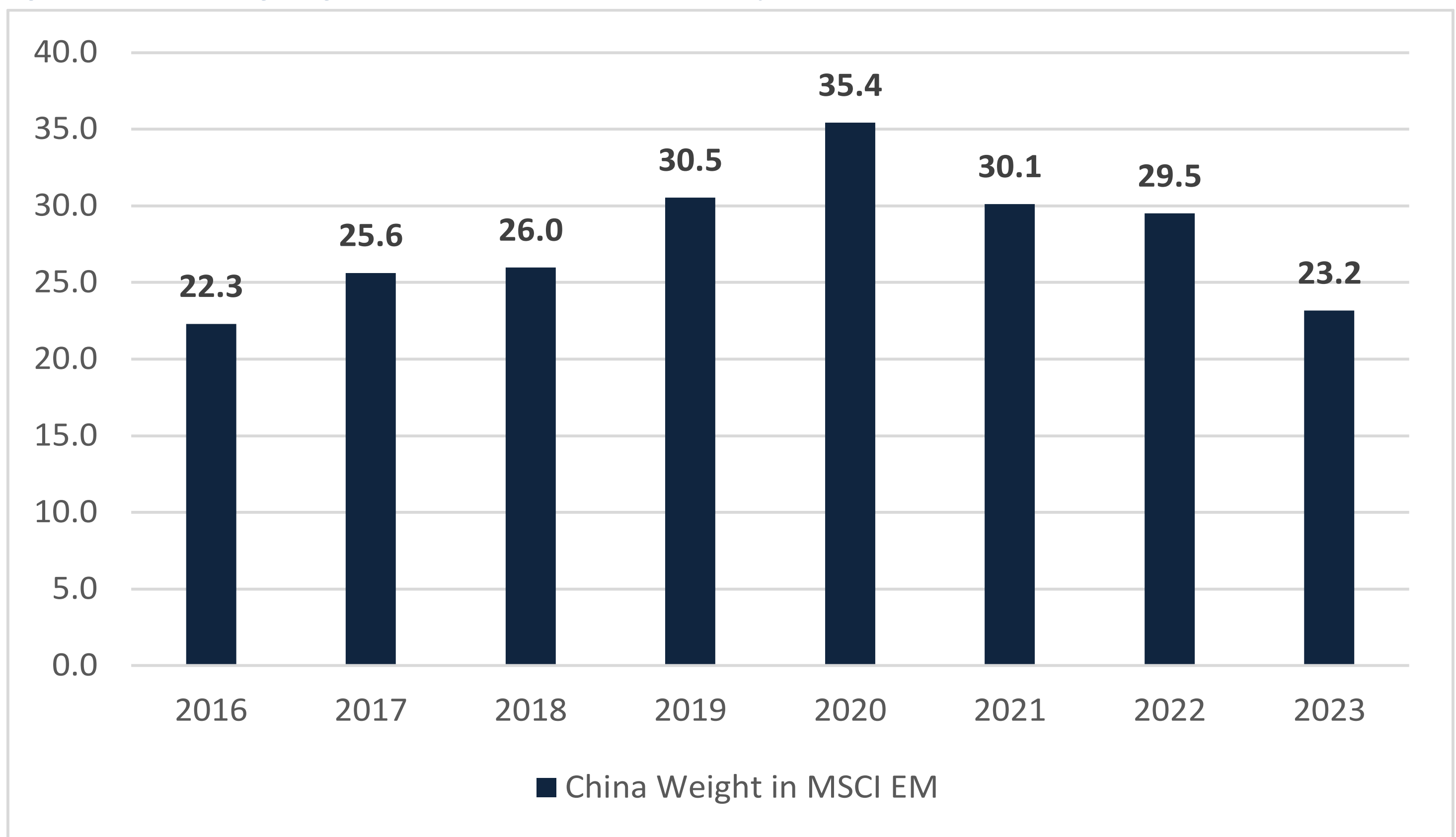
- Intensification of US-China geopolitical tensions, tied primarily to the enaction of restrictions of semiconductor exports from the US and other Western powers. Such measures have triggered similar responses from China in other sectors;

- Chinese authorities' timid policy responses to weakening economic conditions. Such timid policy stance includes the small magnitude of nominal policy interest rate cuts as well as adjustments to reserve requirement ratios and other monetary policy tools adopted thus far. The weakness in economic activity has been accompanied by declining CPI inflation that has included goods sector deflation. In the process, real (inflation-adjusted) interest rate levels have risen sharply throughout the year, reinforcing the weakness in consumption and investment dynamics.

In short, adverse price developments in the property market are adversely impacting household expenditure growth via negative wealth effects while the spike in real interest rate levels – impacted by a thus far timid policy response – is reinforcing the weakness in household expenditure as well as deterring private sector investment spending.

Notwithstanding the abovementioned summary account of China's 2023 macro-policy developments, as we look ahead to 2024 we expect a stabilization, and quite possibly a partial reversal, of such trio of adverse dynamics. For example, over the past several months house price dynamics have begun to stabilize. On the policy front, over the past several weeks the narrative coming out of senior level economic officials with regards to policy direction has shifted markedly in favor of stimulative policies in support of stronger household expenditure. We expect policy rates will be cut further considerably, thus resulting in lower real interest rate levels in 2024. Finally, at the geopolitical level, Western government officials have modestly calibrated their level of engagement with China, in the direction of increased communication and collaboration, possibly as a conscious Realpolitik-type action in recognition of an increasingly likely November 2024 White House victory by Donald Trump.

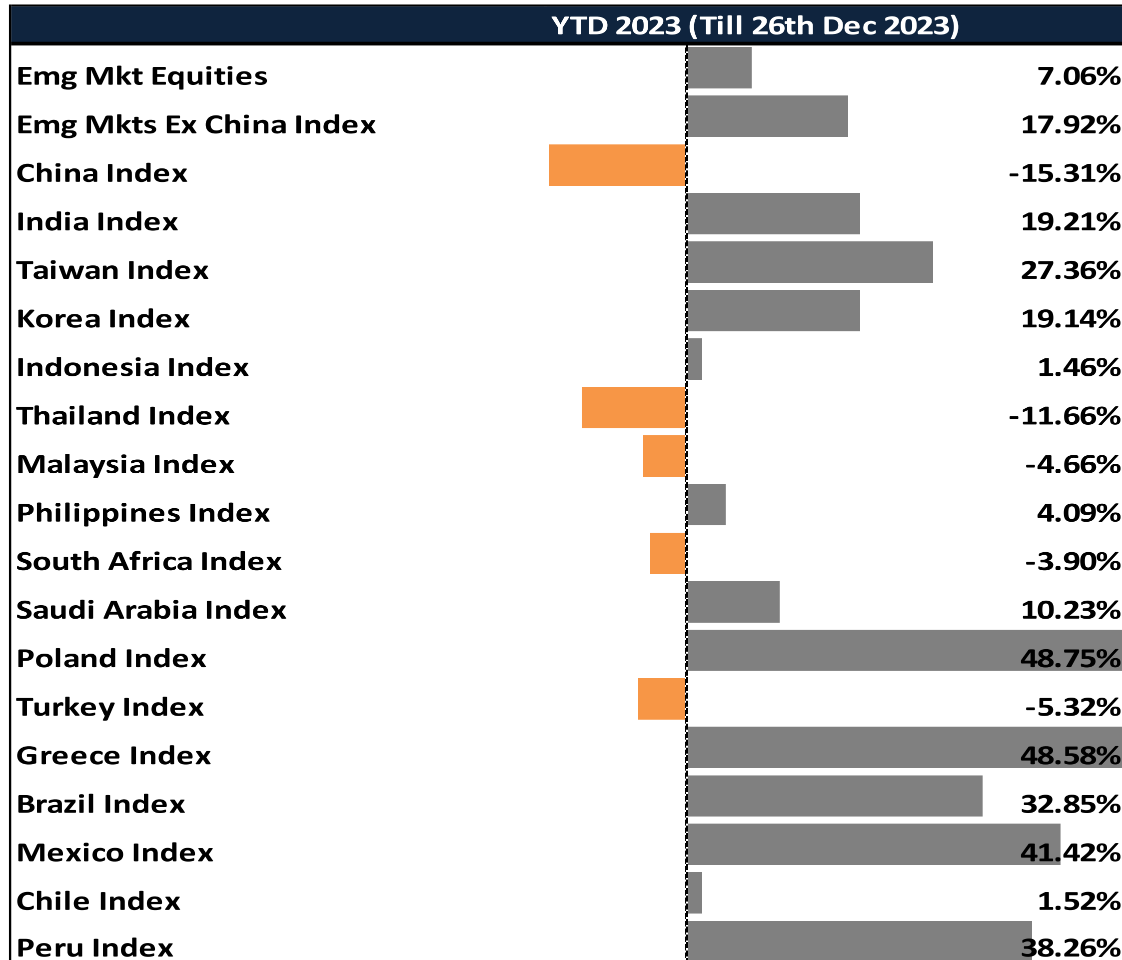
Figure 4. China's Weighting in EM Benchmark Indices on Steady Decline since 2020



Source: MSCI

The magnitude of this year's China related developments on the emerging market equities asset class' year-to-date performance responds to the Chinese market's large weighting in benchmark indices. Fortunately, such weighting has been coming down considerably over the past several years, thus diminishing the Chinese market's previously dominant share of the benchmark (Figure 4). Figure 5 illustrates the broadening country-level outperformance by the emerging market equities asset class versus developed equity index peers over the course of 2023.

Figure 5. China De-Rating Hides Broadening '23 Cross-Country Level EM Equity Outperformance vs Developed Peers



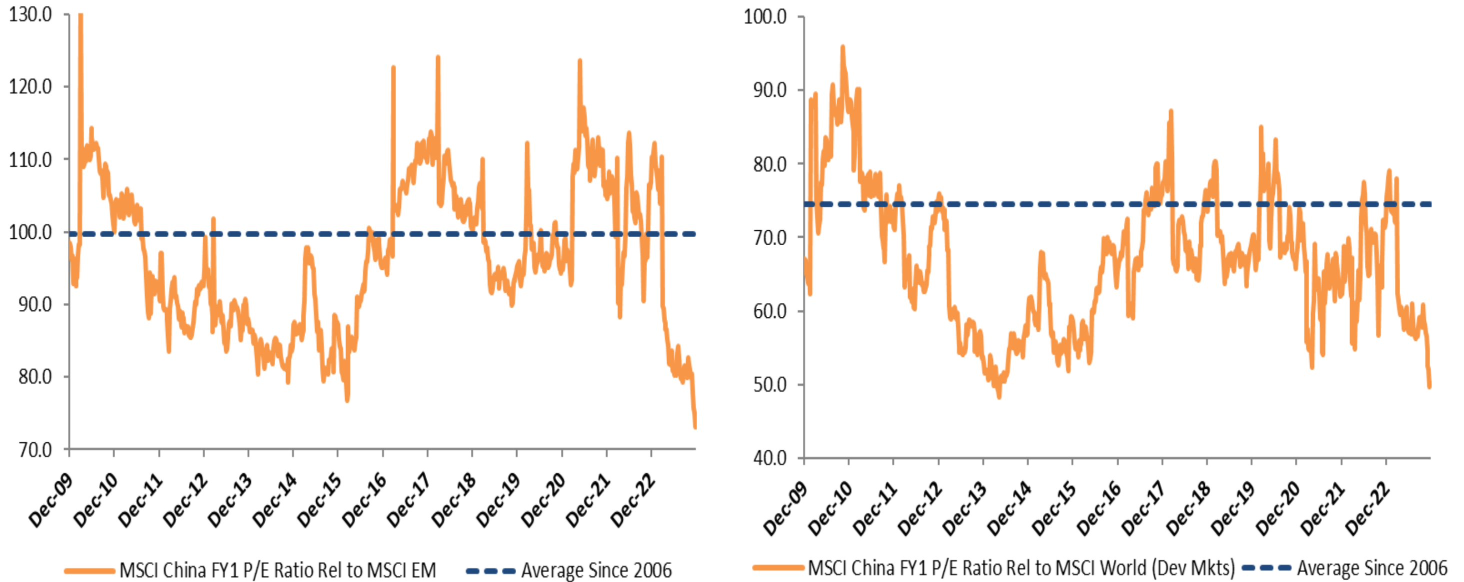
Source: MSCI

As we look ahead to 2024, we expect emerging market equities to outperform developed peers, for several considerations. First, we expect Chinese equities to perform considerably stronger versus developed peers in 2024 as compared to 2023 performance. We hold such an expectation on the basis of Chinese equities' depressed valuation levels – both absolute and relative to global peers – along with a set of positive catalysts likely to support stronger consumption growth and lower risk premium levels. Figure 6 illustrates the extent of Chinese equities' de-rating versus EM and developed peers.

Outside the likely impetus afforded the EM equities asset class in 2024, courtesy of a reversal in adverse China related developments during 2023, we foresee another year of relative outperformance for EM excluding China markets, owing to a number of factors, including:

- Potential for multiple expansion owing not only to domestic economies' resilience but also the potential for EM central banks' ability to cut policy rates given core inflation has already converged to target levels, in contrast to their developed country peers;

Figure 6. Chinese Equity Valuations Hover at Historically Cheap Levels versus EM and Developed Peers, Reflecting Extraordinarily High Risk Premia



Source: MSCI, Bloomberg & Glovista Calculations

- Domestic economic growth outperformance by EM economies versus US and European economic peers as the US economy experiences a mild recession, as discussed above;
- Emerging market equities' extreme under-invested status on the part of global asset allocators and investors;
- Emerging market currencies' revaluation potential versus the US Dollar, though we attribute such factor to be the least consequential in next year's return outperformance potential for emerging market stocks.

Insofar as risk factors conditioning the outlook is concerned, we identify the following: country level policy surprises out of a number of countries scheduled to hold elections next year (e.g. Taiwan, South Korea, India, Mexico, South Africa and Indonesia); the potential for escalation of trade conflict or actual conflict between China and the USA; the potential for G3 central banks' policy mistakes. We deem such risks to be rather low. Insofar as the second-mentioned risk factor is concerned, we ascribe an exceedingly low probability of China initiating an invasion of Taiwan for multiple considerations, including the mutually assured destruction-like effects such action would bring on the global economy as well as the highly asymmetric downside geopolitical and economic risks such scenario would bring about on China. Finally, initiating military invasion stands at odds with China's historical record as well as with Xi Jing Pin's pragmatic political avocation.

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