Outlook

Wealth Management

America Powers On

Now some folks say it's too big, And uses too much gas
Some folks say it's too old, And that it goes too fast

– Lyrics from "Pink Cadillac" by Bruce Springsteen

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Dear Clients,

Since the trough of the global financial crisis (GFC) in March 2009, two themes have underpinned our investment recommendations: US Preeminence and Stay Invested.

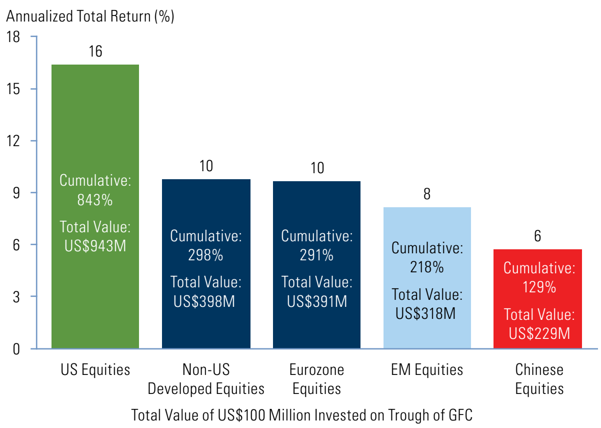
These recommendations have served our clients well over the past 14 years. A reference moderate-risk portfolio designed for taxable investors, and coincidentally a reference portfolio designed for tax-exempt ones, returned 8% annualized, or just over 200% cumulatively, between March 2009 and year-end 2023.

US equities have been the primary driver of this impressive performance. As shown in Exhibit 1, US equities, as measured by the S&P 500, have outperformed non-US developed market equities (as measured by MSCI EAFE) by 7 percentage points on an annualized basis and outperformed emerging market equities (as measured by MSCI EM) by 8 percentage points annualized.

A $100 million investment in US equities would have grown to nearly $1 billion ($943 million, to be precise). By comparison, $100 million invested in non-US developed market equities would have grown to $398 million, and to $318 million if invested in emerging market equities. Even more disappointing, $100 million invested in Chinese equities would have grown to only $229 million and would have carried 30% more risk relative to US equities, as measured by portfolio volatility.

Exhibit 1: Annualized and Cumulative Equity Returns Since the Trough of the GFC

US equities have outperformed non-US equities over the past 14 years.



Data as of December 31, 2023.
Note: All non-US equity returns are calculated in US dollars.
Source: Investment Strategy Group, Datastream, Bloomberg.

This return was achieved notwithstanding:

- The slow pace of US economic recovery in the immediate aftermath of the GFC
- The European sovereign debt crisis in 2011–12
- The downgrading of US sovereign debt by Standard & Poor's in August 2011
- Beijing's surprise currency depreciation of the renminbi in August 2015
- The global COVID pandemic, when US equities dropped 34%
- The 2022–23 Federal Reserve 525-basis-point increase in the federal funds rate—the fastest pace of hikes since the stagflation of the 1970s and early 1980s—during which US equities dropped 28% on an intraday basis

US equities continued their outperformance in the year just ended, returning 26%, compared to 19% for non-US developed equities, 10% for emerging markets, and -11% for Chinese equities.

Inevitably, after such a long run of US equity outperformance, our clients are asking two questions, as they have in past years. First, has the time come to reduce their strategic asset allocation to US equities with a long-term shift toward non-US equities? And second, should clients tactically underweight US equities with a short-term shift toward cash, bonds or non-US equities? And again, our answer to both questions is a resounding no.

In response to the strategic question, our long-standing view of US Preeminence is intact, based on the country's unparalleled combination of the following factors:

- Largest economy in the world, currently at 26% of global GDP
- Highest GDP per capita except for a handful of sparsely populated countries (usually natural resource-rich or tax-haven countries), each representing less than 1% of global GDP
- Largest, broadest and most liquid financial markets that support economic activity in public and private sectors
- Most favorable demographics relative to all major countries except India
- Highest labor productivity
- Strong culture of promoting and rewarding innovation and risk taking
- Persistent and diverse corporate earnings growth
- Extensive natural resources
- Safe-haven status
- Resilience

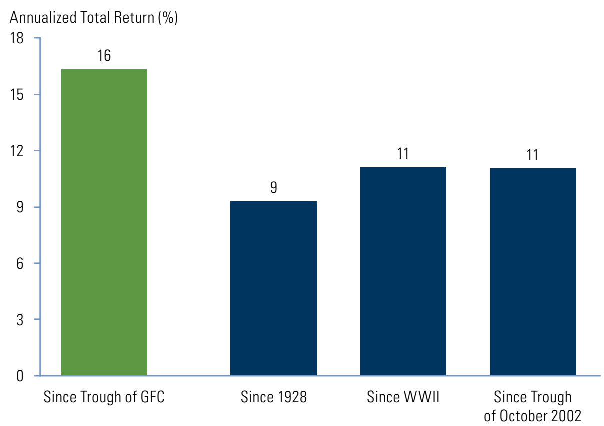
These factors endure and do so even in the face of social, cultural and political fissures (discussed in Section I).

America powers on with no sign of others in the rearview mirror.

In response to the tactical question, we acknowledge that US equities are expensive, both on an absolute basis and relative to non-US equities. However, we recommend clients stay invested in US equities at their customized strategic asset allocation weight and not shift toward bonds, cash or non-US equities.

Exhibit 2: Annualized S&P 500 Total Returns Over Various Time Periods

The return of US equities since the trough of the GFC is higher than returns since earlier time periods.



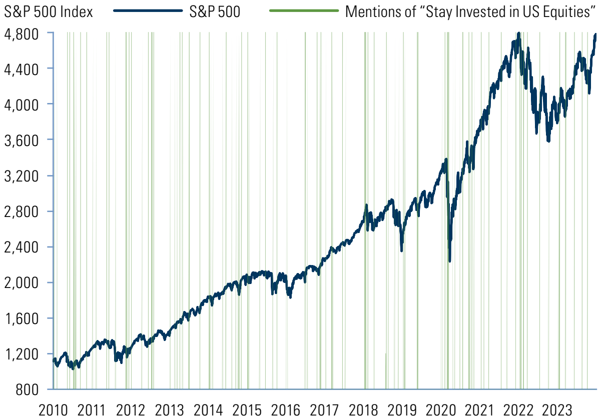
Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

As shown in Exhibit 2, the 16% annualized return of US equities since the trough of the GFC is notably higher than the 9% return since 1928, the 11% return since WWII and the 11% return since the trough of the market in October 2002 following the bursting of the dot-com bubble.

Not surprisingly, such returns have driven S&P 500 valuations to lofty levels. US equities are expensive:

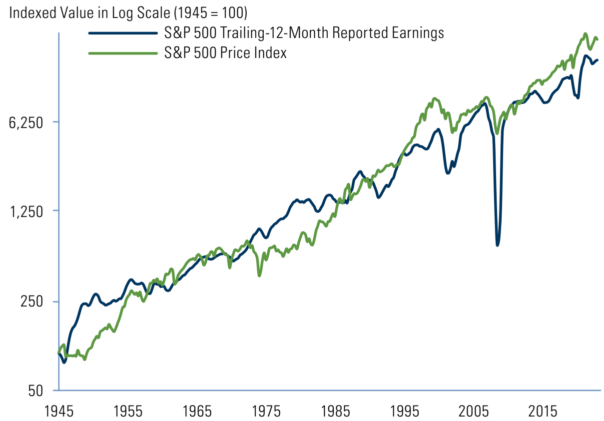
- An Investment Strategy Group metric that combines five different short- and long-term valuation metrics is firmly in the 10th decile, meaning equities have been cheaper at least 90% of the time in the post-WWII period.
- The S&P 500 price relative to operating earnings of the last 12 months is also in the 10th decile and 34% above the long-term median.

Exhibit 3: S&P 500 vs. ISG Recommendation to Stay Invested in US Equities
We have recommended clients stay invested on 121 separate occasions since 2010.



Data as of December 31, 2023.
Source: Investment Strategy Group, Datastream.

Exhibit 4: S&P 500 Price Index vs. Earnings
The hurdle to underweight US equities is high given the upward trend in earnings and prices.



Data through Q3 2023.
Source: Investment Strategy Group, Bloomberg, S&P Global.

- The S&P 500 price relative to expected operating earnings over the next 12 months is in the ninth decile, reflecting the optimism of analysts for 11% earnings growth in 2024, and is 21% above the long-term median.
- The equity risk premium that compares the earnings yield of the S&P 500 to the yield of the 10-year Treasury is in the eighth decile.

Despite these high valuations, we continue to recommend clients stay invested. Since January 2010, when our clients first asked if they should underweight US equities following the 68% return of the S&P 500 after the GFC, we have recommended they stay invested on 121 separate occasions in our various ISG publications and client calls, as shown in Exhibit 3.

Even in 2023, as we navigated the heavy fog of uncertainty and the risk of recession, we recommended clients stay invested at their customized strategic allocation. We had a base case forecast return of 13% and a good case forecast of 27% for the S&P 500. The S&P 500 returned 26%.

We do not endorse a buy-and-hold strategy. However, the hurdle to underweight US equities is very high given the strong upward trend of corporate earnings and of prices that follow earnings, as shown in Exhibit 4.

As Kenny Rogers wisely counseled in his signature hit song “The Gambler,” *You’ve got to know when to hold ’em, know when to fold ’em, know when to walk away, and know when to run.*[1]

In Section I, we expand on our two key investment themes. We show why the gap between the US and other developed and emerging market countries continues to widen across most metrics. We demonstrate that the US is best positioned to withstand changes in globalization trends, while China, the world’s second-largest economy, is most likely to be negatively impacted in comparison to most developed and emerging market countries. Hence, we again recommend maintaining a strategic overweight to US equities.

We also explain why the cheapness of other equity markets does not warrant a tactical shift away from US equities toward non-US equities, given the much stronger earnings growth potential of US companies.

Next, we put forth our one- and five-year expected returns and review our opportunistic tactical tilts going into 2024. We have low levels of portfolio risk allocated to tactical tilts compared to the average levels we have held over the last decade.

We conclude Section I with key risks to our outlook, most of which originate from heightened geopolitical tensions and escalating wars.

In Section II, we review our economic outlook for key developed and emerging market countries.

Section III details our financial market outlook for these countries.

We present our annual outlook and our investment themes on the basis of extensive and rigorous analysis performed by our team, including consultations with leading external experts. Still, we publish this annual report as we have every year, with an appropriate dose of humility. It would help, of course, if we could locate the fabled Goldman Sachs orbuculum, but no one seems to recall when and where it was last seen.

In closing this introductory letter, we take this opportunity to wish you a healthy, happy, prosperous and safe 2024.

The Investment Strategy Group

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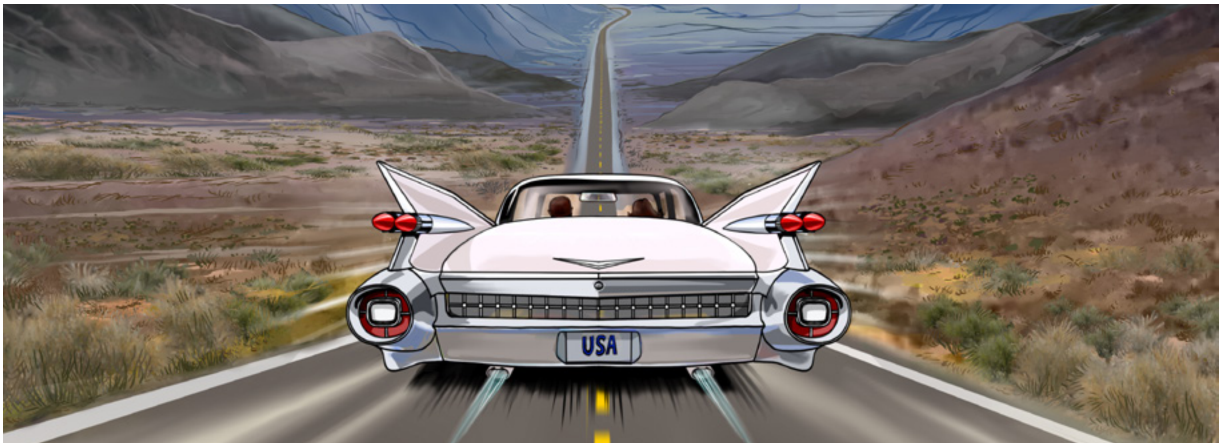


SECTION II: SHIFTING GEARS

SECTION III: PAST THE RAPIDS

Investment Implications of US Preeminence

WE AT THE INVESTMENT STRATEGY GROUP (ISG) first put forth our view of US Preeminence in our 2011 *Outlook*: *Take Stock of America*, in response to the clamor of books and articles about the rise of the East, particularly China, and the fall of the West, particularly the US.

The naysayers said that the GFC of 2008–09 had dealt a fatal blow to US hegemony. Its problems, including a budget deficit equal to 10% of GDP, over-leveraged consumers, and unencumbered entitlement programs such as Social Security, Medicare and Medicaid, would all burden the country and end the United States' dominance as an economic power. Economics professors Carmen Reinhart and Kenneth Rogoff, both of Harvard University, argued that the US would grow at well below trend after the GFC in their 2009 book, *This Time Is Different: Eight Centuries of Financial Folly*. Others said the US would face secular stagnation and a lost decade.

The China boosters argued that China's vast central bank reserves, 9% GDP growth rate in 2009, current account surplus of 5% of GDP and centrally managed governing process (in contrast to the diffused and often messy democratic process of the US) would lead to China becoming the largest economy sometime in the next 20 or so years.

The US economy has proved the naysayers wrong. Since the trough of the GFC, the US economy has grown by 2.2% annualized, comfortably above its trend growth rate. The US has added $13.2 trillion to its GDP, for a total GDP of $27.6 trillion; it accounts for 26% of world GDP.

China has grown by 7% annualized, adding $12.6 trillion to its GDP, for a total of $17.4 trillion. China's economy now accounts for 18% of world GDP, but the gap between the overall size of the US economy and that of China has actually increased.

The gap between the US and China on a GDP per capita basis has widened even more. US GDP per capita has increased by $34,000 to $80,412, while that of China has increased by $8,607 to $12,541. As noted in past reports, China's GDP per capita is about 20% below the poverty level of the US. China's GDP per capita is not projected to catch up to that of the US through the end of the 21st century.

But as mentioned earlier, our view of US Preeminence is not predicated only on the size of the US economy or on its high GDP per capita. It is based on the country's unparalleled combination of being the largest economy in the world and having an immense wealth of resources; large, broad and liquid financial markets; favorable demographics; a productive and innovative labor force; persistent and diverse corporate earnings growth; and resilience.

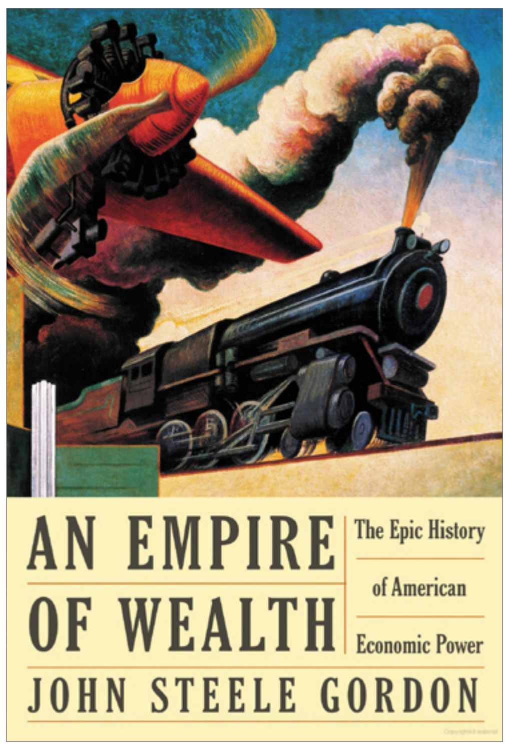
We examine these factors and show why they will persist into the foreseeable future, leading to more reliable and better equity performance. As a result, we continue to advise our clients to overweight US assets in their customized strategic asset allocation relative to market capitalization benchmarks. We also explain why we do not advise a tactical allocation out of US equities into cash or bonds, or into non-US developed and emerging market equities, notwithstanding their cheaper valuations.

Factors Underpinning ISG's Strategic Overweight to US Equities

An Empire of Wealth[2]

As shown in Exhibits 5–7, the US has the largest economy in the world, the highest GDP per capita of any major country and the largest and deepest financial markets.

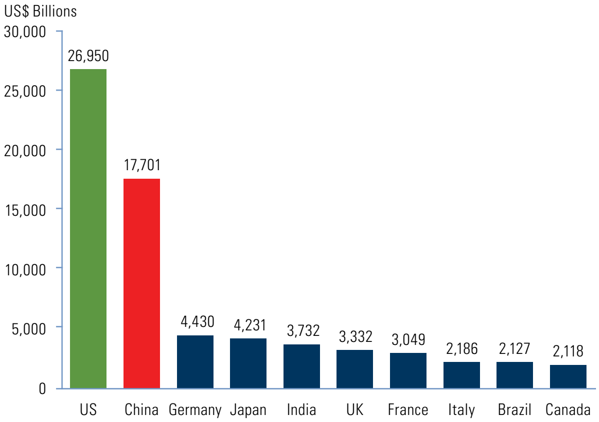
US equity and bond market capitalization dwarfs that of other countries. At just over $70 trillion, it is seven times as large as the market capitalization of the next-largest market.



An Empire of Wealth. Copyright © 2004 by John Steele Gordon, used by permission of HarperCollins Publishers.

Exhibit 5: Top 10 Countries Ranked by 2023 Nominal GDP

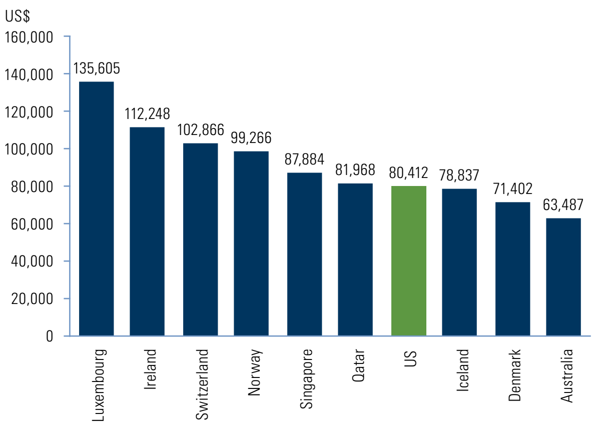
The US has the highest GDP in the world.



Data as of 2023.
Note: IMF full year estimate as of October 2023.
Source: Investment Strategy Group, IMF World Economic Outlook.

Exhibit 6: Top 10 Countries Ranked by 2023 GDP per Capita

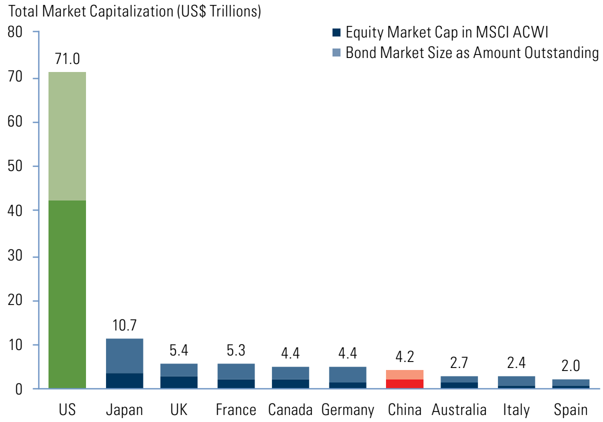
The US has the highest GDP per capita of any major economy.



Data as of 2023.
Note: IMF full year estimate as of October 2023.
Source: Investment Strategy Group, IMF World Economic Outlook.

Exhibit 7: Top 10 Countries Ranked by Size of Bond and Equity Markets

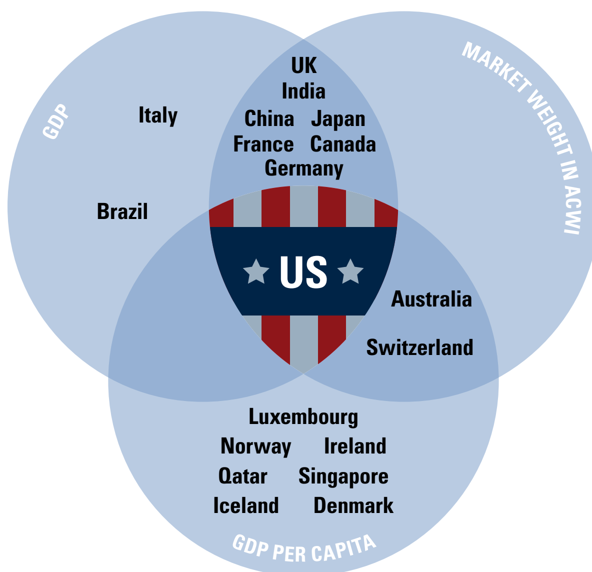
The US has the largest and deepest financial markets.



Data as of December 31, 2023.
Note: Bond market cap represented by Bloomberg Aggregate and JP Morgan bond indices.
Source: Investment Strategy Group, Datastream, Bloomberg, JP Morgan.

Exhibit 8: Top 10 Countries by GDP, GDP per Capita and Market Weight in MSCI ACWI

The US is the only country that ranks in the top 10 globally for GDP, GDP per capita and equity market cap.

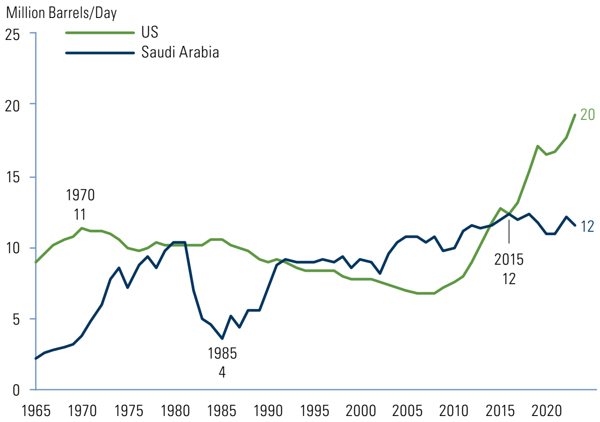


Data as of December 31, 2023.
Source: Investment Strategy Group, Datastream, IMF World Economic Outlook.

No other country has this unique combination, as best illustrated in the Venn diagram in Exhibit 8. For example, Luxembourg has the highest GDP per capita, but it accounts for just 0.1% of world GDP, and has a population of 660,000 and an equity market capitalization of less than 1 basis point of world market capitalization. Switzerland has the third-highest GDP per capita, but its GDP is 0.9% of world GDP, and it has a population of 8.8 million and an equity market capitalization of 1.9% of world levels.

Exhibit 9: US and Saudi Arabia Oil Production, Including Natural Gas Liquids

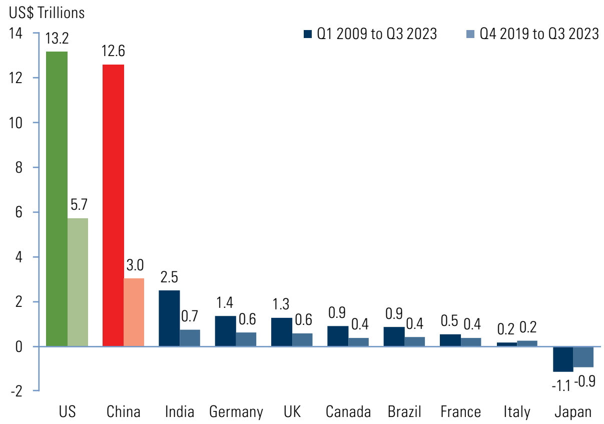
The US now produces 20 million barrels/day of oil and natural gas liquids.



Data through 2023.
Source: Investment Strategy Group, Energy Institute's Statistical Review of World Energy, IEA.

Exhibit 10: Change in GDP Levels Since March 2009 and December 2019

The US has become richer on an absolute GDP basis since the GFC relative to other countries.



Data through Q3 2023.
Source: Investment Strategy Group, Haver Analytics.

The US also has extensive natural resources, including energy sources such as oil and natural gas; metals and minerals such as copper, potash and rare earths; arable land; and renewable water resources.

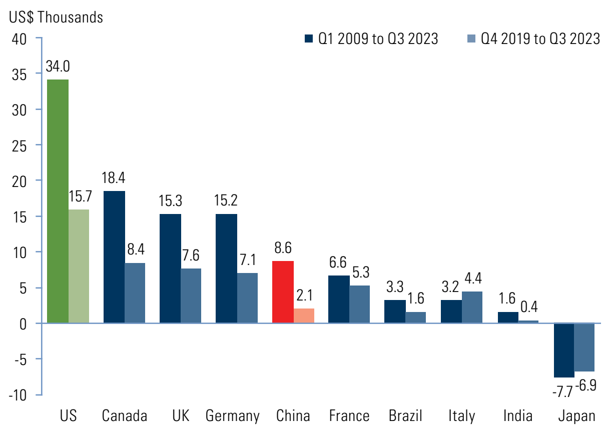
In less than 15 years, the US has increased its share of global oil production including natural gas liquids from 8% to 19%, and it ended 2023 as a net exporter of crude oil and refined products. The US now produces 8 million more barrels per day of oil and natural gas liquids than Saudi Arabia (see Exhibit 9).

US natural gas production and liquefied natural gas (LNG) exports have also increased at a surprising rate—growing by numbers greater than the US Department of Energy forecasts in seven of the past nine years. The US share of world natural gas production has risen to 27%. More importantly, the US accounts for 22% of global LNG exports, having exceeded both Qatar's and Australia's exports for the first time in 2023.

The US has more arable land than any other country, at 158 million hectares (ha), followed by India (155 million ha), Russia (122 million ha), China (119 million ha) and Brazil (56 million ha). On a per capita basis, the US's arable land is 56% of Russia's, but 1.8 times that of Brazil and 5.6 times that of China. As a result of such vast resources, the US has become the world's top exporter of agricultural commodities. Interestingly, 19% of the total agricultural exports are sold to China.

Exhibit 11: Change in GDP per Capita Levels Since March 2009 and December 2019

The US has become richer on a GDP per capita basis since the GFC relative to other countries.



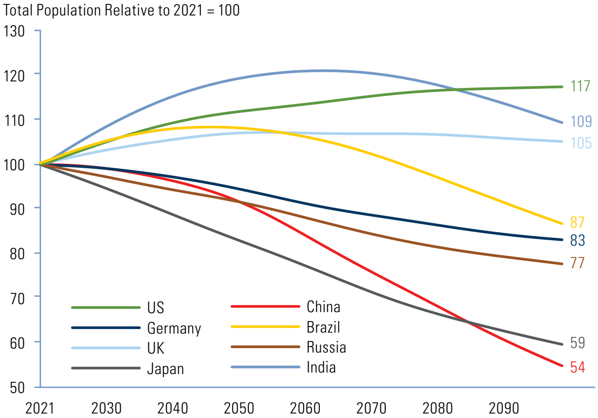
Data through Q3 2023.
Source: Investment Strategy Group, Haver Analytics.

Consider, for a moment, the diversity of the US economy, which drives its equity markets. It is:

- The largest exporter of agricultural commodities
- The largest producer of oil and natural gas liquids
- At the forefront of technological innovation, as the global leader in semiconductor sales, for example, with a 48% share (South Korea is next with 19%)

Exhibit 12: Total Population Projections

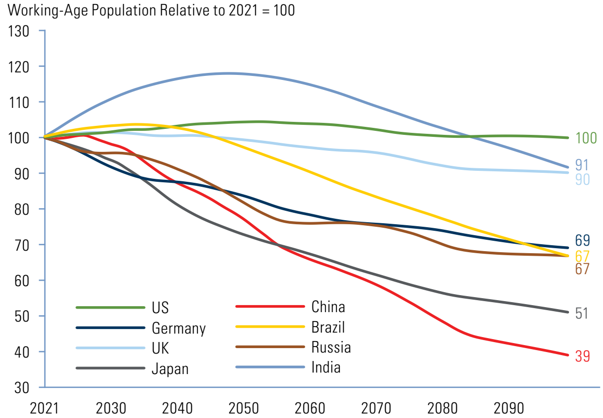
The US has favorable demographics in terms of growth of total population.



Data through 2099 (forecast).
Source: Investment Strategy Group, United Nations.

Exhibit 13: Working-Age Population Projections

The US has favorable demographics in terms of growth of its labor force.



Data through 2099 (forecast).
Source: Investment Strategy Group, United Nations.

As John Steele Gordon so aptly wrote in his 2004 book, *An Empire of Wealth: The Epic History of American Economic Power*, the ultimate strength of the US lies "in its wealth … its capacity to create still more wealth, and its seemingly bottomless imagination in developing new ways to use that wealth productively."[2] Most importantly, the rule of law and the sanctity of property rights protect this wealth creation.

We estimate that no major country will catch up to the US in terms of GDP, GDP per capita, and size and depth of financial markets for the next several decades (if ever!). As shown in Exhibits 10 and 11, the US has become richer both on an absolute basis and on a GDP per capita basis since the GFC relative to other countries. This relative outperformance continued through the pandemic, illustrating US resilience. It is hard for any country to catch up when the US has such a head start.

Demographics

Demographics are a driver of growth in GDP. The US has favorable demographics in terms of growth of total population as well as growth of its labor force, as shown in Exhibits 12 and 13.

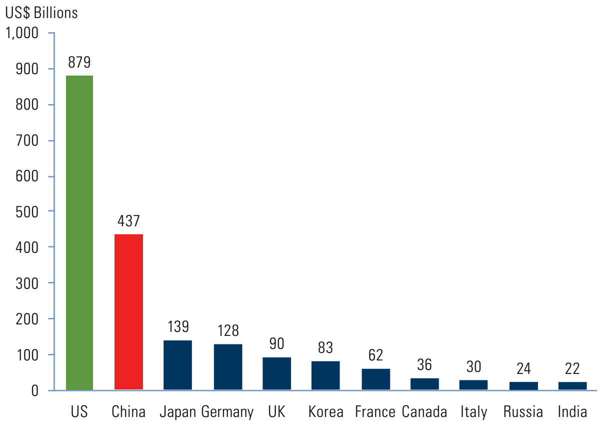
Significance of Such Wealth

Why, you may ask, does this level of wealth matter and bear upon our strategic asset allocation? This wealth enables the US—through both private and public sectors—to:

- Fund research and innovation. The US spent $879 billion on research in 2022, which is more than the next five countries combined (see Exhibit 14), and it ranks among the top five countries as measured by the Modern Innovation System Composite Index and the number of triadic patent families registered. Such innovation contributed to better growth for the economy and better earnings growth for corporations.
- Have greater resilience, enabling it to recover from unexpected human-made and natural disasters such as the GFC and the COVID pandemic.
- Rely less on other economies in terms of importing many raw materials and exporting goods to other countries, unlike what occurs in many European and emerging market countries. Exhibit 15 compares the commodity trade profile of the world's two largest economies. The US is a net exporter of most commodities relative to its domestic consumption, while China is a net importer of most commodities. Similarly, Exhibit 16 compares exports as a percentage of GDP among major economies; the US is much less dependent on exports and, therefore, less exposed to the risks of slower growth in other countries or heightened geopolitical risks that could spill over into war.

Exhibit 14: Top Countries Ranked by R&D Spending

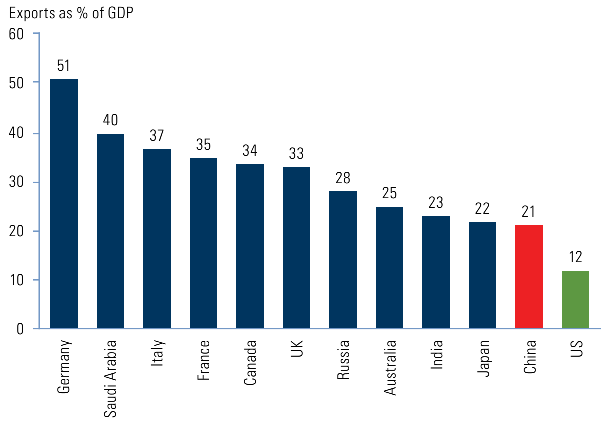
The US spent $879 billion in 2022 on research, which is more than the next five countries combined.



Data as of 2022.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 16: Exports of Goods and Services of the Largest Economies and Key Exporters

The US is much less dependent on exports relative to other major economies.



Data as of 2022.
Source: Investment Strategy Group, World Bank, IMF.

Exhibit 15: Commodity Net Imports as a Percentage of Domestic Consumption

The US is a net exporter of most commodities relative to its domestic consumption, in contrast to China.

	Net Imports as a Percentage of Domestic Consumption (%)	
	China	US
Beef	33	-1
Corn	8	-20
Crude Oil and Refined Products	76	-2
Iron Ore	81	-16
Natural Gas	40	-12
Primary Aluminum	4	55
Refined Copper	23	43
Soybeans	84	-92
Wheat	6	-64

Data as of 2022.
Note: A negative value implies that the country is a net exporter of that commodity.
Source: Investment Strategy Group, Energy Institute Statistical Review of World Energy, USGS, World Bureau of Metal Statistics, USDA.

- Support a military to protect its interests and those of its allies. The US spent $877 billion on its military in 2022, which was more than the next 10 countries combined.
- Maintain its status as the world's reserve currency, which, as former French President Valéry Giscard D'Estaing allegedly said in the 1960s, gives the US "exorbitant privilege."
- Generate faster and more persistent earnings growth.

De-Globalization

Rising geopolitical and economic tensions between the US and China, and to a lesser extent between Europe and China, have led to a significant change in national security strategies and economic policies toward China. Countries including the US, European Union countries individually and in aggregate through the European Commission, Canada, the UK, Japan, South Korea, and Australia have either explicitly or implicitly announced national security strategies to counter China's more assertive and aggressive policies. "De-risking" from China has become a stated policy of both the US and Europe.

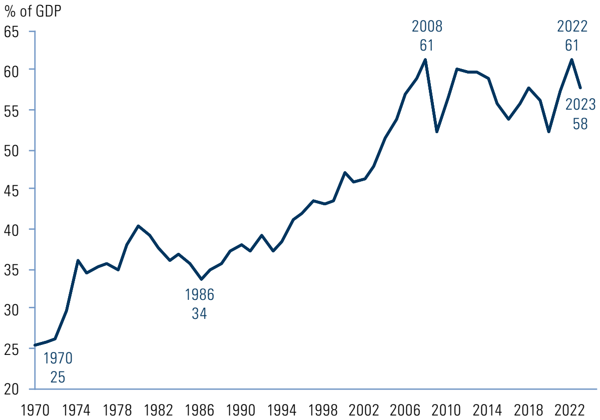
China has also adopted a policy of "de-risking" from the West through its dual circulation strategy, launched in May 2020, whereby developing a domestic market, becoming more innovative and developing key and core technologies have become national priorities. China's 14th Five-Year Plan (for 2021–25) stated that the country should "make technological self-sufficiency a strategic pillar of national development."[3]

As a result, economists and market participants are asking whether the combined impact of "de-risking" from China and China's dual circulation implies a new era of de-globalization with far-reaching economic and political consequences.

We look at two metrics of globalization to see if there has been a shift in global trends: (1) world exports and imports as a percentage of GDP and

Exhibit 17: Global Trade in Goods and Services as a Share of GDP

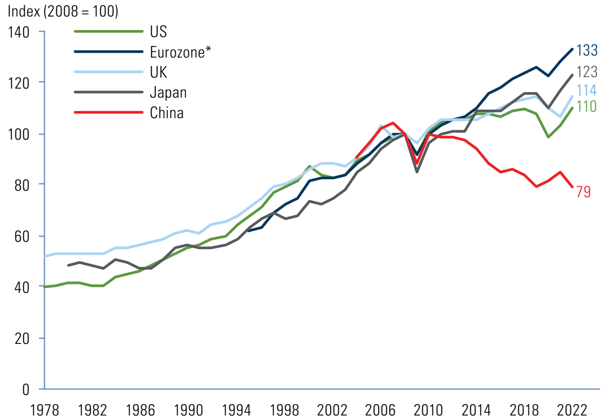
Globalization has stabilized after a level of "hyper-globalization" from 1986–2008.



Data through 2023.
Note: 2023 data is an IMF projection.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 19: Trade in Goods and Services at Constant Prices

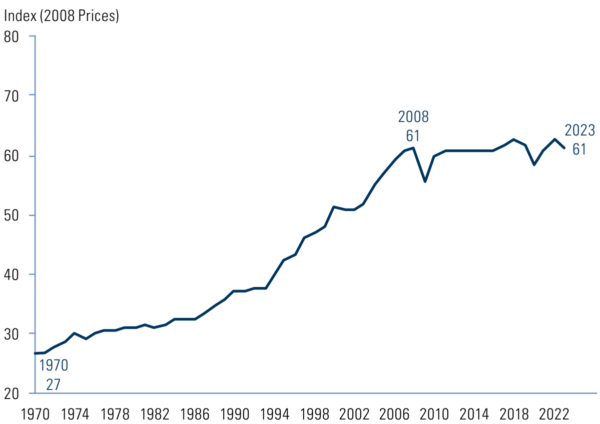
China's trade relative to its GDP peaked in 2007 and has declined steadily ever since.



Data through 2022.
Source: Investment Strategy Group, Haver Analytics.
* Does not include intra-Eurozone trade.

Exhibit 18: Trade in Goods and Services at Constant Prices

The stabilization of globalization is even more evident for constant prices.



Data through 2023.
Note: 2023 data is an IMF projection.
Source: Investment Strategy Group, Haver Analytics.

(2) capital flows as measured by foreign direct investment (FDI) and portfolio flows.

Trade

A focus on the first metric, trade, shows that globalization has stabilized after a level of "hyper-globalization"[4] between 1986 and 2008, as depicted in Exhibit 17. Adjusted to constant prices, the stabilization is even more evident, as shown in Exhibit 18.

However, this stability belies considerable variation across countries and points to a possible reversal of globalization. The Eurozone, Japan, the UK and the US have continued to experience an increase in trade volumes relative to their GDP. In China, trade relative to GDP peaked in 2007 and has declined steadily ever since (see Exhibit 19).

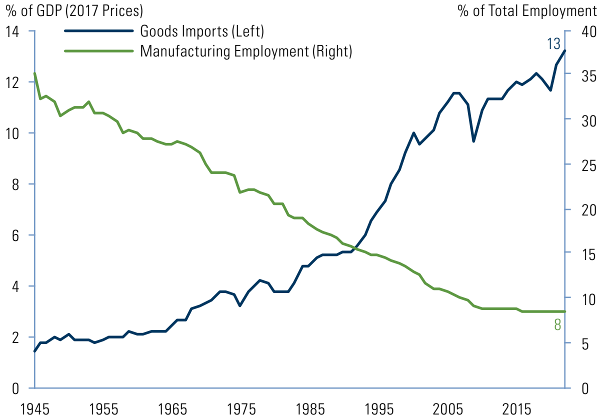
There has also been a shift to friend-shoring, as seen in a significant increase in trade as a share of GDP in Mexico and Vietnam. US imports from Canada and Mexico have increased 30% compared to pre-COVID levels, while imports from China are up only 6%. As a result, China's share of US imports has declined from 21% to 17%.[5]

We should note that China's share of global trade continued to increase rapidly after it joined the World Trade Organization (WTO) in 2001. In fact, Dani Rodrik, professor of international political economy at Harvard University, whose research focuses on globalization, has said that "China was clearly the greatest beneficiary of the hyper-globalization game." He also notes that "China manipulated the rules of the world economy to its advantage, essentially free-riding on the openness of other countries."[6]

We estimate that China's economy has benefited from foreign demand for its goods by about $2.9 trillion since 1980. This gain has allowed China

Exhibit 20: US Goods Imports and Manufacturing Employment

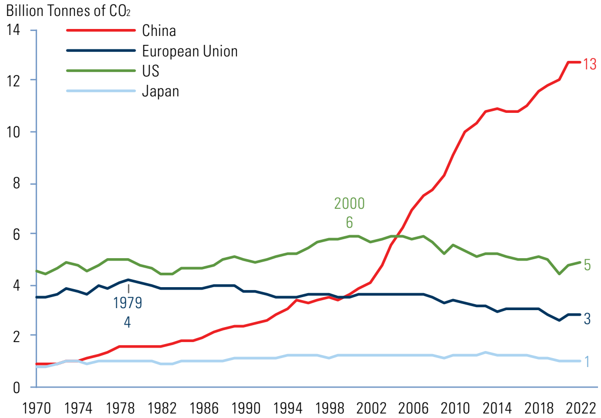
One of the losers of hyper-globalization that ended in 2008 was the manufacturing labor force in the US.



Data through 2022.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 21: Carbon Dioxide Emissions

China's emissions have tripled since it joined the WTO in 2001.



Data through 2022.
Source: Investment Strategy Group, Emissions Database for Global Atmospheric Research.

to lift 800 million people above the World Bank's poverty line of $6.85/day for upper-middle-income countries.

In the near term, we expect China's exports as a share of GDP to continue declining and its share of global exports to stabilize. In the medium term, we expect China's share of global exports to decline as the US and Eurozone "de-risking" strategies take hold. The two economies account for nearly 40% of world GDP. Should the rest of the G7 follow through on their pledge at the May 2023 Summit in Japan to "de-risk" from China, China would face a less hospitable environment for its exports in countries with 50% of the world's GDP and some of the highest GDP per capita.[7]

In our opinion, two big losers of the hyper-globalization that ended in 2008 were the manufacturing labor force in the US (see Exhibit 20) and the environment (see Exhibit 21).

Manufacturing Labor Force: According to David Autor, professor of economics at the Massachusetts Institute of Technology, and co-authors, "Labor markets more exposed to import competition from China experienced more plant closures, larger declines in manufacturing employment, employment-population ratios, earnings for low-wage workers, housing prices, and tax revenues; and larger increases in childhood and adult poverty, single parenthood, and mortality related to drug and alcohol abuse."[8]

Pol Antràs, professor of economics at Harvard University, writes that "it is by now a widely accepted view that trade integration has been a nonnegligible contributor to increased income inequality in the U.S."[9]

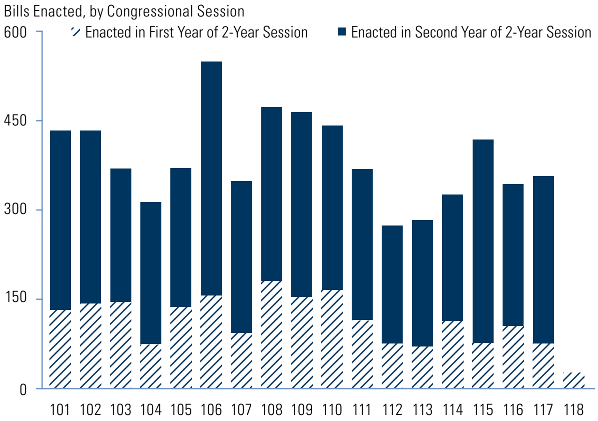
Importantly, globalization has also had an impact on political polarization in the US. In other research, Autor et al. have found strong evidence that labor markets negatively impacted by the China trade shock "exhibit growing ideological polarization in some domains, meaning expanding support for both strong-left and strong-right views and pure rightward shifts in others."[10] Such political polarization has hampered the effectiveness of the US Congress and various administrations.

For example, Axios has reported that the 118th Congress has been "one of the most unproductive

> "It is by now a widely accepted view that trade integration has been a nonnegligible contributor to increased income inequality in the U.S."
>
> *— Harvard Professor Pol Antràs*

Exhibit 22: Bills Enacted by US Congressional Session

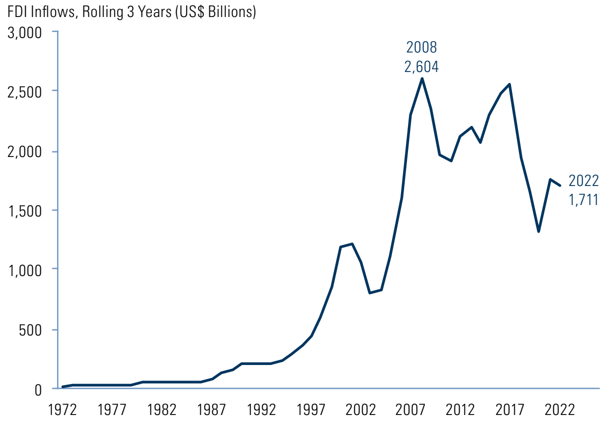
The 118th (2023) Congress is one of the most unproductive in modern history.



Data as of December 18, 2023.
Source: Investment Strategy Group, Axios, Quorum.

Exhibit 24: Global Foreign Direct Investment Inflows

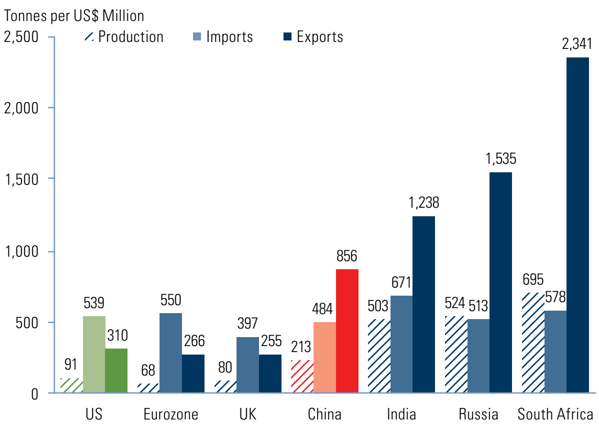
FDI increased through 2008 but has since declined.



Data through 2022.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 23: CO_2 Emissions Embodied in Manufacturing Production, Imports and Exports

The carbon emissions in Chinese exports are much higher than those in the US.



Data as of 2018.
Source: Investment Strategy Group, OECD.

in modern history" (see Exhibit 22) and "five of the six most unproductive years have been since 2011."

Environment: The carbon intensity of manufacturing production in major emerging market economies remains higher than in developed economies. As a result, as globalization has increased trade with emerging market countries, it has correspondingly increased carbon emissions. For example, carbon emissions in the US are 91 tonnes per US$1 million of domestic manufacturing, while emissions embodied in imports are 539 tonnes per US$1 million—nearly a 500% difference in carbon emissions, as shown in Exhibit 23. The carbon emissions in Chinese exports are eight times as high as the carbon emissions of goods manufactured in the US and nearly 13 times the carbon emissions of goods manufactured in the Eurozone.

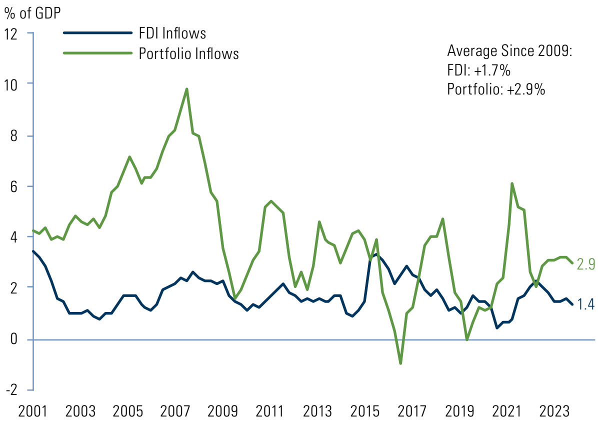
Capital Flows

A second measure of globalization is capital flows as measured by FDI and portfolio flows. As shown in Exhibit 24, FDI increased through 2008 but has since declined. Furthermore, while capital flows into the US have been relatively steady (see Exhibit 25), capital flows into China have declined and are well below their historical averages (see Exhibit 26). We expect capital to continue shifting away from China: this movement will be partly driven by the past performance of its capital markets, partly driven by the less hospitable environment in China for foreign businesses and their executives, and partly driven by the deterioration in the country's export manufacturing competitiveness, as shown in Exhibit 27.

Given the heightened geopolitical tensions with China, we expect the trends in globalization to continue in line with what has transpired over the last decade:

Exhibit 25: US FDI and Portfolio Inflows as a Share of GDP

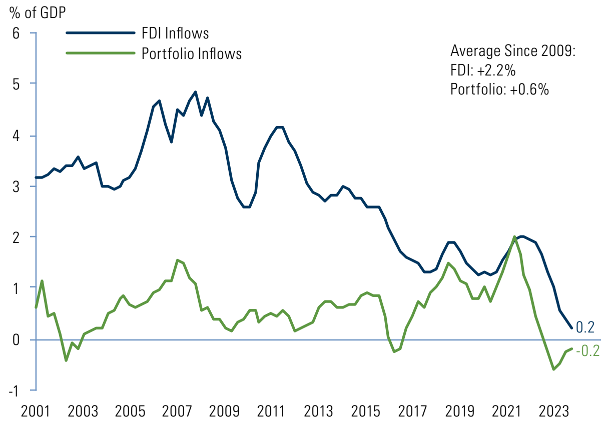
Capital flows into the US have been relatively steady.



Data through Q3 2023.
Note: we use 4-quarter rolling data.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 26: China FDI and Portfolio Flows as a Share of GDP

Capital flows into China have declined and are well below historical averages.



Data through Q3 2023.
Note: we use 4-quarter rolling data.
Source: Investment Strategy Group, Haver Analytics.

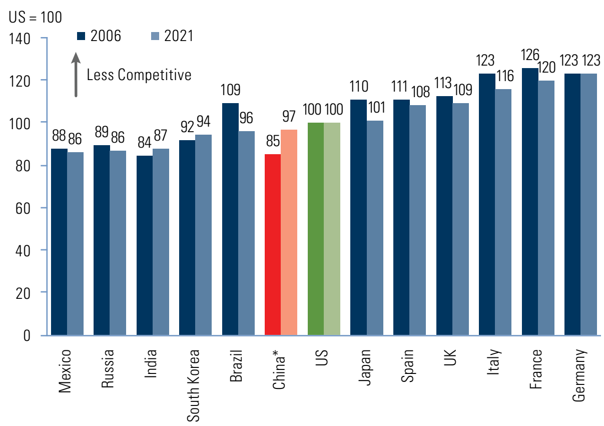
- No decrease in global trade as a percentage of global GDP
- More regionalization of trade into friendly blocs such as increased trade within North America, within Europe and within the China-Russia bloc
- Less trade with and capital flows into China from the US, Canada, UK and the Eurozone

As Joseph S. Nye Jr., Harvard University Distinguished Service Professor and author of *Is the American Century Over?* (in the book, he says that it is not), recently wrote, "Globalization is not over."[11]

We believe that the changing flow of trade and capital will benefit the US and negatively impact China, given the substantial role of exports in China's economy over the past two decades.

Exhibit 27: BCG Manufacturing Cost Competitiveness Index

China's manufacturing cost advantage has eroded.



Data as of 2021.
Source: Investment Strategy Group, Boston Consulting Group.
* Based on the Yangtze River Delta region.

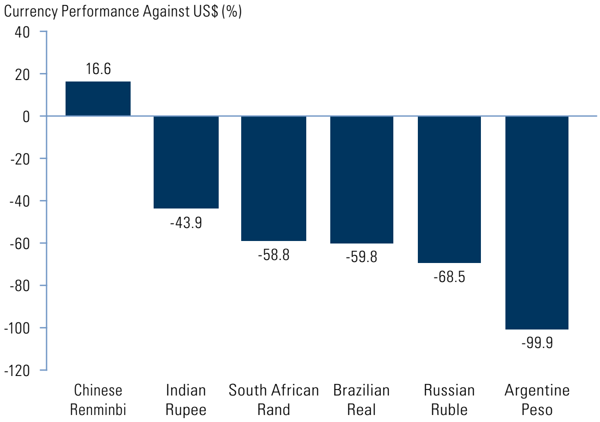
De-Dollarization

2023 was a year of de-dollarization announcements:

- China and Brazil signed a memorandum of understanding (MOU) to establish renminbi (RMB) clearing arrangements in Brazil so the two countries can use the RMB for cross-border transactions.
- China and Argentina agreed that Argentina will pay for Chinese imports in RMB.
- China and Saudi Arabia signed a currency swap agreement for RMB 50 billion (26 billion Saudi riyals or US$6.93 billion). Interestingly, the Saudi riyal is pegged to the US dollar, so one can argue that this swap agreement is not an indication of de-dollarization but more a matter of geopolitical window dressing.
- Argentina made an International Monetary Fund (IMF) payment in RMB.

Exhibit 28: Major EM Currency Performance Against US Dollar Since 2001

Major EM currencies have experienced significant depreciation since China joined the WTO.



Data through December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

- News agencies reported several oil and LNG purchases settled in RMB.[12]
- Iran and Russia finalized an agreement to trade in their local currencies because both countries are subject to US sanctions.
- India has signed agreements and MOUs to allow trades to settle in the Indian rupee, including trades with Bangladesh, Malaysia and the UAE (the UAE dirham is also pegged to the dollar).
- The Association of Southeast Asian Nations (ASEAN) countries announced that they had signed an agreement to increase the use of local currency transactions and improve "regional payment connectivity."
- South Korea and Indonesia signed an MOU to encourage trade in their own currencies.
- President Lula da Silva of Brazil proposed a common currency for BRICS (Brazil, Russia, India, China and South Africa) nations at the BRICS Summit in South Africa in August 2023, but the proposal fell flat and had no follow-up. It is economically unviable to have one currency for such disparate economies with different growth rates, varied commodity exposures and inadequate financial infrastructure for cross-border transactions.[13] These currencies are highly volatile and have experienced significant depreciation—all of more than 40%—since China joined the WTO, as shown in Exhibit 28. It is unlikely that China, which has treasured the stability of its currency, will expose itself to such volatile currencies in any meaningful way.

If de-dollarization is defined as some emerging market countries led by China trying to carry out transactions while circumventing the dollar-based financial system in fear of future sanctions or to avoid current ones, then de-dollarization will continue on a small scale and at the fringes of global trade. Our best estimate of the value of what has occurred to date is negligible as a percentage of global trade—barely 0.5%. Even on such a small scale, there have been reports that "Russian oil companies and their customers are running into liquidity issues with rupees and yuan [RMB] as payment for their oil."[14] The RMB is not even a fully convertible currency, and the Chinese capital markets are not fully open capital markets.

If, on the other hand, de-dollarization is defined as the dollar losing its status as the world's dominant reserve currency, then de-dollarization is nonexistent as there is no challenger to the dollar's reserve status.

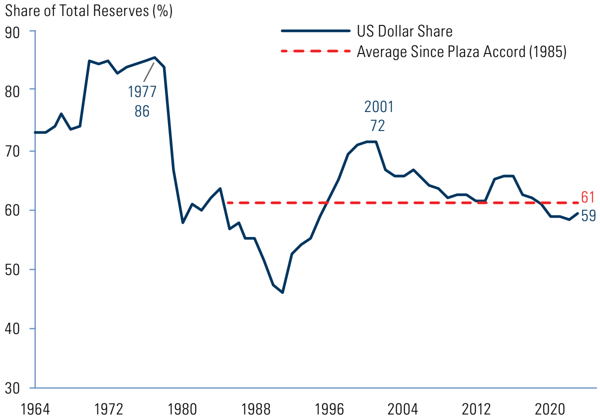
The dollar has been the dominant currency for more than 75 years, since the Bretton Woods System was established in 1944 as a system for global payments. The system was based on the US dollar, which was convertible into gold. It met the standard requirements of being a medium of exchange, a unit of account and a store of value, and it was supported by the factors that underpin US preeminence. Its dominance is measured by its continuing role in global finance and trade, as detailed below.

The dollar has been the dominant currency for more than 75 years, since the Bretton Woods System was established in 1944 as a system for global payments.

Official Central Bank Reserves: The dollar currently comprises 59% of foreign denominated currency reserves. This compares to an 86% peak in 1977. As shown in Exhibit 29, post the Plaza Accord of 1985, the peak held in dollars reached 72% in 2001, and it has had an average of 61% over the last 38 years. The next-largest currency held in reserves

Exhibit 29: US Dollars Held in Official Central Bank Reserves

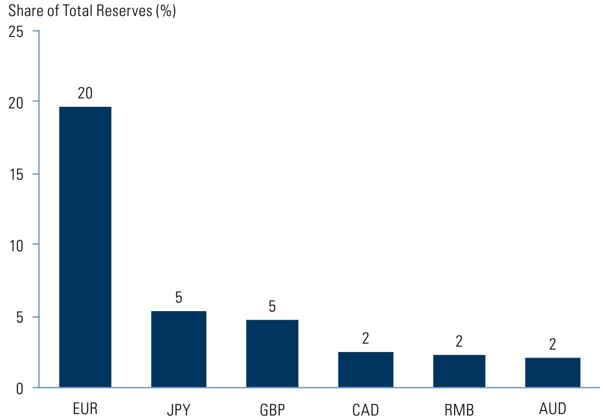
The dollar comprises 59% of global foreign exchange reserves.



Data through Q3 2023.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 30: Share of Currencies Held in Foreign Exchange Reserves

After the US dollar, the next-largest currency held in reserves is the euro, followed by the Japanese yen.



Data as of Q3 2023.
Source: Investment Strategy Group, Haver Analytics.

is the euro, at 20%, followed by the Japanese yen and the British pound at 5%, and the Canadian dollar, Australian dollar and renminbi at 2% (see Exhibit 30). While the weight of the dollar is near its long-term average, the quantity of dollars held by central banks has increased considerably, as total reserves have increased from $2 trillion in 2000 to $14 trillion in 2023. Central bank holdings of dollars have, in fact, increased from $1.1 trillion to $6.5 trillion, representing a slightly smaller share of a much larger pie.

Dollar Invoicing in Global Trade: The dollar accounted for 96% of trade invoicing in the Americas, 74% in the Asia-Pacific region and 79% in the rest of the world. It accounted for only 23% in Europe, where the euro is dominant.

Share of Foreign Debt Issuance: About 70% of foreign currency debt is denominated in dollars. The share has been relatively stable over the last decade.

Foreign Currency Transactions: The dollar has dominated foreign exchange transaction volumes and has been on one side of around 88% of all trades over the past two decades.

Commodities: With the exception of some locally priced natural gas contracts such as those in Europe, all key commodities are quoted in dollars. The call by some OPEC+ countries to change the denomination for oil is reminiscent of a similar call nearly 50 years ago, when the then-governor of the Iranian National Bank stated that OPEC would sever the link with the dollar for pricing of oil and instead use the IMF Special Drawing Rights.

Although past dominance is not a guarantee of future dominance, the dollar's status as the world's

The New York Times

NEW YORK, TUESDAY, JUNE 10, 1975

OPEC WILL SEVER LINK WITH DOLLAR FOR PRICING OF OIL

New Basis Is to Be Special Drawing Rights—Higher Charges Set This Fall

By United Press International

LIBREVILLE, Gabon, June 9 — The oil-producing nations agreed today to sever the link between oil prices and the dollar and to start quoting prices in Special Drawing Rights, the governor of the Iranian national bank, Mohammed Yeganeh, said.

Mr. Yeganeh said that ministers from the 13 nations of the Organization of Petroleum Exporting Countries also agreed that oil prices must go up when the current price freeze ends Oct. 1.

Mr. Yeganeh spoke after the ministers met privately on the

FORD WILL SUBMIT REPO TO ATTORNEY GENERAL WITH DATA ON ASSASSI

The *New York Times* reported in 1975 that "OPEC Will Sever Link with Dollar for Pricing of Oil."

The Economist cover from December 2004.

reserve currency is intact for two reasons. First, the factors that underpin US preeminence endure, and second, the dollar has a major incumbency advantage. The widespread use of the dollar as outlined above is self-reinforcing—it is much more cost-effective and efficient for economies to continue using the dollar. But the facts have not stopped naysayers from questioning the reserve status of the dollar every few years.

As Ian Bremmer, founder and president of Eurasia Group, wrote in April 2023, "rumors of the dollar's death are greatly exaggerated."[15]

US Structural Fault Lines

Although the US is preeminent, we are not Pollyannaish about some of its structural fault lines.

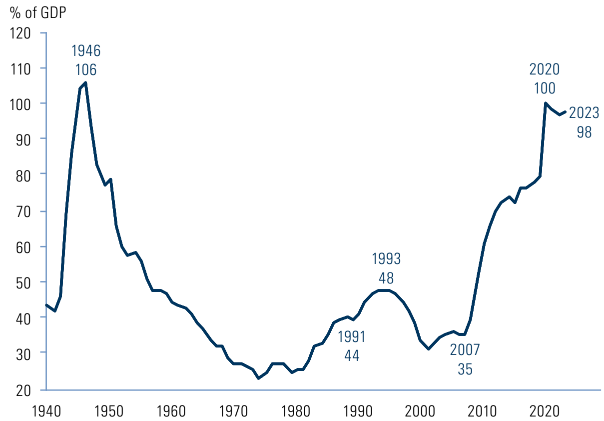
US Debt: Federal government debt as a share of GDP has increased from a pre-GFC low of 35% in 2007 to 98% in 2023 (see Exhibit 31). However, while debt-to-GDP has nearly tripled, the cost of financing that debt has increased by just 0.7 percentage points, from 1.7% of GDP to 2.4% of GDP (see Exhibit 32); the smaller increase is due to the low interest rates prior to 2022. Although we know this debt trajectory is not sustainable, we do not know where the tipping point might be. Our base case expectation is that the US will address the debt, but certainly not before the November 2024 elections.

In 1993, debt-to-GDP stood at 48%. Interest rate increases were partly driven by the so-called bond vigilantes (bond investors who drove interest rates higher by selling their bonds in objection to profligate government spending), and Congress was forced into running a balanced budget. At the time, no one would have speculated that debt-to-GDP of 100% was sustainable. Yet, in 2020, it reached 100%, and the economy and financial markets have prospered over this period.

Income Inequality: Income inequality has risen steadily since 1980, and among major developed

Exhibit 31: US Federal Government Debt as a Share of GDP

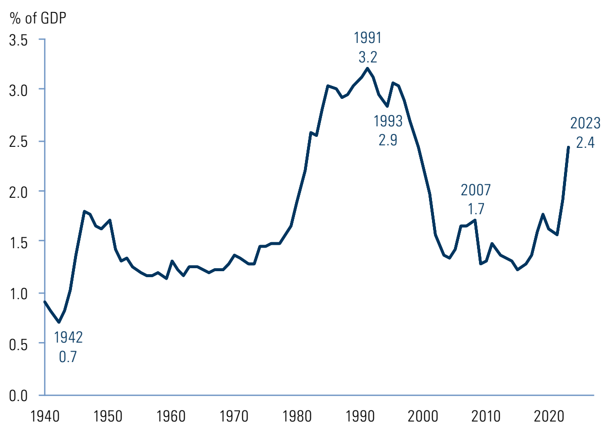
Federal debt as a share of GDP has increased from a pre-GFC low of 35% in 2007 to 98% in 2023.



Data through 2023.
Note: 2023 data is a CBO estimate.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 32: US Government Debt Service as a Share of GDP

The cost of financing debt has increased to 2.4% of GDP in 2023.



Data through 2023.
Source: Investment Strategy Group, Haver Analytics.

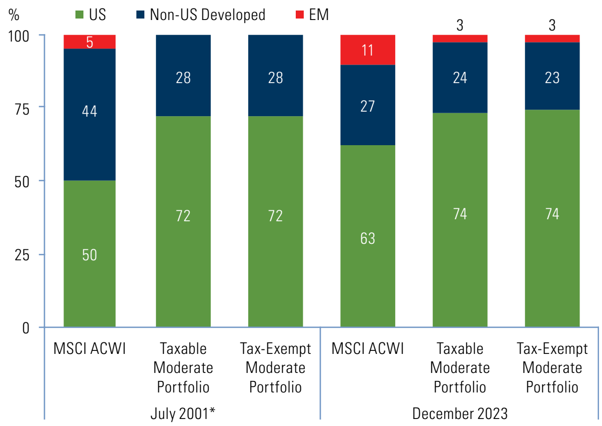
economies, inequality is highest in the US. Some re-shoring of manufacturing and the abatement of what Autor described as the China shock will alleviate some of the income inequality.

Life Expectancy: Life expectancy has declined from 78.8 years in 2019 to 77.5 years in 2022.[16] Some of this decline is due to the pandemic and some to the opiate and fentanyl drug addiction crisis. The decline from the pandemic will diminish over time but, sadly, the solution to the drug addiction crisis remains elusive.

Political Polarization: And finally, the US is more politically polarized than other major democracies. It ranks as one of the most politically divided countries; however, the respondents in the Edelman Trust Barometer survey are optimistic that the divisions can be overcome. We will discuss this topic further when we outline the risks to our 2024 outlook.

Exhibit 33: ISG Strategic Asset Allocation to Equities in July 2001 and December 2023

Our strategic allocation to US equities stands at 74% of total public equity exposure in a moderate-risk portfolio.

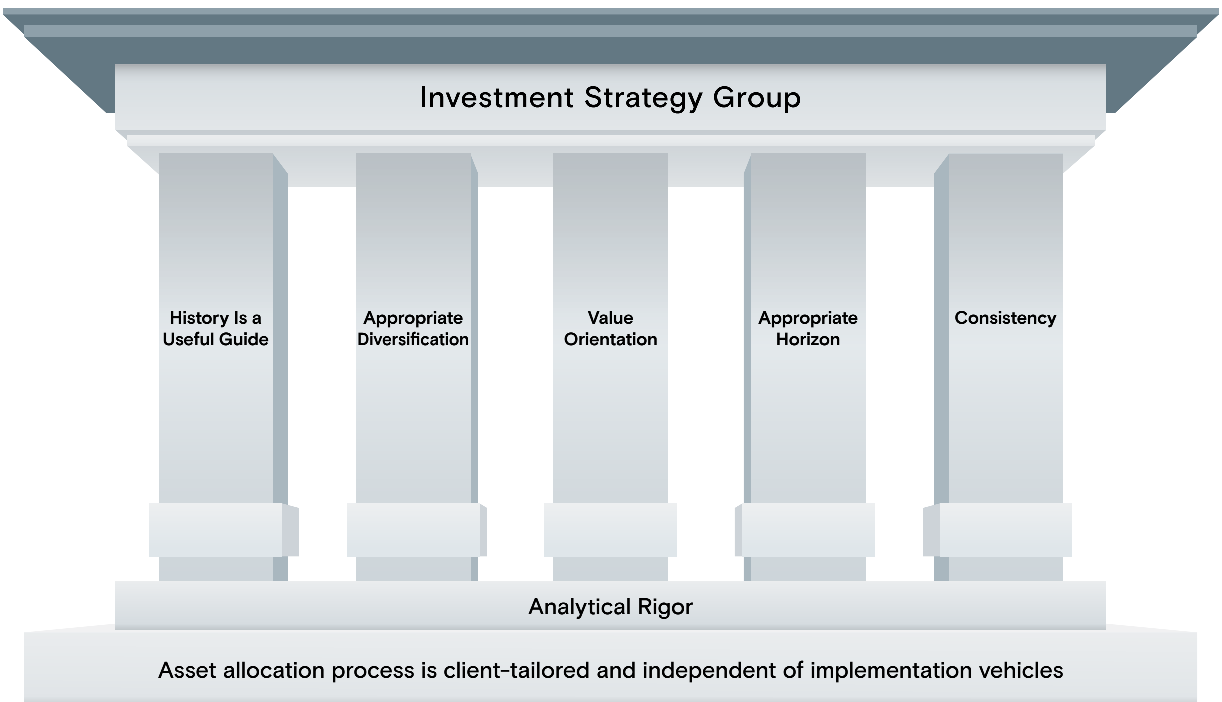


Data as of December 2023.
Source: Investment Strategy Group.
* ISG inception date

Our Strategic Asset Allocation Overweight

As shown in Exhibit 33, our strategic allocation to US equities stands at 74% of total public equity exposure in a moderate-risk portfolio for taxable and tax-exempt clients. We are overweight US equities by 11 percentage points relative to the

Exhibit 34: Pillars of the Investment Strategy Group's Investment Philosophy



MSCI All Country World Index (ACWI). At the inception of ISG in 2001, our allocation to US equities was 72%, which was 22 percentage points higher than the ACWI benchmark at the time. The strong outperformance of US equities has increased the share of US equities in the benchmark from 50% to 63%.

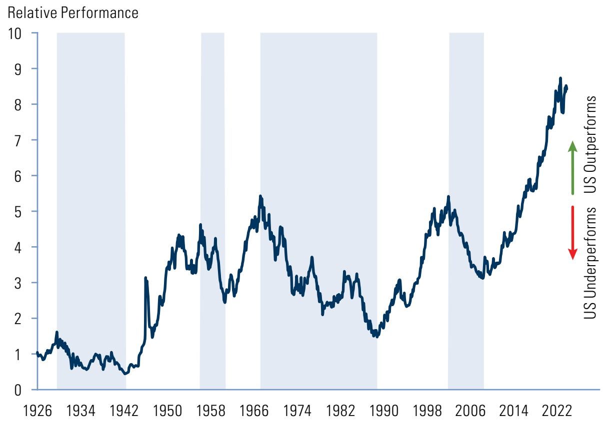
We could have changed our asset allocation to maintain the 22-percentage-point overweight to US equities; however, that would have required a total allocation of 85% to US equities and very little in non-US equities. Given that diversification is one of the pillars of our investment philosophy (see Exhibit 34), we opted to maintain a weight of 74%.

We should note that the allocation to US assets in private equity and credit assets has typically averaged around 70% as well.

We now turn to the rationale for our tactical recommendation to stay invested in US equities and not allocate assets to cash, bonds or non-US equities.

Exhibit 35: Historical Total Return of US vs. Non-US Developed Equities

The recent outperformance of US equities relative to non-US equities is not unprecedented.



Data through December 31, 2023.
Note: Shaded areas denote US equity relative underperformance. Emerging market equities are excluded as data is not available prior to 1988. US Equities and Non-US Developed Equities use data from Global Financial Data from 1926 to 1969, and S&P 500 and MSCI World ex-US indices from 1970 to 2023.
Source: Investment Strategy Group, Global Financial Data, Datastream.

Investment Rationale for Staying Invested in US Equities and Not Overweighting Non-US Equities, Bonds or Cash

US equities have had one of the longest and strongest periods in history of outperformance relative to non-US equities, bonds and cash.

US equities started to outperform non-US developed equities in June 2008, and continued for a period of over 15 years, by 7.0 percentage points on an annualized basis (see Exhibit 35). But that is not as unprecedented as it seems. US equities also outperformed non-US equities by 10.9 percentage points annualized between November 1988 and January 2002, and by 20 percentage points annualized between April 1942 and March 1956. We think US equities will, at best, outperform non-US equities, but obviously not by the same magnitude as during the last 15 years, and will, at worst, match the returns on non-US equities with much less risk.

To put the US equity outperformance of the last 15 years in perspective, US equities historically have outperformed non-US equities by 2.3 percentage points annualized since 1926 and by 2.7 percentage points in the post-WWII period. In our strategic asset allocation models for clients, we assume one percentage point of outperformance annualized.

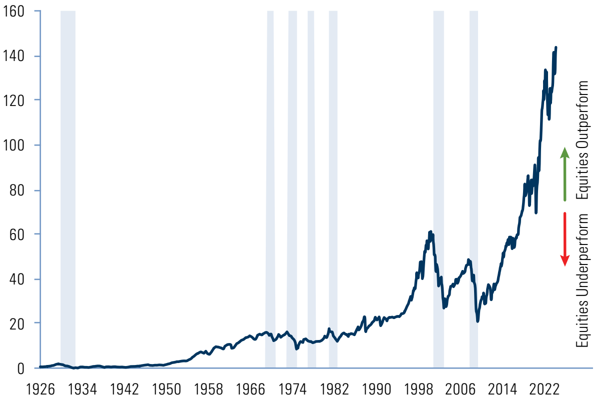
Similarly, US equities have significantly outperformed US intermediate-maturity Treasury bonds over the last 15 years, by 14 percentage points annualized (see Exhibit 36). Historically, US equities have outperformed US bonds by 5.4 percentage points annualized since 1926 and 6.2 percentage points in the post-WWII period. In our strategic asset allocation modeling, we assume they outperform bonds by 4.6 percentage points annualized.

With respect to cash, US equities have significantly outperformed Treasury bills as well, by 14.8 percentage points annualized (see Exhibit 37).

US equities have had one of the longest and strongest periods in history of outperformance relative to non-US equities, bonds and cash.

Exhibit 36: Historical Total Return of US Equities vs. US Intermediate Treasuries

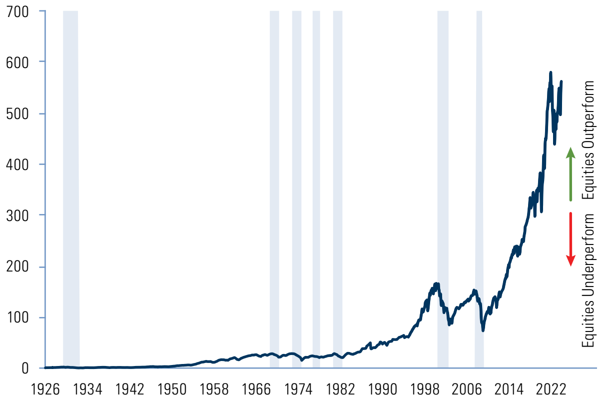
US equities have significantly outperformed US intermediate-maturity Treasury bonds over the past 15 years.



Data through December 31, 2023.
Note: Shaded areas denote US equity relative underperformance. US Equities use data from Global Financial Data from 1926 to 1969, and S&P 500 Cap index from 1970 to 2023. US Intermediate Treasuries use data from Ibbotson from 1926 to 1972 and Bloomberg US Intermediate Treasuries index from 1973 to 2023.
Source: Investment Strategy Group, Global Financial Data, Ibbotson, Datastream.

Exhibit 37: Historical Total Return of US Equities vs. US Treasury Bills

US equities have significantly outperformed Treasury bills.



Data through December 31, 2023.
Note: Shaded areas denote US equity relative underperformance. US Equities use data from Global Financial Data from 1926 to 1969, and S&P 500 Cap index from 1970 to 2023. US Treasury Bills use data from Ibbotson from 1926 to 1991 and Bloomberg US Treasury Bills (1-3 month) index from 1992 to 2023.
Source: Investment Strategy Group, Global Financial Data, Ibbotson, Datastream.

Historically, US equities have outperformed Treasury bills by 6.9 percentage points annualized since 1926 and 7.3 percentage points in the post-WWII period. We assume an outperformance of 5.7 percentage points in our strategic asset allocation modeling.

By any measure, US equity returns have been outsized relative to non-US equities, bonds and cash. And yet, we continue to recommend our clients stay invested at their customized strategic asset allocation target for US equities.

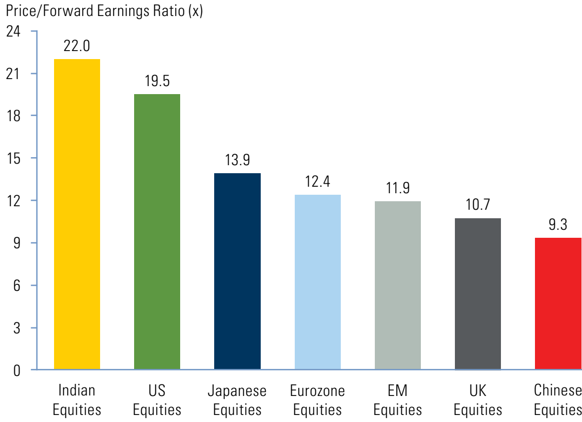
Staying Invested in US Equities Relative to Non-US Equities

US equities are the most expensive of any country (or region) after Indian equities (see Exhibit 38). Nevertheless, we do not advise underweighting US stocks and allocating proceeds to other developed or emerging market equities. We have seven key reasons:

- Non-US equities are not as cheap as they appear.
- Valuation differentials among countries and regions have not been a good predictor of outperformance or underperformance of markets.

Exhibit 38: Price-to-Forward Earnings Ratios

US equities are the most expensive after Indian equities.

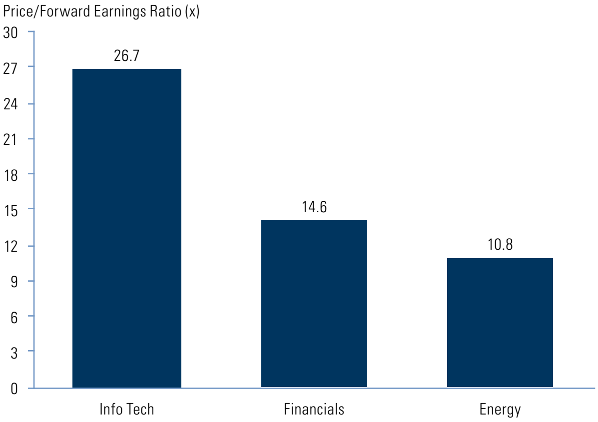


Data as of December 31, 2023.
Source: Investment Strategy Group, FactSet.

- US earnings per share (EPS) has grown and will continue to grow at a faster rate than that of most other markets.
- US equities have less exposure to the slowing economy in China.
- Faster economic growth in emerging markets has not translated into higher EPS growth,

Exhibit 39: Price-to-Forward Earnings Ratio for US Technology, Financials and Energy Equities

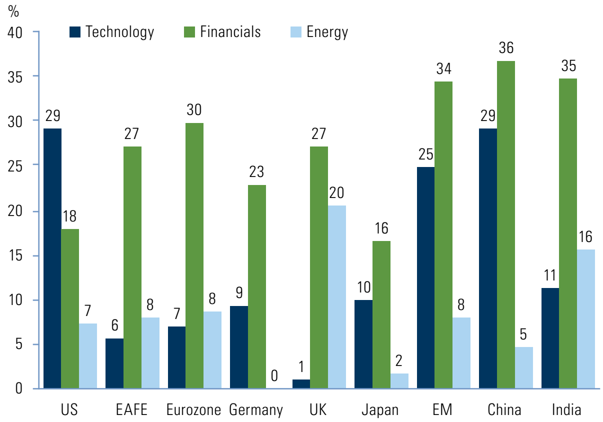
There is a large difference in valuations across sectors.



Data as of December 31, 2023.
Source: Investment Strategy Group, FactSet.

Exhibit 40: Share of Earnings by Sector

The US has one of the highest weights to the technology sector at 29%.



Data as of December 31, 2023.
Note: Technology includes the information technology, interactive media and services, and broadline retail sectors.
Source: Investment Strategy Group, Datastream.

so allocating assets to emerging markets in search of faster earnings growth and better equity market performance has not been an effective strategy.

- To the extent that generative artificial intelligence (GenAI) increases economic growth rates, the impact on the US is expected to be higher than in other countries.
- While the US faces its own domestic political tensions and uncertainties, US assets provide a safe haven as the world confronts much higher geopolitical risks in 2024 than it has over the last several decades.

Moreover, we expect somewhat similar returns across different equity markets over the next five years, as shown on Exhibit 62 later in this section. Therefore, tactical shifts will not result in higher long-term returns and will incur unnecessary transaction costs and taxes for taxable investors.

We examine each of these reasons below.

Relative Valuations: The United States is clearly the most expensive equity market after India when one compares earnings multiples. We measure multiples in this case as the price of the equity market divided by consensus earnings over the next 12 months (P/E). However, we believe it is necessary to make an important adjustment to the sector weight of each index.

First, as shown in Exhibit 39, there is a very large difference in the market multiples of each sector in the US. For example, technology stocks trade at a P/E of 26.7x; while financial stocks and energy stocks are much cheaper, at P/Es of 14.6x and 10.8x, respectively.

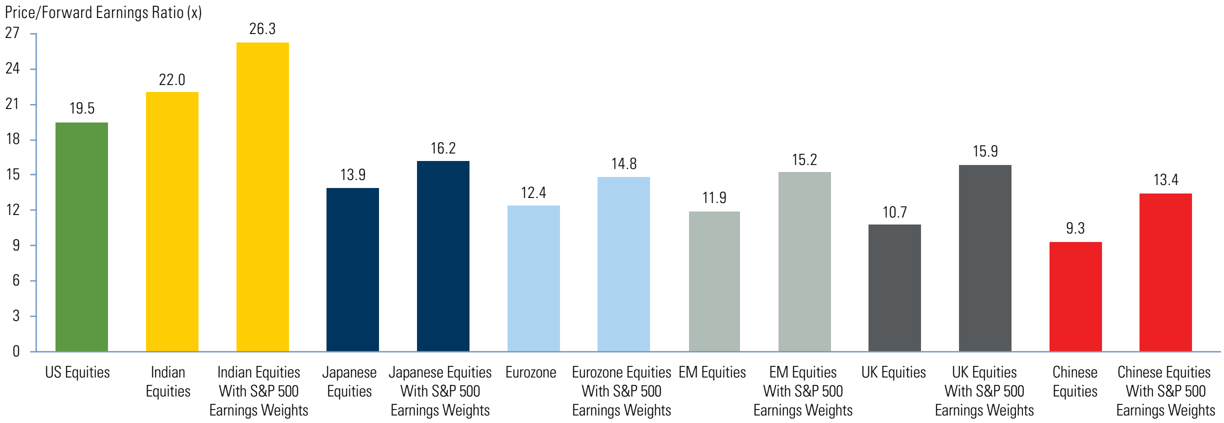
Second, each country index has a very different sector weight: for example, the US has one of the highest earnings weights to the technology sector, at 29%, while the UK has one of the lowest, at 1% (see Exhibit 40). Similarly, the energy sector has a low weight in the US, at 7%, compared to 20% in the UK.

Adjusting for these factors, US equities are not as expensive as described earlier once the sector weight has been adjusted for each country. As shown in Exhibit 41, the sector-adjusted bar is higher for each country and region. For example, while US equities are at an 82% premium to UK equities, the premium declines to 23% after adjusting for sector weights.

Valuation Differentials Are Not a Useful Signal for Subsequent Relative Performance: Valuation differentials between the equity markets of countries have not been a predictor of countries' relative performance. In Exhibit 42, we compare the relative valuation of non-US developed equities as measured by the MSCI EAFE index to the subsequent year's performance relative to the US. The valuation discount has been steadily widening

Exhibit 41: Price-to-Forward Earnings Ratio

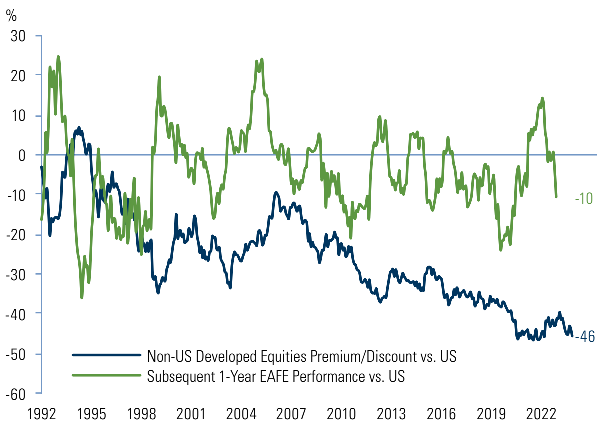
EM and EAFE equities are not as cheap as they appear to be when adjusted for US sector weights.



Data as of December 31, 2023.
Source: Investment Strategy Group, FactSet.

Exhibit 42: EAFE Equity Valuation Discount to US and Forward 1-Year Relative Returns

EAFE's valuation discount to the US has not been a useful signal for outperformance.



Data through December 31, 2023.
Source: Investment Strategy Group, Datastream, Bloomberg.

since the early 1990s, showing the EAFE equities have become cheaper and cheaper relative to US equities. The relative cheapness, however, has had no impact on the performance of EAFE equities relative to that of US equities in the subsequent year. The correlation of the two is only -0.21.

The conclusion is similar for emerging market equity valuations. The correlation between the two time series is -0.10, implying only a marginal impact of valuation differentials on relative performance.

US Earnings per Share Grows Faster: US companies generally outearn their counterparts in developed and emerging market countries. To avoid any hint of bias in selecting the period to compare EPS growth across countries and regions, we have selected peak earnings levels prior to the GFC and indexed that point to 100. For example, the peak earnings level for the US prior to the GFC was in Q3 2007, whereas in Germany it was Q1 2008 and in China it was Q3 2008.

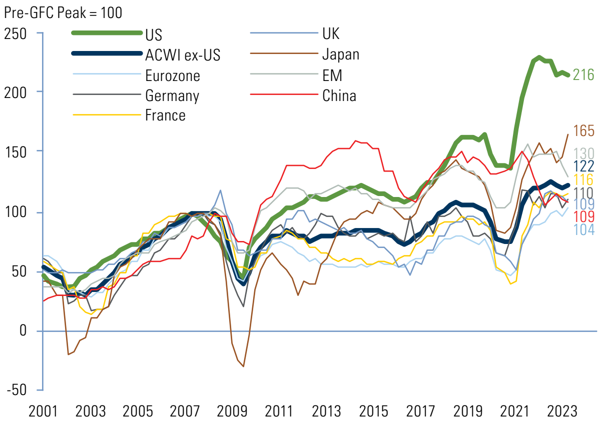
The upward trend of earnings growth in the US has been relatively steady except for a steep drop during the GFC; a modest decline in 2014–16 partly driven by a fall in oil prices from a peak of $107 in mid-June 2014 to a low of $26 for West Texas Intermediate in early 2016 and a drop during the global pandemic (see Exhibit 43).

From its peak level in Q3 2007, US EPS has more than doubled, while the EPS of the rest of the world has increased by 22%, with Eurozone EPS showing the lowest growth at only 4% over this 15-year period. Japan achieved the next highest EPS growth after the US, driven by Abenomics (economic policies implemented by Prime Minister Shinzo Abe) and, more recently, by a cheap yen that boosted the value of the country's exports in local currency terms.

Notably, the strength of US EPS growth is broad-based across most sectors. Among developed economies, US EPS has grown faster in every sector over the last 10 years except for the energy sector, and faster in every sector over the last 20

Exhibit 43: Trailing-12-Month Earnings per Share in Local Currency

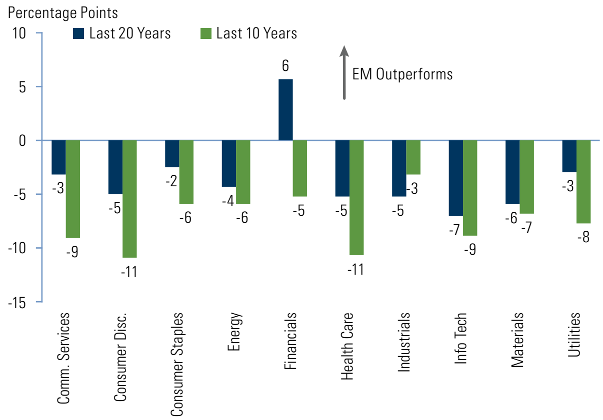
The upward trend of earnings growth in the US has been relatively steady.



Data through Q3 2023.
Source: Investment Strategy Group, Datastream.

Exhibit 45: MSCI EM Annualized EPS Growth Gap vs. the S&P 500

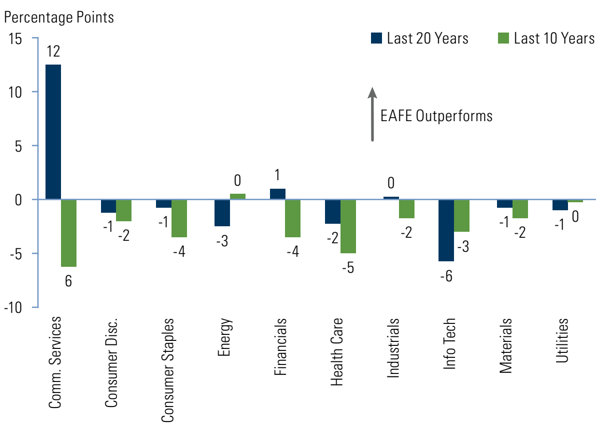
US EPS has grown faster than that of EM in every sector over the last 10 years.



Data through 2023.
Source: Investment Strategy Group, Datastream.

Exhibit 44: MSCI EAFE Annualized EPS Growth Gap vs. the S&P 500

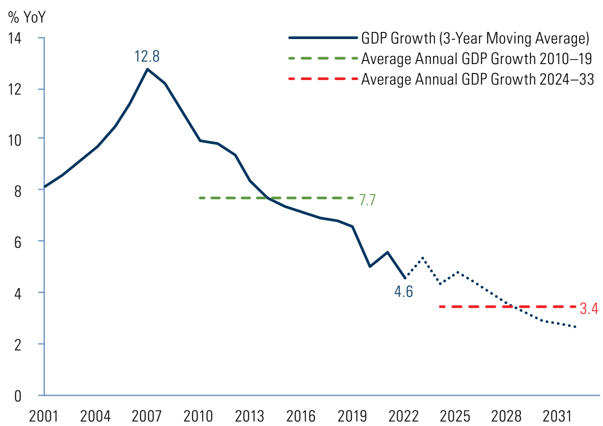
US EPS has grown faster than that of EAFE over the last 10 years in every sector but energy.



Data through 2023.
Source: Investment Strategy Group, Datastream.

Exhibit 46: China's GDP Growth Rate

China's growth rate peaked in 2007 and has been on a steady decline since.

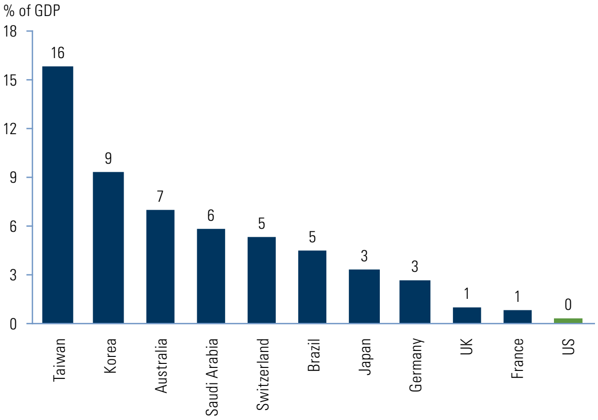


Data through 2022. Forecast through 2033.
Source: Investment Strategy Group, Haver Analytics.
Note: Forecasts have been generated by ISG for informational purposes as of the date of this publication. There can be no assurance the forecasts will be achieved.

years except for the communication services and financial sectors (see Exhibit 44).

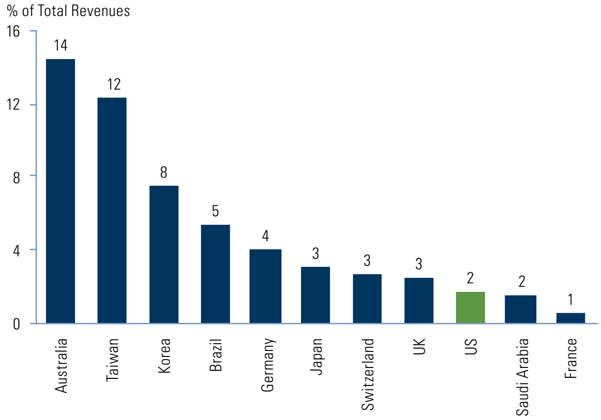
We note that the 12-percentage point annualized higher growth rate of EAFE EPS in communication services is driven by the low base of earnings at the start of the period, when BT Group (formerly British Telecommunications), Orange S.A. (formerly France Telecom) and Deutsche Telekom were recovering from losses; they all had had significant write-downs following the bursting of the dot-com bubble. Likewise, the financial sector outperformance is driven by the strong EPS growth of Japan's financial

Exhibit 47: Exports to China as Share of GDP
The US economy has lower exposure to China through exports relative to other countries.



Data as of 2022.
Source: Investment Strategy Group, Datastream.

Exhibit 48: Share of Corporate Revenues Generated in China
US companies generate only 2% of their sales in China.



Data as of 2022.
Note: Based on MSCI index constituents for each country.
Source: Investment Strategy Group, Datastream.

sector, which was also recovering from a low base after the bursting of the Japanese equity and property market bubble of the early 1990s.

A similar pattern appears in emerging market countries. US EPS in every sector has grown faster than the same sector in emerging markets over the past 10 years, and faster in every sector except financials over the last 20 years (see Exhibit 45). Financials in the US lagged because of the 90% drop in EPS during the GFC, compared with a 74% drop for EAFE financials and a 35% drop for emerging markets. Chinese banks have generally avoided recognizing losses on bad loans, making comparisons across the financial sector less meaningful.

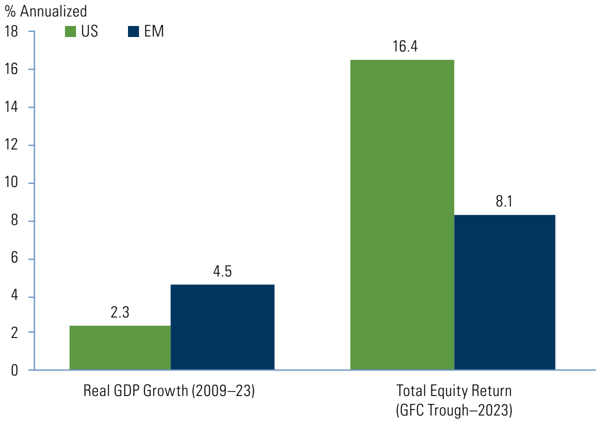
We caution investors to carefully examine the idiosyncratic factors that can distort EPS growth data over different periods. Above, we highlighted the effects of starting from a low base as one idiosyncratic factor. Another is distortion effects due to the pandemic. For example, pan-European stocks (including UK stocks) had higher EPS growth rates than the US between 2020 and 2023, driven by luxury goods, autos and the energy sector in 2022. These sectors have bigger weights in pan-European indices, and they benefited from a post-pandemic recovery and the increase in oil prices after the Russian invasion of Ukraine.

We expect US companies to continue outperforming non-US companies in generating persistent, faster and more diverse growth in earnings. US corporate management has been ranked the highest in the world,[17] US labor productivity is the highest in the world and the US equity market has the highest exposure to the technology sector among major markets (in line with that of China), which provides the fastest EPS growth in the world. Moreover, the base effects that accounted for faster EPS growth in some EAFE and emerging market sectors no longer exist.

Exposure to China: As discussed extensively in *Middle Kingdom: Middle Income*, our December 2022 China *Insight*, we expect a significant slowdown in China's economic growth rate

Exhibit 49: US and Emerging Market Annualized Real GDP Growth and Total Equity Returns

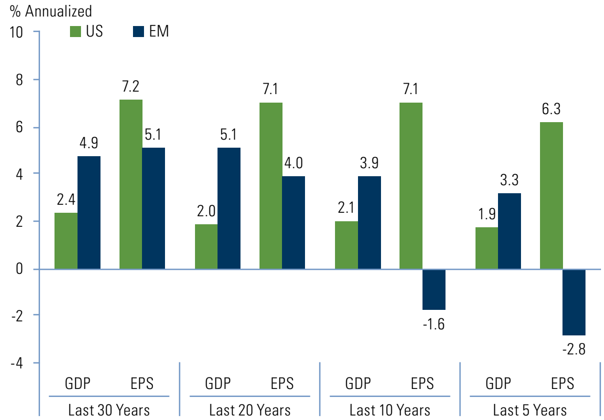
EM economies grew twice as fast as the US yet generated half the total equity return since the GFC trough.



Data through December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

Exhibit 50: Emerging Market vs. US Annualized Real GDP and EPS Growth Over Different Periods

US EPS growth outpaced that of emerging markets irrespective of the period examined.



Data through December 31, 2023.
Source: Investment Strategy Group, Datastream, FactSet.

over the next decade. We forecast China's GDP growth will slow to about 3% by 2028 and settle at slightly above 2% by 2033. Cumulatively, China's growth rate will be about 3.4% over the next decade—less than half of its 10-year average annual growth rate of 7.7% prior to COVID (see Exhibit 46).

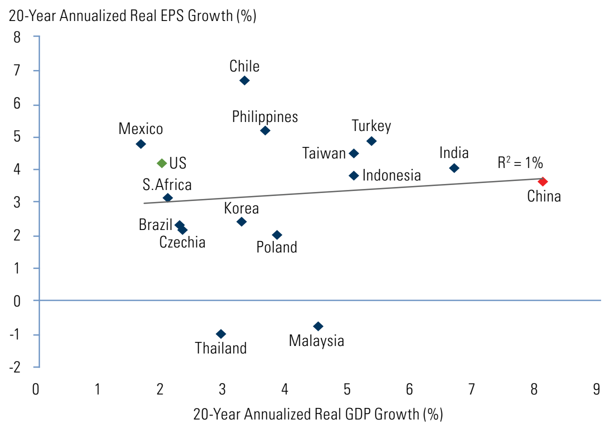
Given the expected slowdown, we prefer US equities to non-US equities: the US economy has lower exposure to China because exports are a smaller percentage of overall GDP (see Exhibit 47) and a smaller percentage of its corporate revenues originate in China (see Exhibit 48).

Third-quarter earnings reports from mostly European companies, such as LVMH, Hermes, Kering, Adidas and BMW, and some US companies, such as Estee Lauder and Nike, reflected slower sales growth in mainland China and from Chinese tourists traveling outside China. In some cases, companies reported actual declines in sales. We expect this trend to continue, given our China growth trajectory through 2033.

Higher Economic Growth Does Not Yield Higher Returns: Some market commentators have suggested that given the valuation differential between the US and emerging market countries, investors should re-allocate assets away from US equities to emerging markets given their faster economic growth rates. We strongly disagree with that view.

Exhibit 51: Emerging Market Annualized Real GDP Growth and Real EPS Growth

The relationship between economic growth and EPS growth in emerging markets over the last 20 years is very weak.



Data as of December 2023.
Source: Investment Strategy Group, Datastream, FactSet.

It is a myth that higher economic growth leads to higher earnings growth and equity market outperformance. Since the trough of the GFC, the GDP of emerging market countries has increased at double the rate of the US, yet their equity market returns have lagged by over 8 percentage points annualized (see Exhibit 49). This inverse relationship is driven by slower EPS growth irrespective of the period examined over the last 30 years (see Exhibit 50).

Exhibit 52: Performance Over First Six Months of Crisis Periods

US assets provide a safe haven in times of crisis.

Episode	Beginning Month	DXY Performance (pp)	S&P 500 vs. MSCI EAFE* (pp)	S&P 500 vs. MSCI EAFE (Local, pp)	US Intermediate Treasuries (%)
1973 Oil Crisis	Oct-73	3.6	-0.5	-2.7	-0.7
1979 Oil Crisis/US Embassy in Tehran Seized	Nov-79	-1.0	-2.8	1.7	8.8
Gulf War	Jan-91	14.0	11.2	1.2	3.9
Asian Currency Crisis	Jun-97	4.2	18.9	13.0	4.9
Long-Term Capital Crisis	Sep-98	4.1	4.8	2.6	-0.2
Dot-Com Bubble	Mar-00	7.4	8.0	1.6	4.4
September 11	Sep-01	5.1	6.6	1.7	3.1
Lehman Bankruptcy (GFC/Lehman Bankruptcy)	Sep-08	7.6	0.5	-3.9	6.1
COVID-19	Dec-19	1.0	8.0	7.2	5.8
Greek Government Loan	Apr-10	-5.6	-5.2	2.4	5.5
Russian Invasion of Ukraine	Feb-22	12.4	4.8	-6.0	-4.8
Average		**4.8**	**4.9**	**1.7**	**3.3**

Note: US and non-US developed equities are represented by S&P 500 and MSCI EAFE (US dollar and local terms), respectively.
Source: Investment Strategy Group, Datastream.
* US$ i.e., Unhedged

Finally, the lack of correlation between higher GDP growth and faster EPS growth is also evident within EM countries. As shown in Exhibit 51, China has been one of the fastest-growing emerging market countries, yet its EPS growth has lagged that of many other countries. Mexico's economy, on the other hand, has grown more slowly, but Mexico's EPS growth has been higher than that of most other countries.

Impact of Generative Artificial Intelligence: Our colleagues in Global Investment Research, Jan Hatzius and Joseph Briggs, have recently upgraded their long-run global growth forecasts to reflect their assessment of the impact of GenAI. They estimate that the US economy will be impacted earlier than other developed and emerging market countries, and that the long-term benefits will be highest in the US, Canada, Israel, Hong Kong and Switzerland; an incremental growth rate of 0.4% is forecast to be reached by 2043.[18]

Safe-Haven Status: Given the heightened geopolitical risks that are outlined later in this section, we prefer the safe-haven status of US assets in general. We examine the returns of US assets over six months from the start of a crisis.

During financial or geopolitical crises, the US dollar has appreciated in nine out of 11 occurrences, by an average of 4.8% (see Exhibit 52). The magnitude of outperformance of US equities relative to non-US equities is shown on an unhedged basis as well as on a local currency basis that approximates a hedged portfolio. If the MSCI EAFE is unhedged, the spread between the S&P 500 and MSCI EAFE is 4.9 percentage points, because it incorporates the beneficial impact of the dollar. If the portfolio is hedged, US equities outperform in eight out of 11 occurrences, but by an average of 1.7 percentage points.

US Treasuries also provide a safe haven in times of crisis—on average appreciating by 3.3% over the six months following the start of a crisis.

Given our view that 2024 is a year of heightened geopolitical risks, we prefer to stay invested in US equities rather than non-US equities.

Staying Invested in US Equities Relative to Chinese Equities

China is the cheapest market based on the P/E ratio among major markets, as shown in Exhibit 41. It is cheapest both with and without S&P 500 sector weight adjustments. Valuations are in the bottom decile relative to their long-term history, in contrast to US equities, which are in the 10th decile of valuations. China has been more expensive 90% of the time and the US has been less expensive 90% of the time.

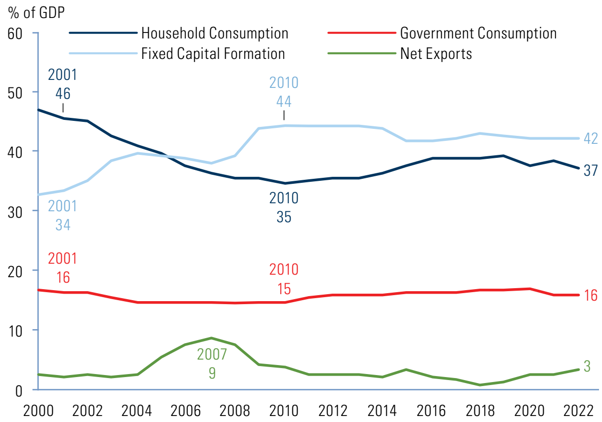
To offset some of the weakness in Chinese equities, the Chinese financial regulator has been encouraging companies to pay more dividends and buy back stocks.[19] The "national team," Chinese government-related entities that purchase domestic equities to stabilize the stock market, was also active in the second half of 2023.[20] While such government-driven market interference can provide some respite to the downdraft in Chinese equities in the short run, we do not believe that such activities can underpin equity markets in the long run.

We do not recommend a tactical shift out of US equities into Chinese equities, for five reasons:

- The Chinese economy is slowing.
- Economic growth remains imbalanced, fueled by increasing debt relative to GDP.
- Given its unfavorable demographics, China is likely to face even greater challenges than Japan when Japan's working-age and total population peaked.
- Some central government policies have favored state-owned enterprises over the private sector even though the private sector has generated much higher profitability and EPS growth.
- Policy uncertainty is high in China.

Exhibit 53: China's Consumption, Investment and Net Exports as a Share of GDP

China's economy remains imbalanced: consumption is too low and investment is too high.



Data through 2022.
Source: Investment Strategy Group, Haver Analytics.

Slowing Chinese Economy: As shown in Exhibit 46 above, China's growth has been slowing at a steady pace. Additionally, it has become harder to find comprehensive data on China's economy. For example, China's official GDP growth for 2023 is expected to be just over 5%, yet some China experts such as Daniel Rosen, Logan Wright and others at Rhodium Group suggest that 2023 GDP growth was closer to 1.5%.[21] They point to "anecdotal signs of trouble."

We examine some of these anecdotal signs.

After its unemployment rate for 16- to 24-year-olds in urban areas reached 21.3% in June 2023, China stopped publishing the data. However, a December 2023 article in the *Wall Street Journal*, "China's Jobless Don't Always Show Up in the Data. But They Show Up in the Library," provides some indication that employment has deteriorated for college-educated Chinese.[22]

Similarly, a December 2023 Bloomberg article, "A New Wave of Chinese Middle-Class Migrants Is Coming to the US," highlighted that the number of people from mainland China crossing the southern US border without proper paperwork has doubled in recent years, reaching almost 60,000 migrants over the last 14 months.[23]

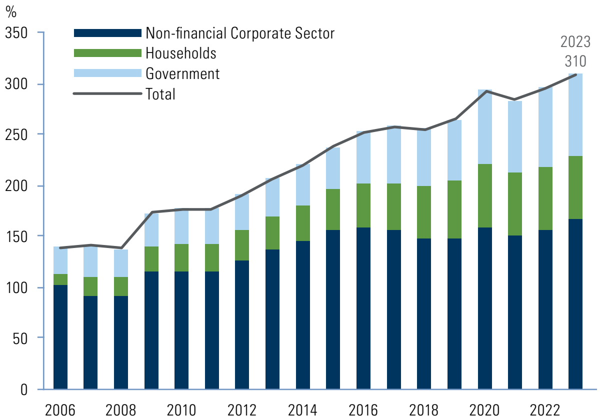
In China, local financial analysts and economists have been discouraged from publishing negative economic outlooks. Wind, a provider of financial information in China, has restricted offshore users' access to some of its business and economic data.[24]

We conclude that such actions are, in all likelihood, not a reflection of a stable and robust economy.

Imbalanced Economy: China's economy has remained as imbalanced as it was when Premier Wen Jiabao first shared his view in 2007 that China's economy had structural problems apt

Exhibit 54: China's Debt-to-GDP Ratio

China's debt-to-GDP ratio has increased to over 300%.



Data through 2022. Investment Strategy Group estimate for 2023.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, Bloomberg, Haver Analytics.

to "cause unsteady, unbalanced, uncoordinated and unsustainable development." He mentioned that growth was mainly driven by investment and exports.

Those engines of growth are no longer viable. We touched upon exports earlier, showing exports as a declining share of GDP. We also project that the "de-risking" strategies of the West will only further dampen export growth.

With respect to investment, the share of fixed capital formation (including infrastructure and property investment) in GDP is, in fact, higher than it was in 2007 (see Exhibit 53). To maintain its high growth rates, China, with the help of its local governments, overinvested in infrastructure and property development and grew its debt to fund these investments.

China's debt-to-GDP has increased to over 300% (see Exhibit 54). Should the country continue to pursue its investment-driven growth model, it will require even greater amounts of credit, as the incremental capital required for every unit of output (known as ICOR) has increased rapidly since the GFC. Local governments are now having trouble servicing their debt, and local government financing vehicles are defaulting on commercial paper and nonstandard forms of borrowing such as trust loans. According to Wind data, defaults in 2023 more than doubled from pre-pandemic levels.

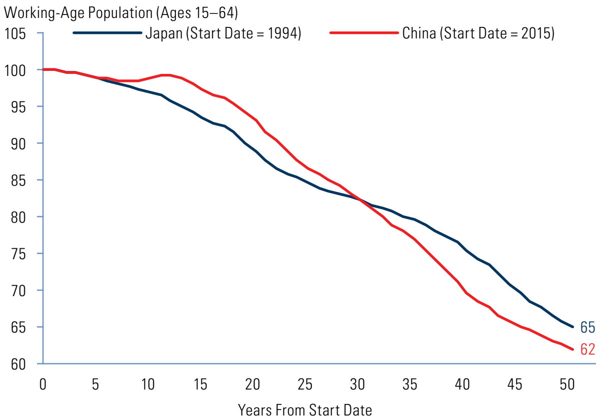
They say a picture (or two) is worth a thousand words. The province of Guizhou is the fourth-poorest province in China; it has a GDP per capita that is 40% lower than that of China. Recall that China's GDP per capita is 20% below the poverty level of the United States. Yet this province is reported to have five of the 10 tallest bridges in the world. The bridges are marvels of engineering and traverse some of the most beautiful landscapes in China. However, this infrastructure investment has resulted in very high debt levels that the province can no longer service, and it has asked for the support of the central government.[25] With Guizhou's government debt at 337% of its revenue, our colleagues in Global Investment Research wrote that Guizhou has the second-highest repayment pressure of any province in China.[26] As a result, Guizhou has had to rely on central government financial support.[27]

China faces a similar problem in the property sector. Between 2002 and 2019, the property sector accounted for about 25% of GDP growth. However, in both 2022 and 2023, the property sector was a large drag on GDP growth of 2.5 and 1.5 percentage points, respectively. Sales declined

The province of Guizhou in China is reported to have five of the 10 tallest bridges in the world.

Exhibit 55: China and Japan Working-Age Population Projections

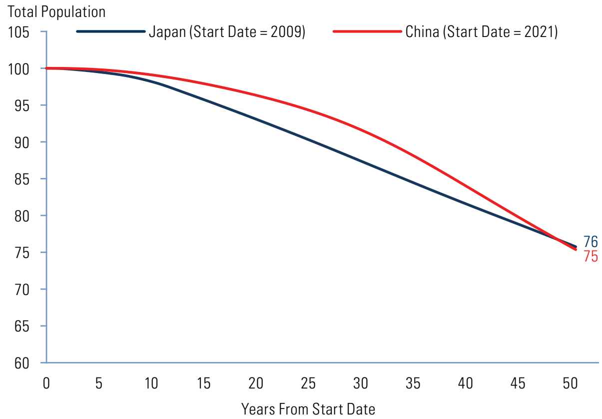
China is projected to undergo a decades-long demographic shift similar to the one Japan is experiencing.



Data through 2044 (forecast) for Japan. Data through 2065 (forecast) for China.
Source: Investment Strategy Group, United Nations.

Exhibit 56: China and Japan Total Population Projections

China is expected to have a very similar demographic trajectory to Japan.



Data through 2044 (forecast) for Japan. Data through 2065 (forecast) for China.
Source: Investment Strategy Group, United Nations.

by over 20%, and floor space sales declined about 25% each year over the last two years. *Financial Times* interviews with real estate brokers show transaction price declines of between 10% and 30% from their peak in 2021.[28]

Nearly half of China's top property developers have either missed payments or are formally in default. Names like Country Garden and Evergrande have become easily recognizable in the financial industry globally.

President Xi Jinping's recent New Year's Eve speech stating that "winds and rains are the norm" on the path ahead, affirms our view of the slowdown and makes us even more hesitant to recommend transferring some assets out of US equities into Chinese equities.[29]

Given the expected slowdown in the key engines of growth in China and the significant credit deterioration in the local government and property sector, we believe it is more prudent to ignore the cheap valuation of Chinese equities.

While China has a similar demographic profile, it faces more headwinds than Japan did, so we are more cautious about Chinese equities and their EPS growth trajectory.

Similarities to Japan: In past *Insight* reports related to China, we have often compared China's demographics to those of Japan (see Exhibits 55 and 56). It is expected that the countries will have very similar trajectories over the 50 years following their respective peaks in working-age population and total population.

Japan's unfavorable demographics contributed to an anemic annual GDP growth rate of 0.8% between its working-age population peak in 1994 and 2023, and 0.4% since its overall population peak in 2009. Its GDP as a share of global GDP declined from 18% in 1994 to 4% by 2023. Its investment-to-GDP ratio stood at 35% in 1990 and had declined to 26% by 2022.

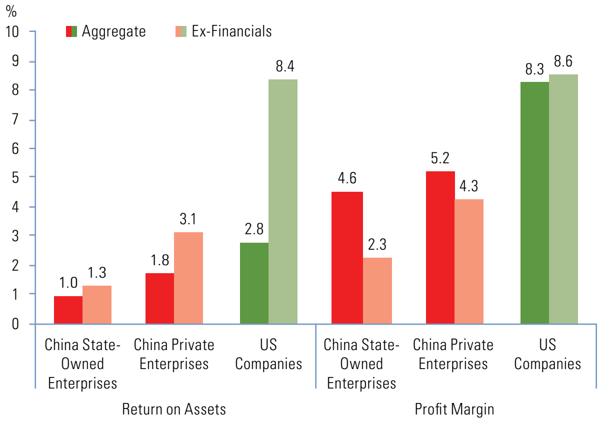
Japan's equity market, as measured by MSCI Japan's price index, declined by 74% from its peak levels in December 1989 through June 2012, when prices troughed. Over that period, earnings dropped 42%.

While China has a similar demographic profile, it faces more headwinds than Japan did, so we are more cautious about Chinese equities and their EPS growth trajectory.

First, China's GDP, like Japan's, is about 18% of world GDP (as of 2023).

Exhibit 57: Return on Assets and Net Profit Margin of *Fortune* 500 Companies

Chinese state-owned enterprises are less profitable than both their private peers and US companies.



Data as of 2022.
Source: Investment Strategy Group, *Fortune*.

But unlike Japan, whose GDP per capita was above that of the US, China's GDP per capita is below the poverty level of the US. China is facing poor demographics from a much lower level of wealth.

Second, China has further economic rebalancing ahead of it relative to Japan. At the peak of its working-age population, Japan had a relatively high level of fixed asset investment at 31% of GDP, but it was still lower than that of China at 42% of GDP.

Third, Japan was not allocating as many resources to a military buildup in 1994, at 0.9% of GDP, whereas China is allocating 1.6% of its GDP to military expenditures, and that figure is likely to grow. The Congressional Research Service states that China's announced budget figures are likely understated, as they appear to exclude some "defense-related expenditures, such as some paramilitary spending, some personnel compensation costs, and some defense-related research, development, testing, and evaluation expenditures."[30]

Finally, the governments of Japan's major export markets, such as the US and Europe, were not "de-risking" from Japan as its working-age population was peaking, in contrast to the current situation with China. China is facing a less hospitable environment among Western countries than Japan was facing in 1994.

From a geopolitical perspective, it may be useful to compare China to the former Soviet Union. The Soviet Union also faced a less hospitable Western world before the fall of the Berlin Wall. Like China, it had a high fixed investment-to-GDP ratio that peaked at 33% in the late 1980s. And like China, it needed increasing amounts of capital to generate the same level of GDP.

Given Japan's experience, we are hesitant to allocate assets to Chinese equities. That is not to say that Chinese equities may not rally; in fact, Chinese equities are much cheaper than Japanese equities were in late 1989. Nevertheless, China faces many more headwinds to its EPS growth.

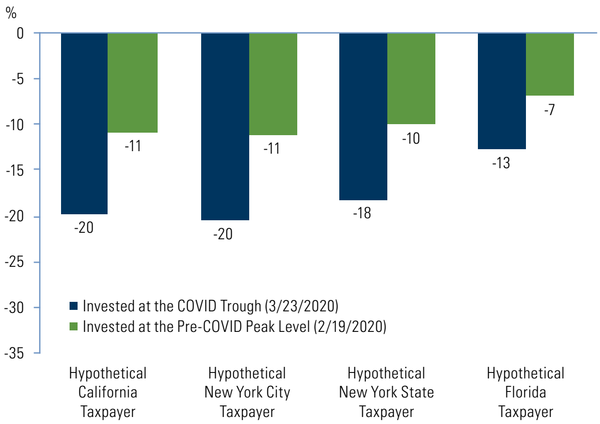
Favoring State-Owned Enterprises: China's leadership started favoring state-owned enterprises (SOEs) over private sector businesses in 2016 after the 2016–20 Five-Year Plan, when President Xi called for SOEs to be "stronger, better and bigger."[31] This policy toward SOEs will lower the profitability of Chinese equities both absolutely and relative to US equities.

Large Chinese SOEs are 44% less profitable than their private sector counterparts and 64% less profitable than US companies, based on return on assets (see Exhibit 57). Their profit margins are similarly lower than those of Chinese private sector companies and US companies.

The gap is even wider when financials are excluded from the analysis. SOEs are 58% less profitable than private sector companies on this basis and 85% less profitable than US companies. Chinese SOEs in the financial sector are typically slow to recognize losses and are not required to write down the value of their assets, as they would have to in the US. The phrase "extend and pretend," which was used to describe Japanese banks extending the maturity of the loans on their balance sheets and pretending that they were all performing loans in the 1990s and early 2000s, applies to the Chinese banks today.

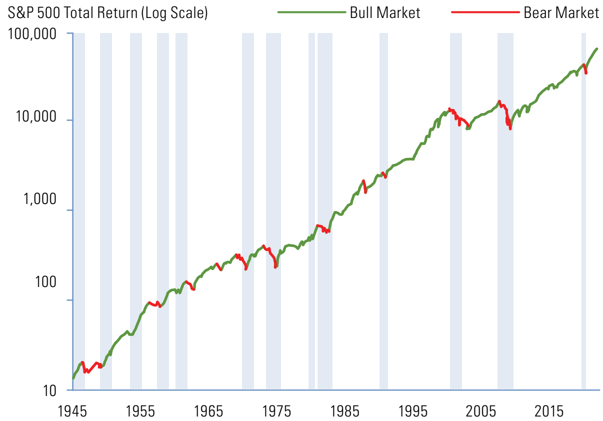
Policy Uncertainty: Companies operating in China face considerable policy uncertainty. The regulatory crackdown on internet companies officially started on November 10, 2020, when the State Administration for Market Regulation announced new draft rules for regulating internet companies. The shock to the financial markets occurred a week earlier when the Ant Group's initial public offering was suspended on November 3, 2020.

Exhibit 58: Required Decline in US Equities to Offset Tax Consequences of Selling
Capital gains taxes increase the hurdle to exit the equity market for taxpaying investors.



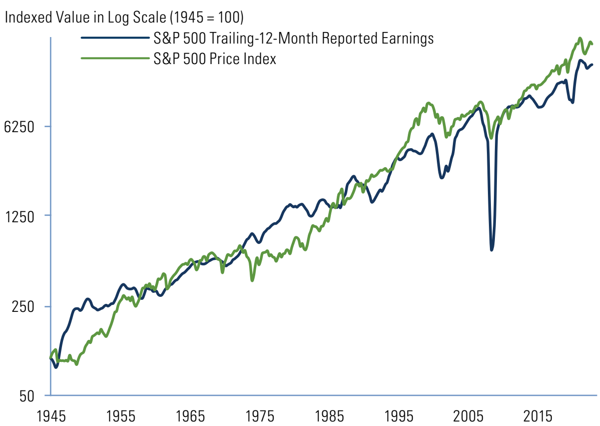
Data as of December 31, 2023.
Note: Showing S&P 500 price returns.
Source: Investment Strategy Group, Datastream.

Exhibit 60: S&P 500 Total Return
US equities are upward trending.



Data through December 31, 2023.
Note: Shaded periods denote recessions.
Source: Investment Strategy Group, Bloomberg.

Exhibit 59: S&P 500 Price Index vs. Earnings
The hurdle to underweight US equities is high given the upward trend in earnings and prices.



Data through Q3 2023.
Source: Investment Strategy Group, Bloomberg, S&P Global.

Since then, various regulators have fined companies such as Alibaba (e-commerce), Tencent (gaming), DiDi (ride-hailing), Meituan (food delivery) and education and tutoring companies. They have introduced new antitrust and anti-monopolistic guidelines. They have also proposed limiting gaming activities in China.

Because of this crackdown, Chinese internet stocks declined 74% on a cumulative basis between February 2021 and October 2022, accounting for a market capitalization loss of $2.3 trillion.

Although some of the proposed rules have been reversed, in our view, the uncertainty of what regulators might impose on private companies at any time makes Chinese stocks unattractive relative to US stocks.

Staying Invested in US Equities Relative to Bonds or Cash

After such a long run of US equity outperformance that has resulted in lofty valuations of US stocks, our clients are also asking whether they should lock in some of their gains by selling their US equities and allocating the proceeds to bonds or cash.

We do not recommend such an allocation, for three reasons:

- We have marginally higher expected returns for US stocks than for bonds and cash over the next one and five years.
- For taxable investors, the decline required in US equities to offset the tax consequences of selling US equities with significant capital gains is very high. As shown in Exhibit 58, equity markets have to decline about 20% for taxpayers in California or New York City to offset the tax payments they would face if they bought their US equities at the trough of the pandemic. If they bought their US equities at the pre-pandemic

Exhibit 61: US Recession Risks

ISG probability of US recession within 1 year is 30%.

	Probability of US Recesssion Within 1 Year:	
	In January 2023	Current
William C. Dudley	70%	35%
Jason Furman	50%	25%
Mark Zandi	55%	20%
Investment Strategy Group	45–55%	30%
GS Global Investment Research Jan Hatzius and David Mericle	35%	15%
Bloomberg Consensus	68%	50%
Unconditional (Since WWII)	18%	18%
Unconditional (Since 1980)	13%	13%

Data as of December 31, 2023.

Source: Investment Strategy Group, Goldman Sachs Global Investment Research, William C. Dudley, Mark Zandi, Jason Furman.

Note: These forecasts are estimated, based on assumptions, and are subject to significant revision and may change materially as economic and market conditions change.

peak, equities would have to decline about 10%. The required drop for Florida residents is less. The required decline increases significantly for equities purchased in earlier years. For example, the decline required to offset the tax payments for equities purchased in the trough of the GFC is over 30% for a California or New York City taxpayer. Realistically, execution slippage and transaction costs impose an additional hurdle.

- Our general investment philosophy for investing in US equities is to stay invested and benefit from the upward trend of US EPS and the prices that eventually follow earnings (see Exhibits 59 and 60). Unless there is high conviction of a recession or geopolitical crisis that the financial markets have not yet priced, we generally do not recommend underweighting US equities in favor of bonds or cash. As written in *Reminiscences of a Stock Operator*, a book dedicated to famous trader Jesse Livermore, "after spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: it never was my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight!"[32]

We now turn to our one- and five-year expected returns across publicly traded asset classes.

Our One- and Five-Year Expected Total Returns

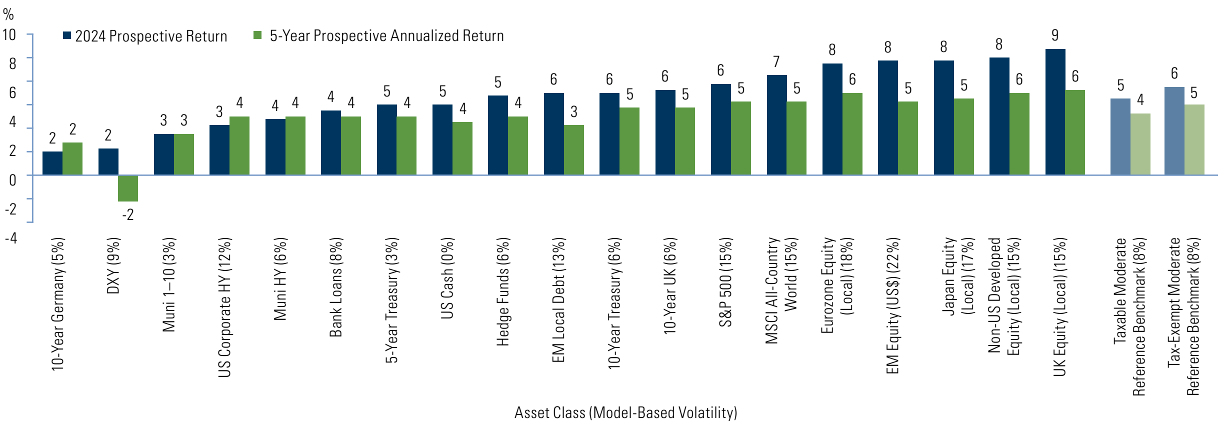
ISG's one-year expected returns are driven by our estimates of:

- A 30% probability of a US recession, which is well below reported consensus but slightly above the estimate of most of the economists we follow closely. Our colleagues in Global Investment Research, Jan Hatzius and David Mericle, estimate the lowest probability at 15% (see Exhibit 61). We forecast a higher probability of recession relative to the unconditional probability of 18% since WWII and 13% since 1980, because our yield curve diffusion index is still flashing red and several macroeconomic indicators point to above-average risk of recession.
- Global growth of 2.9%, which is in line with ISG's best estimate of trend growth of 3.0%. We estimate:
  - US growth of 1.9%, which is near trend.
  - Eurozone and UK growth of 0.5%, which is well below trend.
  - Japanese growth of 0.9%, which is above trend.
  - Emerging market growth of 4%, which is at trend. We have the least confidence in our emerging market growth estimates given the growing lack of transparency in Chinese economic data and the Russia-Ukraine war.
- Mid-single-digit EPS growth in most countries and regions. We generally have more confidence in our earnings forecasts than in forecasts of any multiple expansion or contraction that would impact the total return. Historically, year-over-

"After spending many years in Wall Street and after making and losing millions of dollars I want to tell you this: it never was my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight!"

— Jesse Livermore

Exhibit 62: ISG Prospective Total Returns



Data as of December 31, 2023.

Source: Investment Strategy Group. See endnote 33 for list of indices used.

Note: Forecasts have been generated by ISG for informational purposes as of the date of this publication. There can be no assurance the forecasts will be achieved.

year earnings have been less volatile than changes in market multiples. For example, in the US, EPS has had a 12% volatility since 2007, while market multiples have had a volatility of 16%. In emerging markets, the data shows EPS volatility of 16% and market multiple volatility of 20%. Of course, there are exceptions: in Japan, earnings have had 22% volatility, while market multiples have had 19% volatility. We estimate:

– US earnings growth of 7.0%, which is slightly above trend.
– Earnings growth of 4.6% in the Eurozone and the UK and 5.9% in Japan, for EAFE EPS growth of 5%. This rate is slightly below trend growth and in line with the below-trend growth of the economies.
– Emerging market earnings growth of 11.1%, which is well above trend growth of 5.6% and much stronger than GDP growth. This double-digit earnings growth is driven by a recovery from the 2023 decline in commodities and semiconductor prices. South Korea, for example, is expected to have an EPS increase of 57% given its large exposure to the semiconductor industry.

- A modest appreciation of 2% in the dollar as measured by DXY and a modest depreciation in emerging market currencies.

As shown in Exhibit 62, we expect most non-US equities to outperform US equities by about two percentage points. In our base case scenario, to which we assign a 60% probability, non-US developed equities return 8% compared to 6% for US equities. We assign a 20% probability to returns exceeding our expectations and a 20% probability to non-US developed equities having a negative mid-teens returns.

We note that non-US developed equity returns are presented in Exhibit 62 in local currency terms; if the dollar appreciates by our expected 2%, US and non-US developed equities will have similar returns.

Emerging market equities are expected to have an 8% return. While emerging market equities have a higher base case return than US equities, we assign only a 50% probability to this scenario. We assign a 30% probability to the downside scenario with a negative 19% return. On a probability-weighted basis, emerging market equities have the lowest expected returns of all equity markets.

We expect mid-single-digit returns in high-quality US fixed income assets. If this forecast is realized, the reference benchmark for a US moderate-risk model portfolio returns 5% for taxable clients and 6% for tax-exempt clients. These expected returns are lower relative to our forecasts for last year and relative to what was achieved in 2023.

In 2023, the reference benchmark for a taxable moderate model portfolio (50% global equity / 50% municipal bonds) returned 13.5% and the reference benchmark for the tax-exempt model portfolio (50% global equity / 50% government/ corporate bonds) returned 13.9%.

Our Tactical Tilts

In 2023 our tactical asset allocation team initiated 15 tactical tilts, roughly in line with our long-term average of 14 tilts a year. S&P 500 volatility as measured by VIX was slightly below its 20-year average, affording the team fewer opportunities for tactical asset allocation in US equities. On the other hand, the volatility in oil, natural gas and uranium as well as the 180-basis-point swing in US Treasury rates led to enough market dislocations to provide opportunities for several higher-impact tilts.

Most of the tactical tilts were initiated and removed during the year, including tilts on West Texas Intermediate (WTI) oil, natural gas, Eurozone banks and energy companies, currencies, and Chinese internet stocks (through a conservatively implemented call option).

The tactical tilts returned over 6% after fees, outperforming the benchmark—the Barclays 1-10 year municipal Bond Index—which returned 4.6%. Our tactical tilts are typically funded out of bonds.

The overall beta of the tactical tilts to the S&P 500 was 0.17, compared to a long-term average of 0.36 since the inception of ISG.

As of year-end 2023, we had seven tactical tilts, and the level of risk allocated to such tilts was close to the lowest level of risk over the last decade.

Overweight 10-Year UK Gilts Through 10-Year SONIA Swap: We initiated a tactical tilt in August 2023 to express a view on declining rates in the UK bond market. We expect central bank policy rates to steadily decline to a terminal rate of 2.25%, whereas the markets are expecting a much slower pace of declines. Given our GDP growth rate forecast of 0.5% for 2024 (which is below the UK's trend growth rate of 1.25%), we expect the Bank of England to start cutting policy rates in May 2024. Historically, gilt rates have fallen very sharply following the last hike of a hiking cycle and ahead of the first cut.

We expect this tilt to provide a mid-single-digit return.

Overweight 10-Year Treasuries: We initiated a tactical tilt in October 2023 to express a view of declining rates in the US bond market. We expect the Federal Reserve will cut policy rates four times in 2024, headline and core inflation will fall below 3%, and the 10-year Treasury rate will reach a target of 3.7% by year-end.

We expect this tilt to provide a mid-single-digit return as well.

Allocation to a Relative Value Currency Trade: We initiated a long euro relative to Swiss francs tilt in December 2023. We advised implementing this tactical tilt through a conservative option structure. Long-term valuation models suggest that the Swiss franc is 15–20% overvalued relative to the euro. We expect the Swiss National Bank will signal an end to its monetary policy tightening as well as currency interventions that supported the franc with the goal of lowering inflation.

We expect this tilt to provide a mid-single-digit return.

Overweight US Energy Infrastructure Master Limited Partnerships: The allocation to master limited partnerships (MLPs) is one of the longest-standing tactical tilts since the inception of ISG. It was initiated as an option tilt in 2015 and changed to a long sector position in January 2016. Since then, we have frequently adjusted the position's size as opportunities arose. This tilt has an inception-to-date return of 42.3%. The MLP sector was up 14.1% in 2023, compared to the S&P 500 at 26.3% and to intermediate municipal bonds at 4.6%. Intermediate bonds are the funding source for this tilt.

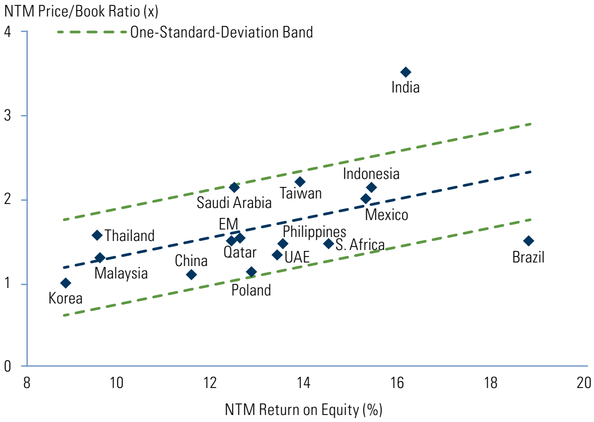
While we have reduced the allocation to MLPs given their strong performance over the last three years, we retain a small allocation for the following reasons:

- Valuations are still attractive even after such strong returns. Valuations as measured by the ratio of enterprise value to earnings before income, taxes, depreciation and amortization (EBITDA) are 9.2x and still cheap relative to the long-term average of 11.3x. We consider 9.7x a

As of year-end 2023, we had seven tactical tilts, and the level of risk allocated to such tilts was close to the lowest level of risk over the last decade.

Exhibit 63: Major EM Countries' Price-to-Book Ratio and Return on Equity

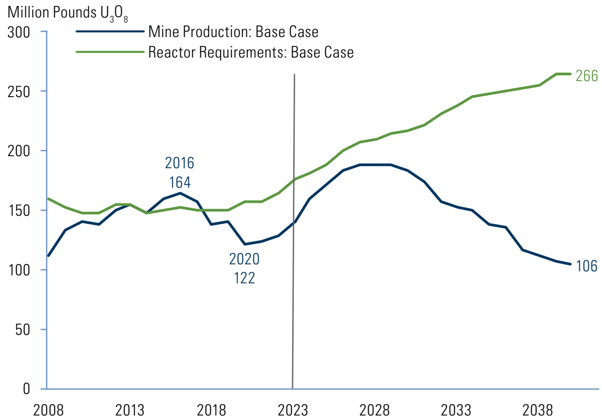
Brazilian stocks trade at a 36% valuation discount relative to what their return on equity would justify.



Data as of December 31, 2023.
Source: Investment Strategy Group, FactSet.

Exhibit 64: Annual Uranium Mine Production vs. Reactor Requirements

Uranium mine production has been insufficient to meet annual reactor requirements since 2018.



Data through 2040. Projection from 2023.
Source: Investment Strategy Group, UxC.

more realistic target as it removes the extreme overvaluations between 2010 and 2015.

- We expect earnings to continue to grow at about 6%.
- The tax-advantaged distribution yield of 7.5% is attractive relative to fixed income and high yield rates. The companies in the Alerian MLP Infrastructure Index generate free cash flow that is 1.7x greater than distributions, so the distribution yield appears secure.

We expect this tilt to provide a high-single-digit return. Our target return is based on a $60–80 range for WTI crude oil prices.

Overweight Brazilian Stocks: We initiated a tactical tilt to Brazilian equities through a call option on the Ibovespa in July 2023. We prefer option structures for riskier tactical tilts to limit the downside. We initiated this tilt for the following reasons:

- Brazilian equities are cheap relative to their own history and relative to other emerging markets. Brazilian equities trade at a 36% valuation discount relative to what their return on equity would ordinarily command (see Exhibit 63). In sharp contrast, India trades at a 74% premium relative to its return on equity.
- Consensus expectations for 2024 earnings are modest and below levels seen in 2022, setting a low hurdle rate for positive earning surprises to boost equity prices.
- The Brazilian central bank has been cutting the Selic policy rate since August 2023; the markets expect another 190 basis points of cuts over the next six months. Rate cuts have typically been a strong catalyst for above-average returns.
- Investor inflows from both foreign investors and local retail investors have just started to pick up. We expect this trend to continue.

We expect a mid-single-digit total return.

Nuclear energy is becoming an increasingly attractive source of electricity as countries seek reliable, carbon-free and secure sources of energy.

Allocation to Physical Uranium: We initiated a small allocation to physical uranium in March 2022. Nuclear energy is becoming an increasingly attractive source of electricity as countries seek reliable, carbon-free and secure sources of energy. Some view nuclear energy as a permanent solution and others as a transition source of energy away from

Exhibit 65: Weekly Uranium U_3O_8 Spot Price

Uranium prices appreciated 90% in 2023.

Data through December 31, 2023.

Source: Investment Strategy Group, UxC.

hydrocarbons while other renewable energy sources are developed.

There has been a sharp decrease in uranium exploration and production from existing mines. Uranium mine production has been insufficient to meet annual reactor requirements since 2018 (see Exhibit 64). Utilities have accessed inventories and extended the enrichment process to extract more yield per unit of raw uranium to make up for the shortfall.

Additional supply has been slow to come online. Mine starts and the expansion of existing production have been stalled by issues such as access to other raw materials, lack of skilled labor and challenges with transportation in places like Kazakhstan.

In the US, the Prohibiting Russian Uranium Imports Act was approved by the House of Representatives in December 2023 and will now move to the Senate. If passed, it would gradually bar US uranium imports from Russia, further tightening supplies for Western utilities.

Demand, on the other hand, is growing steadily, with new reactors coming online in China, operable reactors restarting in Japan and over 20 countries at COP28 pledging to increase their nuclear energy capacity.

The realization of this supply and demand imbalance sent uranium prices skyrocketing in 2023. As shown in Exhibit 65, prices appreciated 90% last year. We think prices are likely to continue their upward trend through 2024, and could approach their prior peak of $140.

Of course, any major nuclear accident would change the supply/demand outlook, as was the case after the Fukushima Daiichi nuclear accident in Japan in 2011.

Allocation to Systematic Strategies: We deployed one systematic strategy called Trend-Based Rotation (TBR) to provide uncorrelated sources of incremental return to a portfolio.

This strategy was introduced in 2021 and was adjusted in 2023. The goal is to rotate risk among 14 asset classes across US and non-US equity indices, commodities, US corporate bonds, US Treasury bonds and US cash. The strategy is driven by the trend in each asset class, is based on the momentum factor, and provides diversification to ISG's more value-oriented tactical tilts.

We expect the strategy to deliver a high-single-digit return.

Risks to Our 2024 Economic and Financial Markets Outlook

We face significant geopolitical risks that could have meaningful impact on global growth and financial markets in 2024. These include:

- Increasingly strained relations between China and the West that increase the risks of mishaps and miscalculations
- The Israel-Hamas war, which could escalate into a broader regional war instead of a regional war by proxy and could include an Israeli attack on Iran's nuclear sites
- Taiwanese elections
- A more aggressive posture by North Korea and greater North Korean engagement with Russia

In the US, the risks are:

- The possibility of government shutdowns early in 2024
- Disrupted and disruptive congressional and presidential elections, which could impact market performance later in the year and will be of greater concern for 2025

It has become commonplace to hear about the record number of people who will be voting in 2024: elections will be held in 76 countries representing four billion people—or half the world's population. In most of these countries, the elections will have no meaningful impact on the rest of the world. In some countries, such as Russia and India, the outcome is predictable. Only a few elections are likely to have meaningful economic and geopolitical impact that will lead to some market volatility. They include the US, UK, Taiwan and, to a lesser extent, Mexico and the European Parliament.

As usual, in assessing risk we have consulted with internal colleagues as well as external geopolitical experts. In alphabetical order, they are:

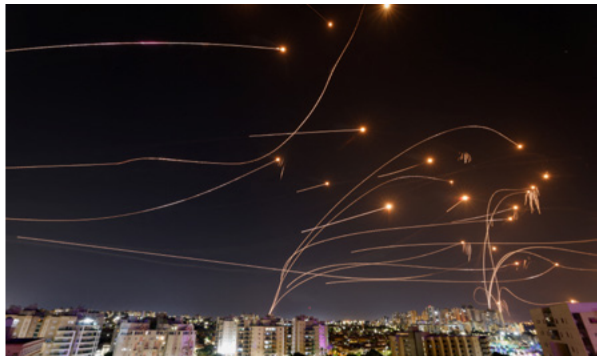
- Andrew Bishop, senior partner and global head of policy research, Signum Global Advisors
- General Sir Nick Carter, former chief of the Defence Staff in the UK
- Robert Kahn, managing director, Global Macro-Geoeconomics, Eurasia Group
- Jon Lieber, head of research and managing director, US, Eurasia Group
- Charles Myers, chairman and founder, Signum Global Advisors
- Karl Rove, senior advisor (2000–04) and deputy chief of staff (2004–07) to President George W. Bush
- Sir Alex Younger, former chief of the Secret Intelligence Service in the UK and regional advisor at Goldman Sachs

Israel-Hamas War

We view the escalation of the Israel-Hamas war as the biggest geopolitical risk in 2024. If conflict in the region continues at its current pace, with limited hostile activity between Hezbollah and Israel and with the Houthi attacks on ships in the Red Sea having no greater impact, the war will be contained with no significant economic and market impact. We note that oil prices dropped nearly 9% and US equities rallied about 11% from the pre-Hamas attacks levels through year-end.

The experts we consulted think the probability of escalation is low because most regional powers, including Iran and Saudi Arabia, do not want a larger war.

Many of the same experts suggest that the war will end in early 2024. However, if the destruction of Hamas is one of Prime Minister Benjamin Netanyahu's primary goals, as he has stated many times, then a longer war is likely. According to the late Ash Carter, the 25th US secretary of defense, the defeat of ISIS took about 3.5 years in Iraq and an additional two years in Syria.[34]



We view the escalation of the Israel-Hamas war as the biggest geopolitical risk in 2024.

In a subsequent assessment, Graham Allison, professor of government at Harvard University, suggested that Israel should learn the lessons the US did from its war with ISIS.[35] While the two wars are very different, the US experience indicates that the defeat of Hamas will take more than just a few months.

Iran

The risk of escalation of the Israel-Hamas war largely depends on Iran and Israel:

- The risk is low if Iran continues to stay on the sidelines and wage war through proxies. Unless there is some serious escalation on the part of Israel, Iran's preference to date seems to be avoiding direct engagement.
- Risk will increase if Iran encourages Hezbollah to become more aggressive and launch more missiles toward northern Israel. Hezbollah is estimated to have over 100,000 missiles, mostly procured from Iran. The Iron Dome's effectiveness will decrease if overwhelmed by missiles from Hezbollah, and many such missiles will land in Israel.[36]

Market volatility will increase if fears of further escalation get priced into the markets.

Nuclear Concerns: Israel may decide to unilaterally strike Iran as Iran continues to increase its stockpile of enriched uranium, including highly enriched uranium (HEU) at 60% and possibly higher percentages.

According to CNN, the International Atomic Energy Agency has confirmed that uranium particles enriched to 83.7% purity—which is close to the 90% enrichment levels needed for a nuclear bomb—were found in Iran's Fordow Fuel Enrichment Plant.[37]

In November, the Institute for Science and International Security reported that Iran is now capable of producing six nuclear weapons in one month, eight in two months and as many as 12 in five months.[38]

Retired General Mark Milley, the 20th chairman of the Joint Chiefs of Staff, stated in testimony before Congress on March 23, 2023, that "from the time of an Iranian decision, Iran could produce fissile material for a nuclear weapon in less than two weeks, and it would only take several more months to produce an actual nuclear weapon."[39]

The Signum Group has suggested that there is a greater than 50% probability that Israel will strike Iran to prevent Iran from developing a nuclear weapon. Before the October 7 terrorist attack, Signum had suggested a strike may occur in the first half of 2024; they have expanded the window during which a strike might occur to the end of the third quarter. Signum highlights Prime Minister Netanyahu's long-standing goal to directly target Iran "as the root cause of much of the region's risks."[40]

Headlines on Iran and its nuclear program and responses from Israel will be a source of volatility in 2024. If there is serious escalation, the markets will experience significant downdrafts.

Drones and Missiles to Russia: With the expiration on October 18 of missile sanctions provisions in United Nations Security Council Resolution 2231, Iran is now free to sell missiles and drones to Russia and any other country. In our 2022 *Outlook*, we quoted Kenneth "Frank" McKenzie Jr., Marine general and commander of the US Central Command covering the Middle East and South Asia; he held that Iran had reached "overmatch," wherein its "strategic capacity is now enormous," and that it has "the ability to overwhelm." Its missiles, he maintained, "can strike effectively across the breadth and depth of the Middle East … with accuracy and volume."[41]

Russia is now producing Iranian-designed drones in its own factories. In turn, Iran has announced plans to buy Su-35 fighter jets, Mi-28 attack helicopters and Yak-130 jet trainers from Russia, further increasing geopolitical risks in the region.[42]

Iran has announced plans to buy Su-35 fighter jets from Russia.

Russia-Ukraine War

Our base case for 2023 was that the war would last well beyond the year, both because there was no face-saving off-ramp for President Vladimir Putin and because Ukraine could not readily come to the negotiating table, given the war crimes committed by the Russians against men, women and children and the extensive damage to civilian structures and infrastructure.

Our experts all believe that intense fighting will continue but the war will remain at a stalemate through the end of 2024.

According to the Rand Corporation, Russia has not escalated its aggression because of three factors:

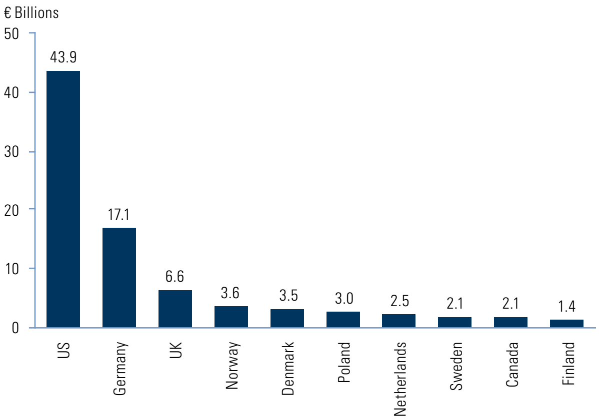
- "Acute concerns" about NATO military capabilities and reactions
- Concern for broader international reactions, especially the possibility that China will withdraw its support
- Russia's view that its goals in Ukraine are achievable without further escalation.[43]

The two biggest factors that could result in escalation are:

- Cuts in US military aid. The US is the largest military aid donor, having contributed €43.9 billion through October 2023—more than the next eight donors (including Germany and the UK) combined (see Exhibits 66 and 67). Both Eurasia Group and Signum think that US aid will continue. Ukraine cannot continue the war without US support; according to General Sir Nick Carter, the Europeans simply cannot fill the funding gap.[44]
- Domestic pressures in Ukraine. The latest Gallup poll showed President Volodymyr Zelensky's approval rating near the record highs set shortly after the Russian invasion in February 2022.[45]

Exhibit 66: Military Government Support to Ukraine by Country

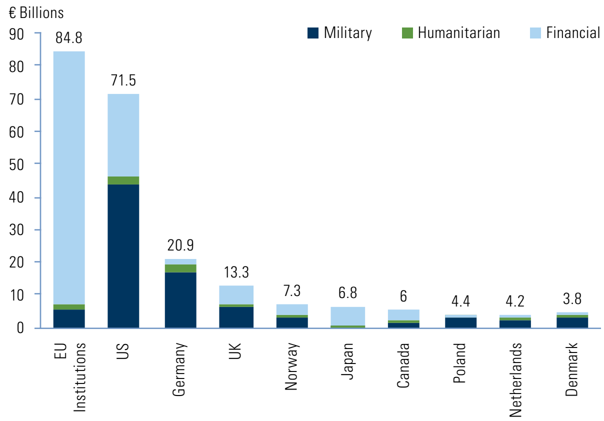
The US is the largest military aid donor to Ukraine.



Data as of October 31, 2023.
Note: Commitments from January 24, 2022, to October 31, 2023.
Source: Investment Strategy Group, Kiel Institute.

Exhibit 67: Government Support to Ukraine by Type of Assistance

European countries and institutions have given more financial and humanitarian aid to Ukraine than the US has.



Data as of October 31, 2023.
Note: Commitments from January 24, 2022, to October 31, 2023.
Source: Investment Strategy Group, Kiel Institute.

- On the other hand, the mayor of Kiev has told interviewers that Zelensky's popularity is falling.[46]
- The biggest threat to US and European support for Ukraine is the extensive corruption among government officials. In 2023, the defense minister, the deputy defense minister, the deputy infrastructure minister, five regional governors, and several other government officials, including a judge, were fired, resigned, were sentenced to prison or were arrested for embezzlement.

In the absence of escalation, the United States Department of Agriculture (USDA) expects Ukraine's production and exports to fall by over 30% relative to levels from two years ago.[47]

With respect to the impact on natural gas markets, we do not expect much volatility since inventories are at 90% of capacity going into the winter months in Europe; this is due in part to exports from the US, a mild winter last year that did not deplete inventories and subdued manufacturing activity in Europe.

Our base case for the Russia-Ukraine war is a stalemate for the foreseeable future.

US-China Tensions

The most immediate catalyst for any material change in US-China relations is presented by the elections in Taiwan on January 13. At the time this report was published, the race appeared to be too close to call between the Democratic Progressive Party (DPP) candidate, Lai Ching-te, and the Kuomintang (KMT) candidate, Hou Yu-ih. The election of the DPP candidate would probably result in more aggressive and provocative actions by China, such as more military flights into Taiwan's Air Defense Identification Zone and more balloons launched over Taiwan. If KMT wins either the presidency or the Legislative Yuan (equivalent to a parliament), the Chinese are less likely to escalate tensions in the region.

Even if China escalates with more aggressive actions, it is unlikely to go to war in 2024 over Taiwan. As we showed earlier in Exhibit 15, China is a net importer of energy and agricultural products, and exports are still a key component of economic growth. President Xi's latest purge of China's senior military personnel due to alleged corruption, and US intelligence reports of missiles filled with water rather than fuel, further support the view that China is unlikely to go to war in 2024.[48]

Signum suggests a 75% probability that China will try to take Taiwan by 2027 and a 35–40% chance that it will do so over the next two years.[49] These estimates are considerably higher than those of most other geopolitical observers.

The next potential source of escalation is a WWII-era ship called the *BRP Sierra Madre* that

The BRP Sierra Madre was deliberately grounded by the Philippines in 1999 on the Second Thomas Shoal.

A Chinese ship fires water cannon at a Philippines vessel in the South China Sea in December 2023.

was deliberately grounded by the Philippines in 1999 on the Second Thomas Shoal to establish the Philippines' sovereignty and maritime rights in the Spratly Islands. The *BRP Sierra Madre* is more shipwreck than ship and will eventually fall apart because the Chinese are blocking other ships from reaching it for repairs. While many observers have suggested it is unlikely that the US would seriously engage in a skirmish with China over a small reef, both the US and the Philippines have objected to the Chinese actions, and the US has asserted freedom of navigation in the South China Sea. We think the Second Thomas Shoal will be a source of some market volatility in 2024.

The meeting between President Joe Biden and President Xi at the November 2023 Asia-Pacific Economic Cooperation (APEC) summit is expected to reduce tensions—at least in the near term. US Ambassador to China R. Nicholas Burns shared that although the meeting was productive, he was not optimistic about the future of US-China relations. But at least for now, military-to-military contact has been reestablished.[50]

In 1922, Bertrand Russell, a British philosopher, published a book about China called *The Problem of China*. The *Economist* summarizes Russell's argument that China, with its resources, population and patriotic spirit, could become the greatest power in the world after the United States. Most presciently, Russell added, "The danger of patriotism is that, as soon as it has proved strong enough for successful defence, it is apt to turn to foreign aggression."[51]

North Korea

The consensus among geopolitical experts is that North Korea will conduct several missile tests and one nuclear test in 2024. The responses from the West will be muted, as there is broad de facto acceptance that North Korea has become a nuclear-weapons state.

Of greater note is the North Korea-Russia cooperation and exchange of military equipment, in which North Korea provides military equipment and munitions to Russia, and Russia provides fighter aircraft, surface-to-air missiles, armored vehicles and other advanced technologies to North Korea. [52]

Cybersecurity

Cyberattacks remain a major threat from state and non-state actors, with the biggest threats emanating from China, Russia, Iran and North Korea.

US intelligence and national security agencies assess China's state-sponsored cyber activities as presenting one of the largest and most dynamic threats to US government and civilian networks. The Office of the Director of National Intelligence also considers Russia a significant threat given its focus on critical infrastructure, including underwater cables and industrial control systems, in the US and allied and partner countries.[53]

Cyberattacks remain a major threat from state and non-state actors.

Use of ransomware is on the rise. In the US, over 320 organizations such as hospital systems, schools and local governments were affected by cyberattacks and ransomware in 2023. The cost of data breaches and ransomware has gone up substantially, and cyber insurance premiums have increased to reflect the higher risks.[54] We expect this pattern to continue in 2024.

Terrorism

Experts believe that the risk of terrorism will increase in 2024, especially after the onset of the Israel-Hamas war. Several terrorism incidents in Europe—what Sir Alex Younger referred to as "atomized events" rather than larger acts of terrorism—occurred last year.[55]

Europol, an organization formed to support European Union member states in preventing and combating international organized crime, cybercrime and terrorism, has stated that the overall terrorist threat to the security of the EU "remains acute." [56]

Thomas Haldenwang, president of Germany's domestic intelligence agency, has said that "the danger is real and as high as it's been for a long time"; al-Qaeda and ISIS are trying to use the Israel-Hamas war to recruit more supporters. [57]

US Government Shutdown

Our colleague in Global Investment Research, Alec Phillips, chief US political economist, shares that although it is a close call, it is likely that the United States will have some type of government shutdown. As with the Taiwan elections, the issue will come to the fore quite soon. The first deadline is January 19, when about 20% of government funding expires. This funding is for Veterans Affairs, Transportation, and Housing and Urban Development. However, because only 20% of government funding is impacted, the drag on GDP growth would be about 5 basis points per week of shutdown on first-quarter growth.

The next deadline is February 2, when the remaining 80% of government funding expires. This funding is for departments such as Defense, Homeland Security, Labor, Education, and Health and Human Services. Phillips estimates that the impact on GDP of a government shutdown will rise to about 20 basis points per week. He expects any shutdown to be short-lived. [58]

We expect minimal market impact.

Several terrorism incidents in Europe occurred last year.

US Elections

A recent Pew Research Center study shows that Americans have become particularly negative about the state of politics in the US:

- 63% express not too much confidence or no confidence at all in the future of the US political system.
- 63% say they are dissatisfied with the candidates who have emerged so far.
- 65% say they always or often feel exhausted thinking about politics, and 55% feel angry.
- 79% use negative or critical words such as "divisive" and "corrupt" to describe their feelings about the political system and elected officials.
- Trust in the federal government stands among the lowest levels seen in nearly 70 years. [59]

The 2024 elections are too close to predict, in our experts' opinion. Some political experts believe that among expected nominees, President Biden is most likely to win the election, and others think President Trump has a very good chance. The Senate is likely to be held by Republicans with a small majority, and the House of Representatives is likely to be held by the Democrats. Many people across the political spectrum are concerned about the strength and resilience of US institutions in the current political environment.

Liz Cheney, former Republican congresswoman from Wyoming, wrote an opinion article in the *Wall Street Journal* on December 14, 2023, saying that the systems of checks and balances in the US will not hold if President Trump is elected, and "once our constitutional system unravels, the damage is irreversible, and our republic fails just as so many others have throughout history."[60]

Larry Summers, former secretary of the Treasury and former president of Harvard University, similarly warned US business leaders in an interview on Wall Street Week on January 5, 2024, that a second term with President Trump risks "undercutting the entire framework within which the United States and its business community have operated for all of our lifetimes."[61]

We turn to two experienced participants in the US political system for their wisdom on this topic: James Baker III, former secretary of state (1989–92), secretary of the Treasury (1985–88) and White House chief of staff (1981–85 and 1992–93), and Karl Rove, senior advisor (2000–04) and deputy chief of staff (2004–07) to President George W. Bush.

Jim Baker: When asked by the *Financial Times* in June 2016 whether America and its institutions were strong enough to survive a shock as seismic as Donald Trump in the White House, he emphatically said yes. "I don't care who wins, whoever gets to the White House. Presidents can do a lot, but they can only do so much through the system of checks and balances. We are a country of laws, limited by bureaucracy and the power structure in Washington. Presidents are not unilateral rulers. If they did not know that, they will find out soon enough."[62]

Karl Rove: He has similarly argued that the current state of political division will pass and that the guardrails in the system will hold. In the *Wall Street Journal* in August 2023, Rove wrote a very thorough and informative opinion piece, "America Is Often a Nation Divided," which shed light on the history of division in the United States going back to 1800. He describes the presidential race between Thomas Jefferson and John Adams, both signatories of the US Declaration of Independence, as "among the most acrimonious in the nation's history." He refers to historian James Roger Sharp, who wrote that each side believed that the other side's election would threaten the existence of the republic.

He concluded by writing: "It's bad today, but it's been worse before, and it will be better ahead … The better angels of our nature as Americans will emerge and win out." We recommend clients read this piece.[63]

And if James Baker's and Karl Rove's words of wisdom do not assure all our clients that the guardrails will hold in the US, we can also heed Alexis de Tocqueville's insight in his book, *Democracy in America*: "The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults." The four-volume work was published between 1835 and 1840.[64]

Key Takeaways

Our two primary investment themes of US Preeminence and Staying Invested have served our clients well over the past 14 years. US equities have outperformed other equity markets and staying invested has allowed clients to capture the ninefold increase in US equities. These investment themes remain valid. However, we do not expect US equities to outperform other equities by the same magnitude; nor do we expect high absolute returns from US equities.

The key takeaways from our 2024 *Outlook* are as follows:

- Stable but Uneven Global Growth: We expect global economic growth to stand at 2.9%, relative to 3% trend growth. The US will also grow in line with its trend while the Eurozone and the UK at 0.5% GDP growth will grow well below trend. Japan will be an exception among developed economies in growing above trend. While emerging market countries together will grow at trend, there will be some dispersion among the BRICS countries with Russia growing above trend due to its war efforts, Brazil below trend, and China at trend.
- Monetary Policy Easing: We believe that most major central banks in developed economies, except for Japan, will start reducing policy rates in 2024. Japan, on the other hand, will end its negative interest rate policy and raise rates. In emerging markets, China will continue to support its economy with an easing monetary policy stance, Brazil will continue to lower rates, and India and Russia may ease modestly in the second half of 2024.

- Recession Risk in the US: We have lowered our risk of recession in the US for the year ahead to 30%, which is above the unconditional probability of recession of 18% but substantially lower than current consensus.
- Modest Mid-Single-Digit Benchmark Returns: After a 14% return in 2023 for a 50% stocks-50% bonds benchmark, we expect a more modest 5% return for taxable investors and 6% for tax-exempt investors in 2024. We expect a well-diversified portfolio leveraging our strategic asset allocation process to outperform a passive benchmark over time.
- Significant Geopolitical Risks: We face a long litany of geopolitical risks this year, including an escalation of the Israel-Hamas War, expected stalemate in the Ukraine-Russia War with some risk of escalation, continued US-China tensions, more ballistic missile testing by North Korea, a growing partnership between Iran and Russia, and continued nuclear enrichment in Iran. While there are elections in 76 countries in 2024, only a handful of those will impact global economies and financial markets, including that of Taiwan in January and that of the US in November.
- Vigilance: As usual, we diligently watch for unexpected risks and remain vigilant in search of market opportunities.

"The greatness of America lies not in being more enlightened than any other nation, but rather in her ability to repair her faults."

– Alexis de Tocqueville

2024 Global Economic Outlook: Shifting Gears

AT THE OUTSET OF LAST YEAR, forecasts brimmed with caution. Worldwide inflation had alarmingly quadrupled to more than 10%[65] and signs of economic overheating were rampant across supply chains and labor markets. It was widely believed that recession was unavoidable, as global central banks had already delivered more than 280 interest rate hikes[66] and were signaling more to come.

But as we enter 2024, policymakers are taking their foot off the brakes. Last year's monetary tightening has thus far succeeded in downshifting economic growth without causing a recession. It has also contributed to a significant decline in global inflation, which is now running at about half its peak pace. As a result, central banks are turning their attention away from curbing inflation toward reducing risks to growth. We expect most major central banks to deliver their first rate cut this year.

There are other positive shifts afoot this year. Following a post-pandemic recovery that was turbocharged by the deployment of forced savings, we see more sustainable drivers of spending, such as labor income, taking over. This is particularly


R 1 3 5
2 4

visible in the US, where employment and wage growth are slowing but remain sufficient to sustain consumption. Meanwhile, Japan is on the verge of achieving price stability after decades of deflation. Indeed, we expect Japan to achieve its third consecutive year of above-target inflation in 2024, a feat it last attained in 1991. Even more broadly, the nascent shift toward artificial intelligence (AI) could ultimately reshape industries and labor markets worldwide.

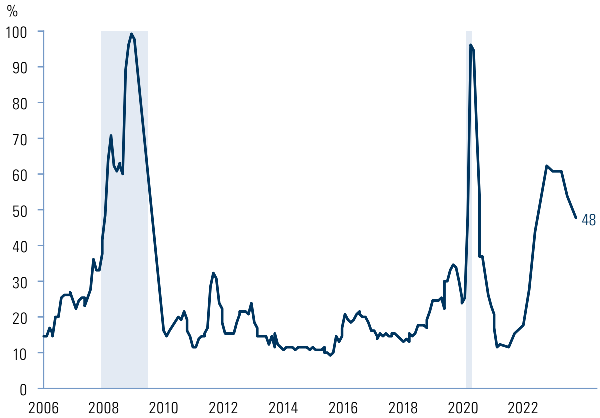
Despite the mileage traversed in the last year, risks still remain. Although both the Eurozone and the UK avoided recession in 2023, the anemic growth we expect this year leaves both regions dangerously close to stall speed. Even in the US, where growth has been most resilient, our recession probability of 30% stands above the historical average of around 18%. Put simply, great uncertainty remains around evolving geopolitical risks and the potential economic drag that may yet materialize from past monetary tightening.

Nevertheless, we need to differentiate the risk of recession from the certainty of one. Global growth has thus far proved more resilient than expected and recession odds have been steadily declining as a result. Moreover, interest rates have fallen alongside inflation, and our forecast calls for both trends to continue this year. The resulting decrease in borrowing costs weakens a key pillar of the recessionary argument.

Against this backdrop, we project another year of trend-like, 2.9% global growth in 2024 and remain vigilant for potholes on the road ahead (see Exhibit 68).

Exhibit 69: 12-Month US Recession Probability According to *WSJ* Survey of Economists

Economists have now placed well-above-average odds on a hard landing for two years.



Data through October 2023.
Note: Average probability of recession starting within 12 months. Shaded periods denote recessions.
Source: Investment Strategy Group, *Wall Street Journal*.

United States: Runway in Sight

Few topics have dominated economic debate in recent years as much as the looming risk of a US recession. Global economists have now placed well-above-average odds on a hard landing for two years, as seen in Exhibit 69. Our 2023 *Outlook* featured a similar concern, placing approximately even odds on a recession given the tightening in financial conditions necessary to tame inflation.

Yet as we enter 2024, several factors are bringing the once-distant runway for a soft landing

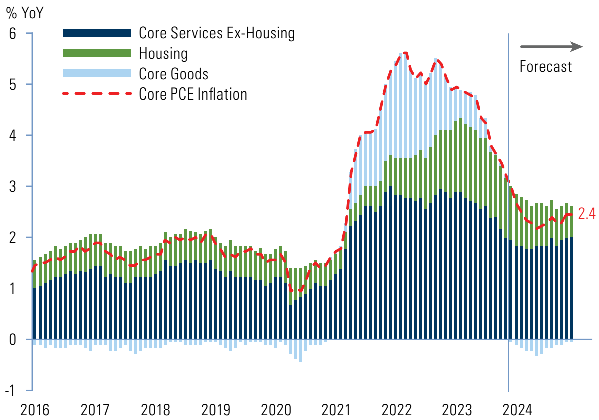
Exhibit 68: ISG Outlook for Developed Economies

	Real GDP Growth Annual Average (%)				Headline Inflation* Annual Average (%)		Core Inflation* Annual Average (%)		Policy Rate** End of Year (%)		10-Year Bond Yield*** End of Year (%)	
	2023	2024 Base Case	2024 Good Case	2024 Bad Case	2023	2024	2023	2024	2023	2024	2023	2024
United States	2.4	1.7–2.1	2.5	0.8	4.1	2.6–3.0	4.8	2.9–3.3	5.375	4.375	3.88	3.50–3.90
Eurozone	0.5	0.3–0.7	0.8	0.0	5.4	2.1–2.5	4.9	2.3–2.7	4.00	2.75	2.02	1.90–2.30
United Kingdom	0.6	0.3–0.7	0.8	0.0	7.3	2.5–2.9	6.1	3.1–3.5	5.25	4.50	3.54	3.10–3.50
Japan	2.0	0.7–1.1	1.3	0.3	3.2	2.5–2.9	3.1	2.5–2.9	-0.10	0.20	0.61	0.50–1.00

Data as of December 31, 2023.
Source: Investment Strategy Group, Haver Analytics, Bloomberg.
* Inflation refers to CPI inflation. Japan core inflation excludes fresh food, but includes energy.
** The US policy rate refers to the midpoint of the Federal Reserve's target range. The Eurozone policy rate refers to the ECB deposit facility. The Japan policy rate refers to the BOJ deposit rate.
*** For Eurozone bond yield, we show the 10-year German bund yield.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 70: Contribution to Core PCE Inflation

We expect inflation to cool further this year, with housing being the key contributor.



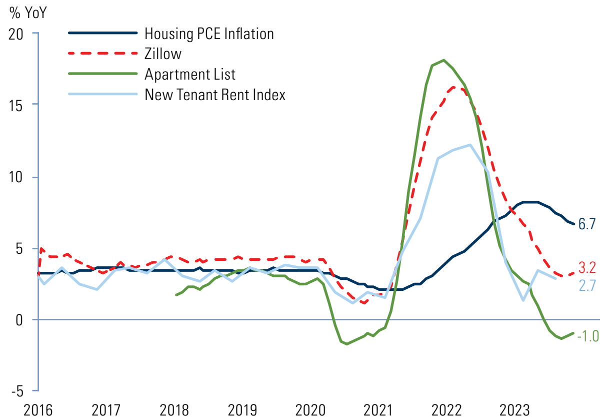
Data through November 2023. Forecast through 2024.

Source: Investment Strategy Group, Haver Analytics.

Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 71: US Market Rents and PCE Housing Services Inflation

The recent easing in rental rates will mechanically feed through to official housing inflation in coming months.



Data through November 2023.

Note: Zillow and Apartment List indices measure rents for a new lease by a new tenant. The New Tenant Rent Index measures prices renters would face if they changed housing unit every period.

Source: Investment Strategy Group, Apartment List, Zillow, Haver Analytics.

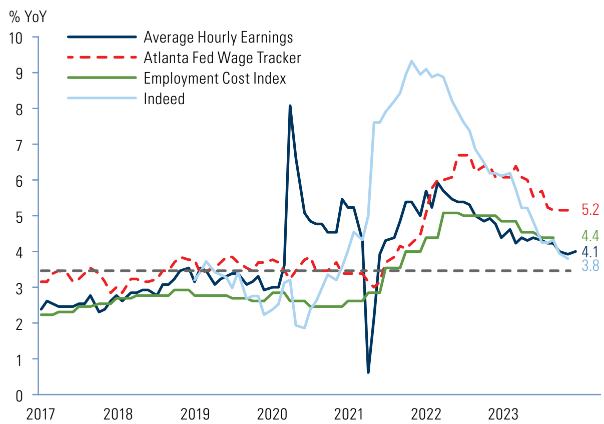
into view. The US economy has proven more resilient to high interest rates than expected, a positive consequence of the private sector locking in lower rates in the last decade by refinancing debt. Major central banks also likely concluded their historic tightening cycles in 2023, setting the stage for cuts later this year. And inflation fell despite resilient growth last year, suggesting that the normalization of supply-side disruptions will continue to exert downward pressure on prices.

We expect the inflation rate to be lower this year than last, at around 2.5% (see Exhibit 70). Goods prices have been the largest contributor to disinflation so far, but housing is poised to drive the next phase. That's because the recent easing in rental rates will mechanically feed through to official housing inflation with a lag of around 12 months (see Exhibit 71).

Disinflation in services other than housing—which represent more than half of the core PCE index—is likely to be more gradual. Wages represent the largest cost in delivering these services, and they continue to grow at a rate above the Federal Reserve's comfort level (see Exhibit 72). That said, the labor market has made substantial progress toward rebalancing—evident in job openings and the quits rate, which are now approaching pre-pandemic levels (see

Exhibit 72: US Wage and Employment Costs

Wages continue to grow at a rate above the Federal Reserve's comfort level.



Data as of December 2023.

Note: Horizontal dotted line indicates the estimated rate of wage growth consistent with 2% inflation.

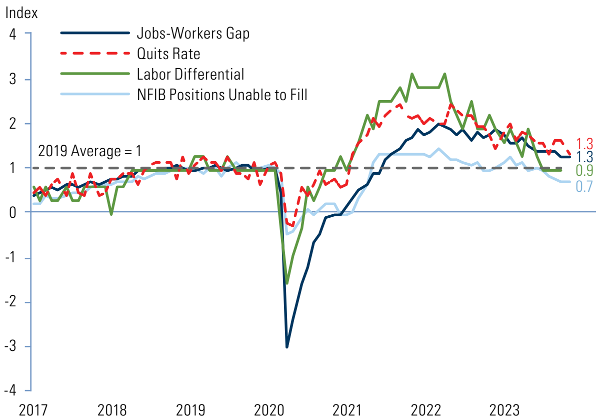
Source: Investment Strategy Group, Haver Analytics.

Exhibit 73)—without a significant rise in the unemployment rate.

This historically rare outcome reflects two unique factors in this cycle. First, job openings greatly exceeded available workers, which has enabled a reduction in job postings without the

Exhibit 73: Measures of US Labor Market Tightness

The labor market has made substantial progress toward rebalancing.



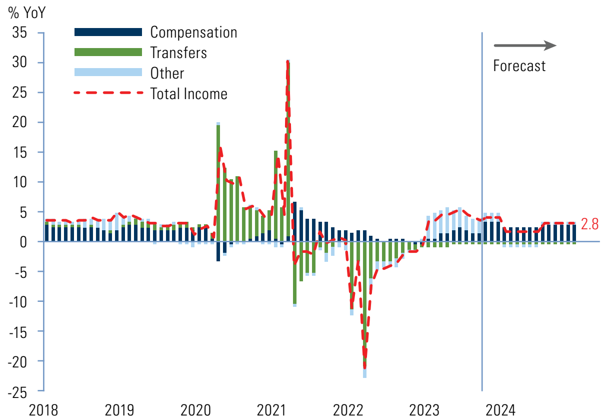
Data through November 2023.

Note: Labor differential is a survey measure of consumers who think jobs are plentiful versus those who think jobs are hard to get. National Federation of Independent Business (NFIB) survey is the percentage of firms with positions unable to fill.

Source: Investment Strategy Group, BLS, Conference Board, National Federation of Independent Business, Haver Analytics.

Exhibit 75: Contribution to US Real Household Income Growth

Solid real income growth should support consumption.



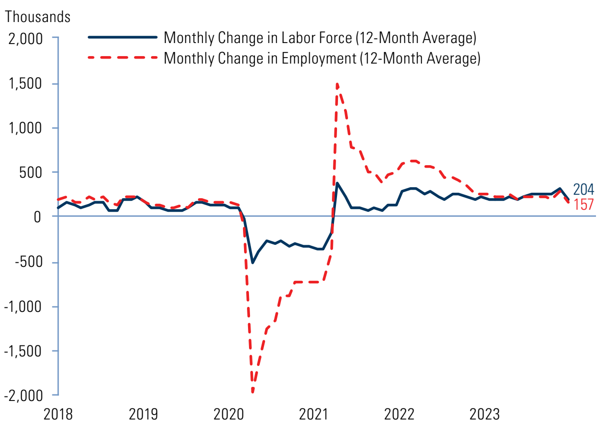
Data through September 2023. Forecast through 2024.

Source: Investment Strategy Group, Goldman Sachs Global Investment Research, Department of Commerce.

Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 74: Change in US Employment and Labor Supply

Employment growth has been aided by strong labor supply.



Data through December 2023.

Source: Investment Strategy Group, BLS, Haver Analytics.

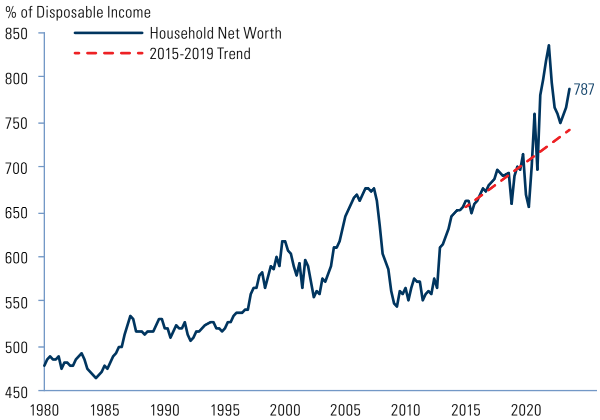
corresponding job losses seen in the past. Second, rising labor supply has absorbed much of the excess demand for workers, dampening the wage pressure that would have prompted further monetary policy tightening (see Exhibit 74). We expect these rebalancing dynamics to continue this year, with a further slowdown in job growth and only a modest increase in the unemployment rate, from 3.7% to 4.1%.

Turning to GDP, we expect trend-like growth of 1.9% in 2024, supported by three factors: a robust household sector, stable investment and gradually easing financial conditions. In considering the first factor, it is worth remembering that household consumption accounts for nearly 70% of US GDP. Although consumption is expected to slow from last year's brisk pace, we still see it growing approximately 2% in 2024. Rising real incomes are the key driver of this forecast, reflecting a waning drag from inflation as well as continued gains in jobs, wages and interest income (see Exhibit 75).

Strong household balance sheets should also support consumption. Household net worth remains at very healthy levels above its pre-pandemic trend, as shown in Exhibit 76. At the same time, consumers' large stock of fixed-rate debt—particularly in mortgages—has kept their debt service ratio at historically low levels despite the increase in interest rates (see Exhibit 77). While there is some worry about rising delinquencies on auto and credit card loans, we view this as a normalization from unusually low

Exhibit 76: Net Worth of US Households and Nonprofit Organizations

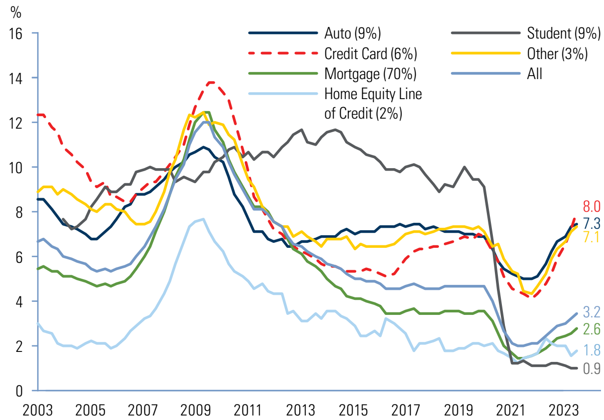
Household net worth remains at very healthy levels above its pre-pandemic trend.



Data through Q3 2023.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 78: US Household Delinquency Rate by Loan Type

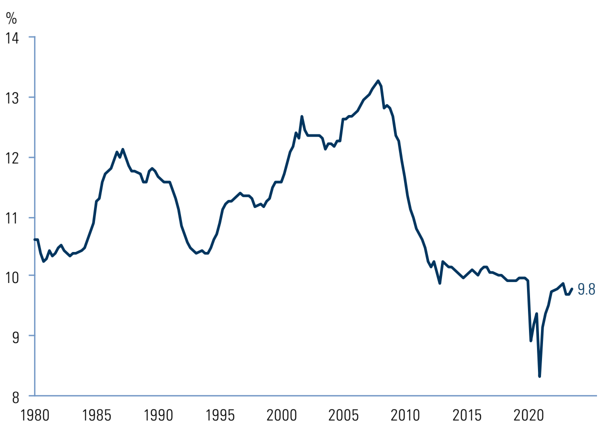
Delinquency rates on consumer debt have normalized, and the increase should slow from here.



Data through Q3 2023.
Note: New delinquent (30+ days) balances. Weight of loan type in total household loans denoted in parentheses.
Source: Investment Strategy Group, Federal Reserve Bank of New York, Haver Analytics.

Exhibit 77: US Household Debt Service Ratio

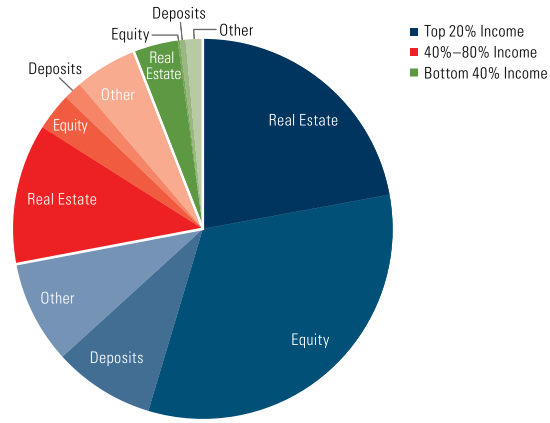
Consumers' large stock of fixed-rate debt has kept their debt service ratio low despite higher interest rates.



Data through Q3 2023.
Note: Ratio of debt service payments to disposable personal income.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 79: Distribution of Increase in US Household Assets Since Q4 2019

Households with higher incomes hold a growing portion of their wealth in less-liquid assets.



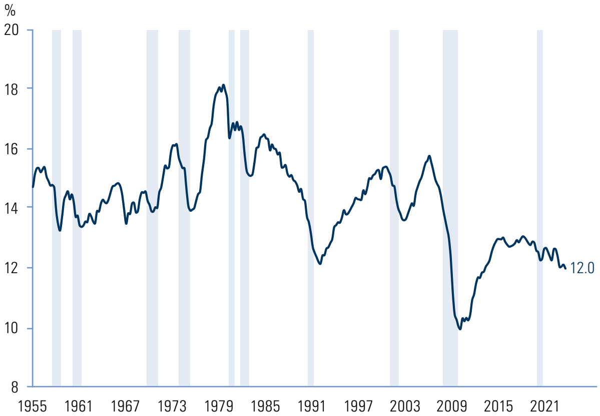
Data through Q2 2023.
Note: Calculated as the change in the balance of each segment since Q4 2019.
Source: Investment Strategy Group, Federal Reserve Board, Haver Analytics.

pandemic-era levels and expect the rate of increase in delinquencies to slow in 2024 (see Exhibit 78).

Other frequently cited impediments to spending seem less alarming on closer inspection. Although households with higher incomes do hold a growing portion of their wealth in less liquid assets such as real estate (see Exhibit 79), they also have the largest share of spendable disposable income. As a result, they will continue to represent a disproportionately large share of spending on both necessities and luxuries. We are equally skeptical of the notion that consumption will falter this year as consumers deplete their pandemic-induced savings. While these savings did spur spending

Exhibit 80: US Fixed Investment as a Share of GDP

Already depressed investment limits the scope for downside this year.



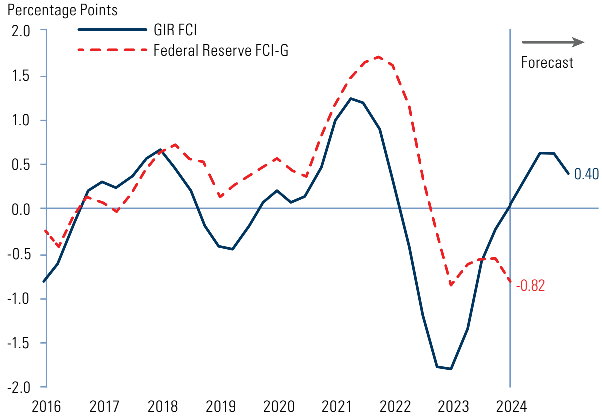
Data through Q3 2023.

Note: Shaded periods denote recessions. Calculation excludes intellectual property product investment.

Source: Investment Strategy Group, Haver Analytics.

Exhibit 82: Impulse from Financial Conditions on US GDP Growth

We believe most of the economic drag from Federal Reserve tightening has already occurred.



Data through Q4 2023. Forecast through 2024.

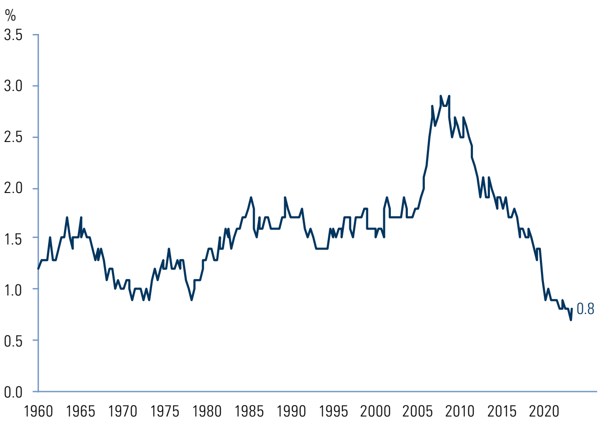
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, Federal Reserve Board.

Note: GIR FCI denotes the quarterly growth impulse from past changes in financial conditions. Federal Reserve FCI-G denotes impulse to growth over the following year.

Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 81: US Homeowner Vacancy Rate

A tight housing market should stabilize residential investment.



Data through Q3 2023.

Source: Investment Strategy Group, Haver Analytics.

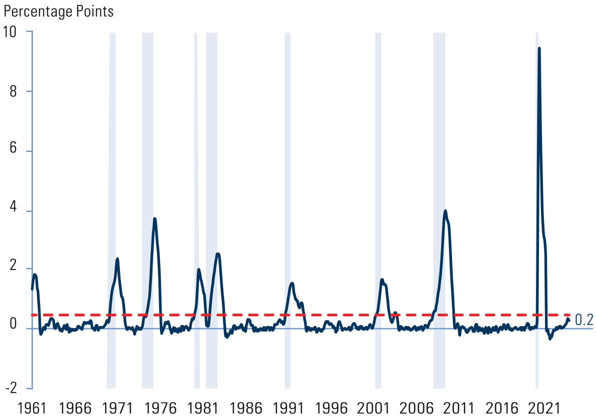
following widespread vaccinations in 2021—and helped alleviate the drag from inflation in 2022—their significance has been waning. In fact, savings balances for most income groups, once adjusted for inflation, had already returned to pre-pandemic levels by early last year.

The US economy is also underpinned by stable investment, the second key factor in our forecast. Fixed investment currently stands at a historically low share of GDP (see Exhibit 80), devoid of the overinvestment often seen ahead of recessions. Residential investment specifically has already declined significantly, as mortgage rates have reached multi-decade highs. But activity is now stabilizing, given the paucity of housing supply—a result of both unwilling sellers and inadequate new construction (see Exhibit 81). As a result, the potential for either significant downside or a substantial surge in investment seems limited, particularly considering still-high interest rates, subdued business sentiment and the diminishing influence of government incentives.

The last factor supporting our growth forecast is gradually easing financial conditions. Although the Federal Reserve's models imply that its past tightening will continue to weigh on GDP growth this year (see Exhibit 82), we believe most of this effect has already occurred. Moreover, any residual drag is likely to be offset by the four 25-basis-point Federal Reserve rate cuts we expect this year, starting in March. Our forecast for generally lower global bond yields and higher risk

Exhibit 83: The "Sahm Rule" Change in the US Unemployment Rate

Small increases in the unemployment rate can create negative feedback loops.



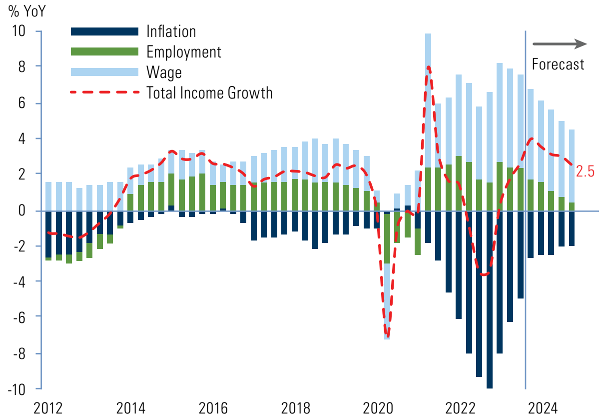
Data through December 2023.

Note: The Sahm Rule, created by economist Claudia Sahm, is an economic indicator that uses the change in the 3-month average of the unemployment rate from its low point in the prior 12 months to identify recessions. An increase above 0.5% is historically consistent with the start of a recession. Shaded periods denote recessions.

Source: Investment Strategy Group, BLS, Haver Analytics.

Exhibit 84: Eurozone Real Labor Income Decomposition

Real incomes should benefit from falling inflation and continued strong wage growth.



Data through Q3 2023. Forecast through 2024.

Source: Investment Strategy Group, Haver Analytics.

Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

asset prices also translates into easier financial conditions.

Despite this relatively optimistic base case, our recession probability of 30% remains above the historical average of around 18%. Great uncertainty persists about the significance of still-inverted yield curves and the lagged impact of past monetary tightening, even if—as we suspect—pandemic distortions may compromise many previously reliable recession signals. Our expectation for a modest increase in the unemployment rate could even prompt a negative feedback loop of weaker spending and increased layoffs, as has been the norm historically (see Exhibit 83).

Said differently, while we can see the runway for a soft landing, seatbelts should remain fastened until we reach the gate.

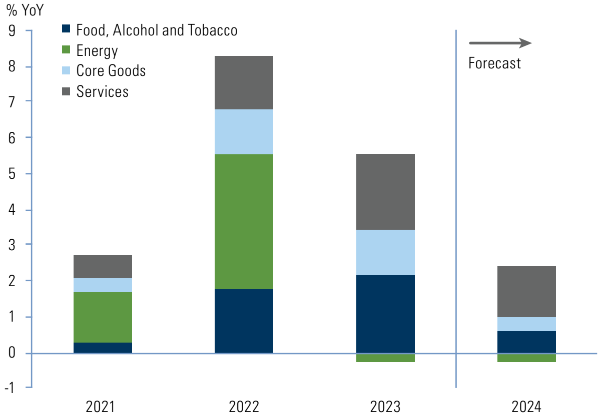
The Eurozone: Status Quo

It is often said that investors should expect the unexpected. Such was the case with the Eurozone economy last year, as a widely anticipated recession never materialized. A resilient labor market, supportive fiscal policies and a favorable external environment all played a role, and a fortuitously mild winter that kept energy prices in check was also key. Despite these positives, however, the economy slowed in the latter half of the year as consumption and investment sagged under the weight of tight financial conditions and mounting price pressures. Inflation did fall dramatically late in the year—to 2.9% in December from a peak of 10.6%—but full-year GDP growth was still anemic, at just 0.5%.

We expect another year of below-potential growth, at 0.5% in 2024, as near-term activity is hindered by modest restraint in fiscal spending, continued tight financial conditions and slower global economic activity. But unlike last year, 2024 should see economic activity strengthen for several reasons. First, real incomes should benefit from falling inflation combined with continued strong wage growth (see Exhibit 84). Second, the drag from tight financial conditions should abate as the European Central Bank (ECB) reduces its policy rate. Third, distributions under Europe's pandemic recovery plan—NextGenerationEU—will offset part of the impact from fiscal restraint. Lastly, production in the manufacturing sector is set to improve modestly as demand recovers and inventories rebuild. Taken together, these factors should push year-over-year GDP growth from 0% in Q4 last year to 1.1% in Q4 2024.

Exhibit 85: Eurozone Inflation Breakdown

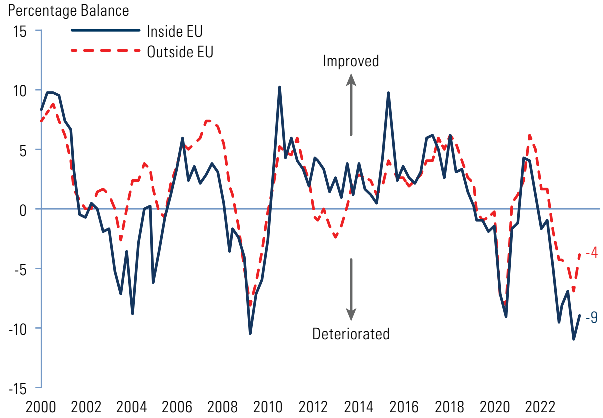
We expect services inflation to decline, albeit gradually given persistent wage pressures.



Data through December 2023. Forecast through 2024.
Source: Investment Strategy Group, Haver Analytics, Eurostat.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 86: Eurozone Competitiveness Position

The energy crisis has eroded the perception of Eurozone businesses' international competitiveness.



Data through Q4 2023.
Note: Inside EU denotes the assessment of the competitive position on the foreign market inside the EU. Outside EU denotes the assessment of the competitive position outside of the EU. Percentage balance equals percentage of respondents reporting an increase in competitiveness minus the percentage of respondents reporting a decrease.
Source: Investment Strategy Group, Haver Analytics, European Commission.

Despite the increase in activity, we foresee a deceleration in inflation to 2.3% this year, down from 5.4% in 2023. This slowdown aligns with our projection of sustained below-trend growth and a waning impact from past energy price increases. Services inflation should also decline, but more gradually, given persistent wage pressures in the still-tight labor market (see Exhibit 85).

In this context, we anticipate the ECB will begin easing policy in April, cutting interest rates by 125 basis points this year. However, we see a growing likelihood of more frequent and earlier rate cuts, given that inflation has recently come in below expectations and that the ECB may be influenced by the US Federal Reserve cuts we expect in March. The ECB is likely to further reduce its balance sheet through the passive runoff of the Pandemic Emergency Purchase Programme (PEPP) in the second half of the year.

Risks to our outlook include a renewed energy price surge and sustained weakness in domestic demand. The Eurozone also faces long-term structural challenges. As seen in Exhibit 86, the energy crisis has exacerbated the perceived decline in its businesses' international competitiveness.

We anticipate the ECB will begin easing policy in April, cutting interest rates by 125 basis points this year. However, we see a growing likelihood of more frequent and earlier rate cuts.

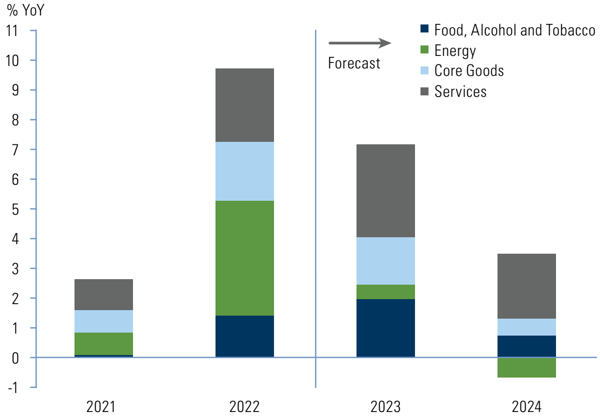
United Kingdom: A Step in the Right Direction

The UK economy also defied expectations for a recession in 2023. The first half of the year saw strong growth, as domestic demand was resilient despite a cost-of-living crisis, and fiscal policy was less restrictive than feared. But economic activity slowed in the second half as interest rates rose, creating a particularly challenging backdrop for the UK given the two- to five-year life span of most UK mortgages.

Although this weak momentum is expected to continue into 2024, the latter half of the year is anticipated to strengthen based on three factors. First, the drag from tight financial conditions

Exhibit 87: UK Inflation Breakdown

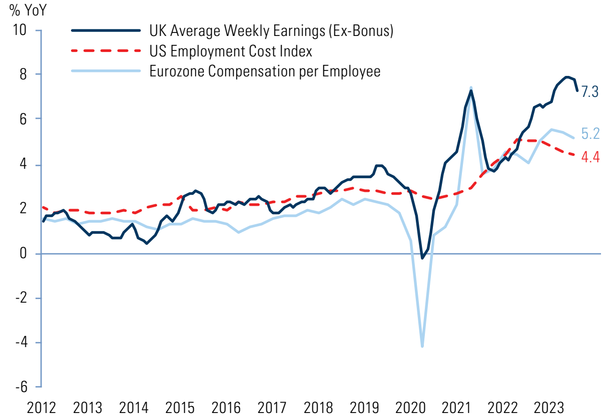
We expect disinflation to broaden from energy prices to food and core goods prices.



Data through November 2023. Forecast through 2024.
Source: Investment Strategy Group, Haver Analytics.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 88: Wage Growth Across Developed Market Countries

A tight UK labor market implies ongoing wage pressure.



Data through October 2023.
Source: Investment Strategy Group, Haver Analytics.

should abate as the Bank of England (BOE) reduces its policy rate. Second, fiscal policy is becoming less restrictive, evident in the Autumn Statement budget announced last November and the additional stimulus measures we expect in the lead-up to this year's general election. Lastly, real incomes and consumption should benefit from continued strong wage growth and falling inflation.

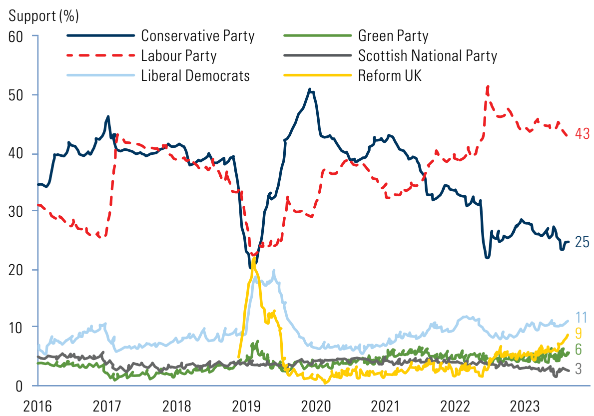
On the last point, we expect the decline in inflation to continue. As seen in Exhibit 87, disinflation should broaden from falling energy prices to moderating food and core goods prices. However, inflation is projected to remain above the BOE's 2% target, as energy prices have stabilized, and a still-tight labor market implies ongoing wage pressure (see Exhibit 88).

Against this backdrop, the BOE is likely to begin lowering its policy rate. We anticipate three 25-basis-point rate cuts this year starting in May, supporting a gradual easing of financial conditions. However, there is a growing likelihood of more frequent and earlier rate cuts given that inflation has recently come in well below expectations.

Political risk is also a feature of this year's outlook, as the Labour Party's current lead in the polls suggests there could be a change in government following the upcoming general election (see Exhibit 89). While a Labour government might have a slightly more expansionary fiscal agenda that could unsettle markets, the traumatic memory of the 2022 "mini-budget" is expected to enforce fiscal discipline and prevent any drastic changes.

Exhibit 89: UK Election Polls

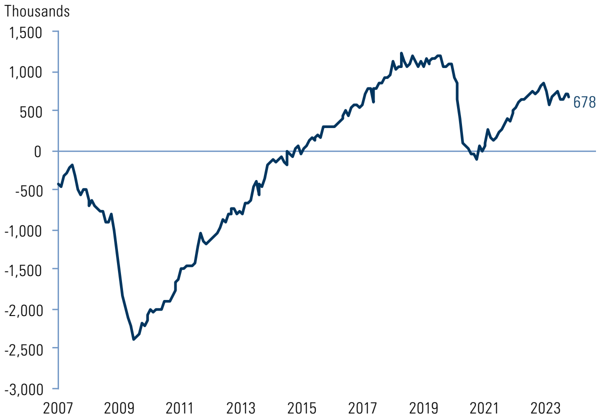
Polls suggest there could be a change in government following the upcoming general election.



Data through December 22, 2023.
Source: Investment Strategy Group, Politico, moving average of various pollsters.

Exhibit 90: Japanese Jobs-Workers Gap

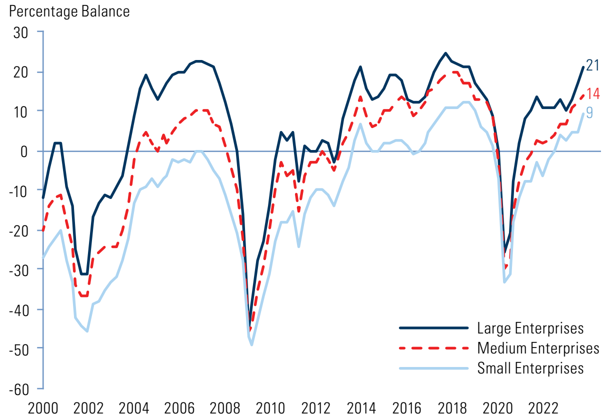
Three consecutive years of above-trend growth have tightened Japan's labor market.



Data through November 2023.
Note: The jobs-workers gap measures the difference between active job openings and the number of unemployed people.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 92: Japanese Tankan Survey of Business Conditions

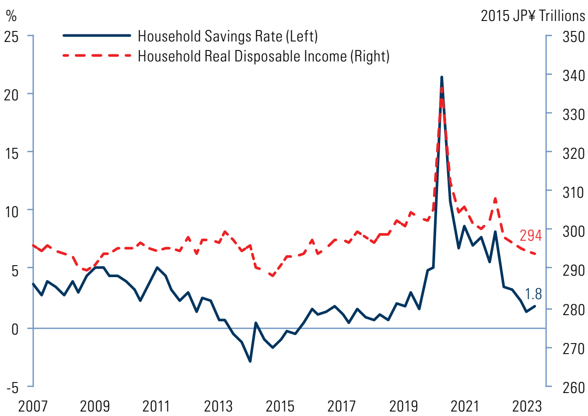
Positive business sentiment will likely support another year of above-trend growth in Japan.



Data through Q4 2023.
Note: Percentage balance equals percentage of respondents reporting favorable business conditions minus the percentage of respondents reporting unfavorable conditions.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 91: Japanese Household Real Disposable Income and Savings Rate

The Japanese economy is well positioned to reverse the trend of declining real disposable income.



Data through Q2 2023.
Source: Investment Strategy Group, Haver Analytics.

Japan: Off With the Shackles of Deflation

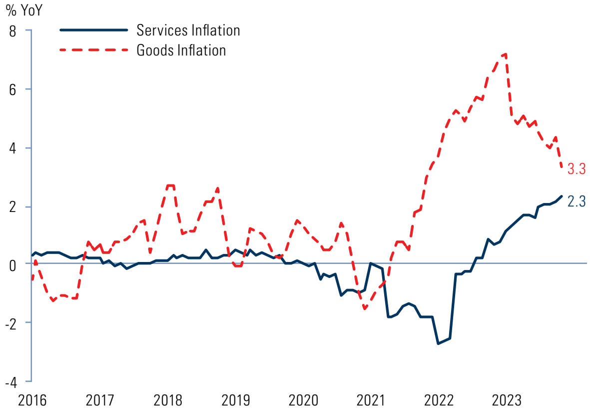
Japan may finally be overcoming its battle with deflation, which began in the 1990s following the collapse of its asset price bubble. The economy has now achieved two years in a row of more than 2% inflation and is on course for a third year, a feat it has not attained since 1989–91. While a sustainable cycle between wages and prices has yet to be firmly established, the prognosis is favorable.

Japan has generated three consecutive years of above-trend growth, with last year's 2.0% GDP expansion driven by pent-up domestic demand and a surge in inbound tourism. This has further tightened the labor market (see Exhibit 90). Although wages have lagged inflation so far—resulting in declining real disposable income (see Exhibit 91)—we think the economy is well positioned to reverse this trend.

Based on early signs from the *shunto* spring wage negotiations, this year's wage gains are likely to at least match last year's 3.6% increase. At the same time, a fiscal stimulus package announced last fall included an income tax refund that our colleagues in Goldman Sachs Global Investment Research estimate will add 1.6 percentage points to disposable income growth this year. We believe these factors—coupled with positive business sentiment and continued appetite for capital spending among businesses (see Exhibit 92)—will likely support another year of above-trend growth of 0.9% in 2024.

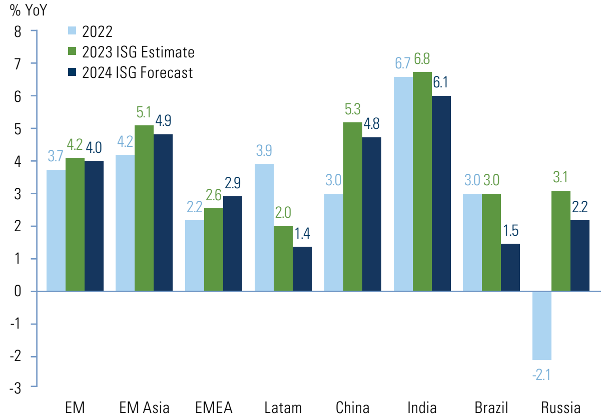
Continued economic strength should help keep inflation above its 2% target, although some moderation in its pace is expected as disinflation from goods prices continues and the boost to

Exhibit 93: Japanese Consumer Price Inflation
The drivers of inflation are shifting from goods to services.



Data through November 2023.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 94: Emerging Markets Real GDP Growth
We expect EM GDP growth to moderate to its long-term trend of approximately 4% in 2024.



Data through Q3 2023. Forecasts through 2024.
Source: Investment Strategy Group, International Monetary Fund.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

domestic prices from a weaker yen abates. In labor-intensive services, already-above-target inflation is likely to remain steady as companies transfer the burden of increased wages to consumers—a trend that could be reinforced by another successful round of wage negotiations (see Exhibit 93). Overall, we anticipate a slight deceleration in inflation to 2.7%, down from 3.2% in 2023.

As the factors driving inflation transition to a more sustainable feedback loop between rising wages and prices, we expect the Bank of Japan (BOJ) to begin rolling back its accommodative policy stance. Thus far, the BOJ has undertaken only minor adjustments to its yield curve control (YCC) policy aimed at ensuring its sustainability amid higher global interest rates. We expect more meaningful policy actions this year, including the BOJ signifying the end of the deflation era by terminating YCC and increasing its policy rate from -10 basis points to a positive 20 basis points.

Emerging Markets: Steering Through Choppy Waters

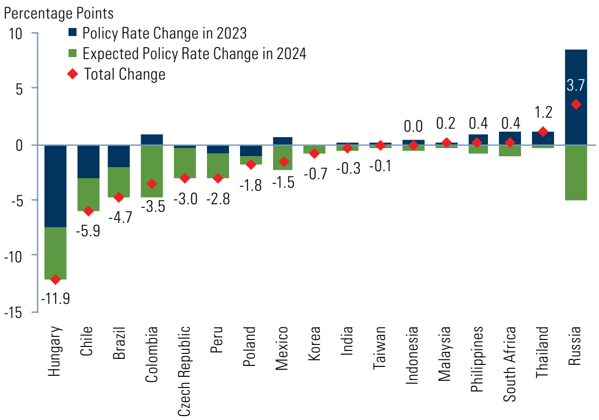
Emerging markets (EMs) faced a challenging environment last year, both at home and abroad. High interest rates crimped domestic demand, while export growth was lackluster despite the unexpected resilience in developed economies. In addition, net portfolio flows experienced a significant slowdown in the second half of the year due to skyrocketing global bond yields and renewed geopolitical unrest in the Middle East. Despite these choppy waters, EM GDP increased by approximately 4.2%, up from 3.7% in 2022. However, this improvement was primarily fueled by recoveries in China and Russia. Excluding these two major EM economies, the expansion in GDP slowed from 4.7% in 2022 to 3.7% last year.

This year, we expect headline EM GDP growth to moderate to its long-term trend of approximately 4% (see Exhibit 94). Our forecast for trend-like growth reflects counterbalancing dynamics. On the one hand, consumption is likely to be bolstered by an increase in real disposable income, as strong labor markets lift wages and inflation recedes alongside fading shocks in food and energy prices. On the other hand, export growth is apt to be muted, given our forecast for slower growth in developed economies.

The backdrop for policy support is equally mixed. We expect most EM central banks to cut their policy rate this year given further progress on disinflation as well as rate cuts by the Federal Reserve, ECB and BOE (see Exhibit 95). But the frequency and magnitude of these cuts will hinge on the degree of disinflation in core prices. This

Exhibit 95: Policy Rate Changes in 2023 and Consensus Expectations for 2024

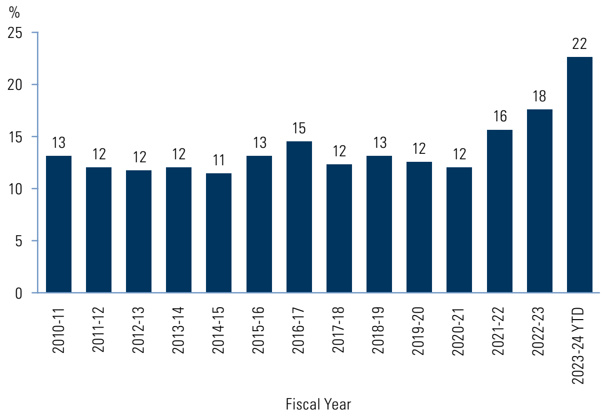
Emerging market central banks will likely cut their policy rates this year given further progress on disinflation.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 96: Share of Capex in Total Expenditures of India's Central Government

India's public capital expenditures have surged recently.



Data through November 2023.
Note: India's fiscal year starts in April and ends in March of the following year.
Source: Investment Strategy Group, Haver Analytics.

could lead to disappointment if still-tight labor markets and steady GDP growth fuel renewed pricing pressures. Similar nuances exist for fiscal policy. Most EM countries are expected to tighten fiscal policy to offset the last several years of generous government spending. But this drag could still be mitigated by the desire of some of these countries to spend prior to their forthcoming elections. Notable examples are Mexico, India, South Africa, Turkey and Brazil. These competing dynamics suggest only a mildly positive economic impulse from EM policymakers this year.

Emerging market economies also remain vulnerable to the external environment, despite their healthier current account balances and higher foreign currency reserves today. Along with the potential for disappointing growth in developed markets or China this year, some EM economies face adverse weather arising from El Niño, as well as elevated geopolitical uncertainty. These last two risks threaten to stoke renewed inflation in food and energy prices, thereby restricting the scope for monetary policy easing. Therefore, we see the risks to our EM growth forecasts as tilted slightly to the downside.

Asia

Asia expanded faster than other EM regions in 2023, growing 5.1% as price pressures subsided. With inflation in countries across the region now near or even below central bank targets, monetary policymakers can again prioritize GDP growth by cutting interest rates. But the extent of those cuts is likely to be constrained by the already narrow—or in some cases negative—spread to the US federal funds rate.

Beyond monetary easing, the region may get a boost from an expected recovery in technology exports, which are showing signs of revival now that the shift in global demand from goods to services has largely transpired. A rebound in technology exports would be particularly beneficial for the East Asian manufacturing hubs such as Korea and Taiwan.

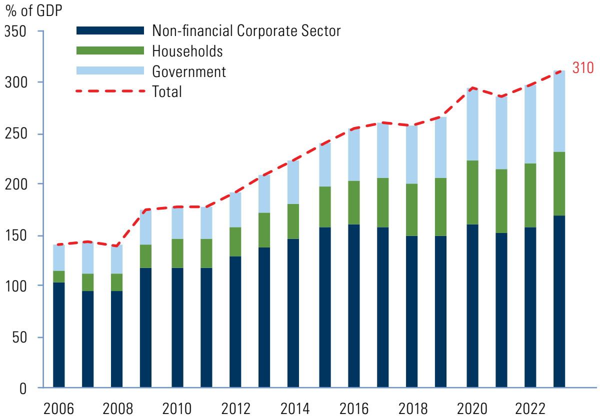
We expect India to be the fastest-growing economy in the region once again this year despite a projected deceleration in its growth rate to 6.1%. This slowdown in part reflects the government's commitment to contain the rise in fiscal spending after the recent surge in investment and public capital expenditures (see Exhibit 96).

China

China's recovery from COVID has been uneven and inconsistent. The initial boost from reopening in early 2023 had already faded by the second quarter. The economy managed to stabilize,

Exhibit 97: China's Debt-to-GDP Ratio

Years of overinvestment have left China with a debt-to-GDP ratio that now exceeds 300%.

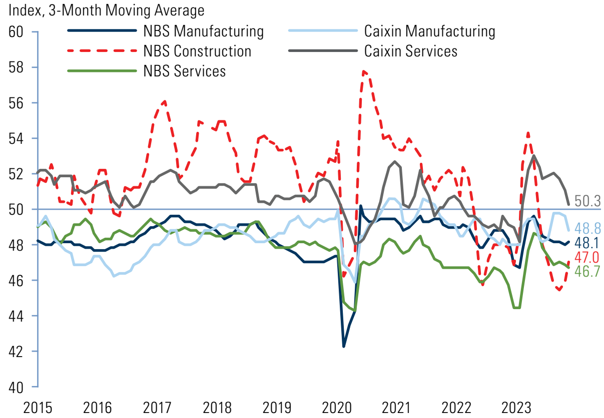


Data through 2022. Estimate through 2023.
Source: Investment Strategy Group, Haver Analytics.

Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 99: Chinese Employment PMIs

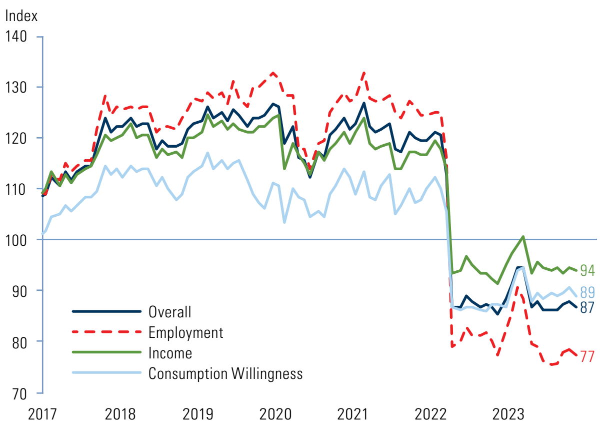
China's labor market is weak according to PMI surveys.



Data through November 2023.
Note: A PMI reading above 50 indicates improving employment conditions, and a reading below 50 indicates deteriorating conditions.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 98: Chinese Consumer Confidence Indicators

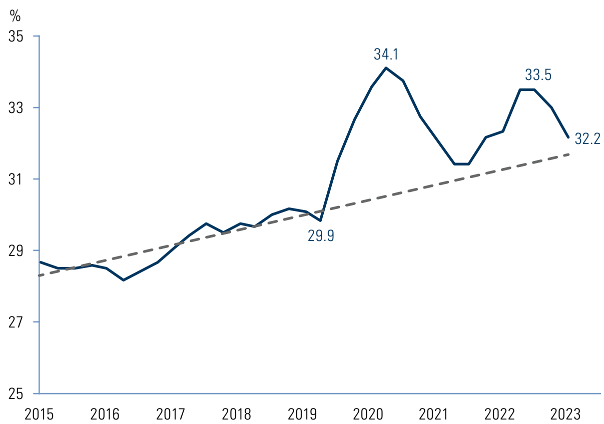
Chinese consumer confidence remains depressed.



Data as of November 2023.
Note: A reading above 100 indicates consumer optimism, and a reading below 100 indicates pessimism.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 100: China's Household Savings Rate

The savings rate of Chinese households is returning to its pre-pandemic trend.



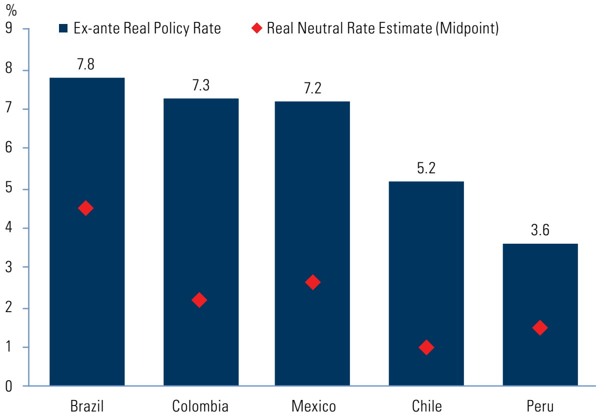
Data through Q3 2023.
Note: Dotted line denotes trend between 2015 and 2019.
Source: Investment Strategy Group, Haver Analytics.

but only after policymakers implemented a series of stimulus measures. These included additional funding for infrastructure investment and reductions in both the policy rate and the commercial bank reserve requirement ratio (RRR).

The challenges faced by China's economy last year were not just cyclical, but structural as well. The sharp downturn in its property sector and the financial struggles of its local governments reflect years of overinvestment that have left the country with a debt-to-GDP ratio that now exceeds 300%

Exhibit 101: Ex-ante Real Policy Rates vs. Neutral Rate Estimates in Latin America

Latin American central banks have lifted policy rates into very restrictive territory.



Data as of December 2023.
Note: Ex-ante real policy rates are obtained by subtracting one-year inflation expectations (survey-based) from latest central bank policy rates.
Source: Investment Strategy Group, Haver Analytics, national central banks.

(see Exhibit 97). Although China may still avoid a financial crisis—most of the debt has been issued in its own currency, is held by domestic investors and has a low coupon rate—the cost of repairing its balance sheet is increasingly crowding out more productive investments. Last year alone, the government announced a RMB 1 trillion package (0.8% of GDP) to address local government debt issues. At the same time, regulators have directed banks to continue lending to struggling property developers despite growing questions about the value of the collateral securing these loans.

In this context, we expect GDP growth to slow to 4.8% this year, down from an estimated 5.3% in 2023. Last year's main growth driver, consumption, will continue to recover. But the pace will be slower due to weak sentiment, a soft labor market and diminished excess savings (see Exhibits 98, 99 and 100). The beleaguered property sector will also continue to be a drag on growth, as newly started construction has yet to recover after falling by 22% in the first 11 months of last year. But for the time being, further real estate weakness should be curtailed by recent government measures, including planned investments in various public housing projects.

As economic activity moderates, the rate of inflation is expected to remain subdued. We project headline inflation to rise by 1.0% this year, up from 0.3% in 2023. The increase reflects a modest pickup in food prices, a fading benefit from lower energy prices and firmer core inflation as consumption demand catches up with supply.

The main risks to the 2024 outlook are related to China's structural issues, especially the previously mentioned debt overhang. The property sector and local government finances remain vulnerable to a more severe downturn if government measures fail to relieve the stress in these sectors.

Latin America

Latin America's growth slowed to 2.0% last year, down from 3.9% in 2022. The slowdown was largely due to these countries' high real interest rates, which more than offset the improvement in their terms of trade.

Latin American central banks were among the first to raise interest rates in this cycle and lifted them rapidly to very restrictive levels (see Exhibit 101). As inflation has subsided, these banks have also been at the forefront of reducing rates. Brazil, Chile, Peru and Colombia have already initiated rate cuts, and Mexico is anticipated to do so soon.

Even as monetary policy is becoming more synchronized across the region, the growth rates of individual countries are diverging. For example, the economies of Chile, Peru and Colombia are likely to see GDP growth reaccelerate from low levels. But Mexico and Brazil are more likely to face slowdowns, as the boost they enjoyed from a stronger US economy and a surge in agricultural production is waning.

In Brazil, the slowdown is likely to be cushioned by more lenient monetary policy and a resilient labor market, which together should bolster investment and consumption. Growth could even exceed expectations if the government refrains from implementing planned fiscal consolidation. However, the resulting increase in economic growth would at least partially be offset by a reduction in the number of cuts undertaken by the central bank. In our base case, we see Brazilian GDP expanding by 1.5% and the central bank reducing its policy rate to approximately 9% by the end of 2024.

Central and Eastern Europe, the Middle East and Africa

Although growth in these regions accelerated last year, it was predominantly fueled by recoveries in Russia and Ukraine. Excluding these two wartorn countries, growth slowed sharply. Several factors contributed to the slowdown, including the wider repercussions of the military conflicts in both Ukraine and the Middle East, tight monetary policies in Eastern Europe, a difficult economic rebalancing in Turkey and recurring power shortages in South Africa.

Despite last year's challenges, some green shoots are emerging for these regions. In Central and Eastern Europe, inflation is falling rapidly, which should allow central banks to extend their rate cutting cycles. Falling inflation—along with still healthy wage growth—will also boost real incomes, which should bolster consumption in the region.

We do not expect the Russian economy to repeat last year's strong growth, which was driven by expansionary fiscal policy and increased military production. Instead, the economy appears to be overheating, evident in the combination of strong domestic demand, high loan growth, a tight labor market and rising inflation. The resulting resurgence in inflationary pressures has already prompted the central bank to embark on an aggressive rate hiking cycle, which should ultimately weigh on domestic demand. Even so, we expect GDP growth of 2.2% this year as fiscal spending on the war continues.

2024 Financial Markets Outlook: Past the Rapids

INVESTORS HAVE ENDURED A WHITE-KNUCKLED RIDE through financial markets in the past two years. The S&P 500 fell 18% in 2022, only to surge 26% higher in 2023.[67] Bonds followed a similar line, with the Bloomberg Global Aggregate Bond Index rising nearly 6% last year after its 16% plunge in 2022.

Despite these gains, last year's journey was no less turbulent. A regional banking crisis, mounting geopolitical tensions and uncertainty over monetary policy contributed to bond volatility reaching multi-decade highs. Indeed, the final months of last year saw global bonds abruptly swing from a loss to a gain as investors grew more optimistic about central bank rate cuts. Broader equities were also volatile during these two months, with the equal-weighted S&P 500 turning a 4% loss for the year into a 14% gain. Investors who stayed the course in 2023 were rewarded, as the value of their bond and equity holdings increased by nearly $20 trillion in aggregate.[68]

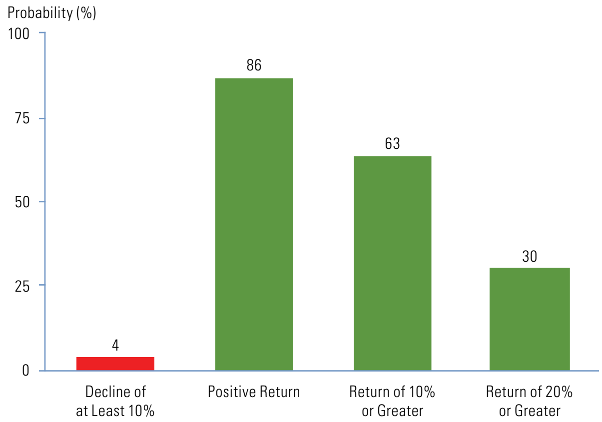
We believe 2024 will once again reward those who stay on board. Our outlook is underpinned by continued trend-like economic growth and the high likelihood of central bank rate cuts this year. Both of these factors support our expectations for better corporate earnings, positive bond returns and lowered odds of a US recession—to 30% from 45–55% last year. We also expect positive returns across global equities (see Exhibit 102), primarily driven by dividend income and growth in earnings.

The S&P 500 has generated a positive annual total return 86% of the time when the economy was expanding in the post-WWII period. This reinforces our long-standing view that recessions are the primary downside risk to equity holders, accounting for about three-quarters of past bear markets. Equity returns were also robust in past periods when the Federal Reserve reduced rates and the US economy avoided a recession, as we expect this year.

Although we are likely through the worst of the rapids, our vigilance remains high for any potentially dangerous twists or treacherous shallows that might upend performance. But we believe that diversified portfolios consistent with our strategic allocation recommendations should have sufficient cushion to absorb most shocks while continuing to ride the currents.

Exhibit 103: Odds of Various S&P 500 One-Year Total Returns During US Economic Expansions

Investors enjoy high odds of a positive return and a greater likelihood of large gains when the economy is expanding.



Data as of December 31, 2023.
Note: Based on data since 1945.
Source: Investment Strategy Group, Bloomberg.

US Equities: Balancing the Scales

For even the bullish among us, the performance of US equities last year was remarkable. The S&P 500's 26% total return not only significantly exceeded the consensus forecast of 6%, but also ranked in the top quartile of historical annual returns. Adding to its impressiveness, this substantial gain was achieved with below-average volatility. This was particularly noticeable in the last two months of 2023, when the index generated a risk-adjusted return that ranked in the top 1% of post-WWII observations.

But last year's stellar performance has also fueled concerns that the scales may have tipped against US equities. Valuations now stand in the 10th decile—equities have been cheaper at least 90% of the time historically. Similarly elevated valuations in past periods have weighed on equity performance over the subsequent five years and lowered the odds of positive returns. The fact that the bulk of last year's returns came from higher

Exhibit 102: ISG Global Equity Forecasts—Year-End 2024

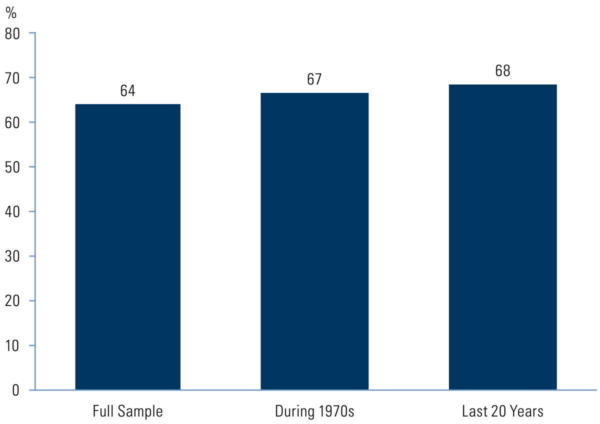
	2023 YE	End-2024 Central Case Target Range	Implied Upside from End-2023 Levels	Current Dividend Yield	Implied Total Return
S&P 500 (US)	4,770	4,950–5,050	4–6%	1.5%	5–7%
Euro Stoxx 50 (Eurozone)	4,521	4,600–4,850	2–7%	3.2%	5–10%
FTSE 100 (UK)	7,733	7,900–8,300	2–7%	4.1%	6–11%
TOPIX (Japan)	2,366	2,450–2,550	4–8%	2.5%	6–10%
MSCI EM (Emerging Markets)	1,024	1,050–1,100	3–7%	2.9%	5–10%

Data as of December 31, 2023.
Source: Investment Strategy Group, Datastream, Bloomberg.

Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Indices are gross of fees and returns can be significantly varied. Please see additional disclosures at the end of this *Outlook*.

Exhibit 104: Percentage of Time Profit Margins Expanded When S&P 500 Sales Grew

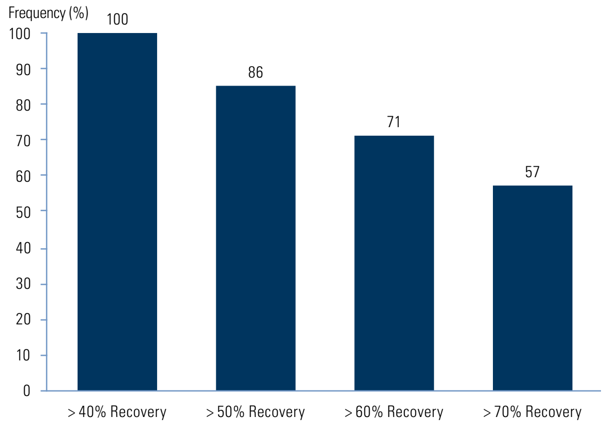
Periods with positive sales growth saw margins remain flat or expand about two-thirds of the time.



Data as of Q3 2023.
Note: Based on data since 1970.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, S&P Global, FactSet, Compustat.

Exhibit 105: Frequency of Margins Recovering Stated Share of Their Peak-to-Trough Decline in 2024

Past profit margin declines have been substantially recovered by the equivalent of year-end 2024.



Data through 2023.
Note: Based on profit margin declines of at least 1 percentage point from peak to trough since 1970. Smaller margin declines were followed by even faster recoveries.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, S&P Global, FactSet, Compustat.

P/E ratios—and not earnings growth—has further intensified these valuation worries. Other sources of angst include still-elevated recession risks, the outcome of the upcoming US presidential election and the evolution of various geopolitical risks.

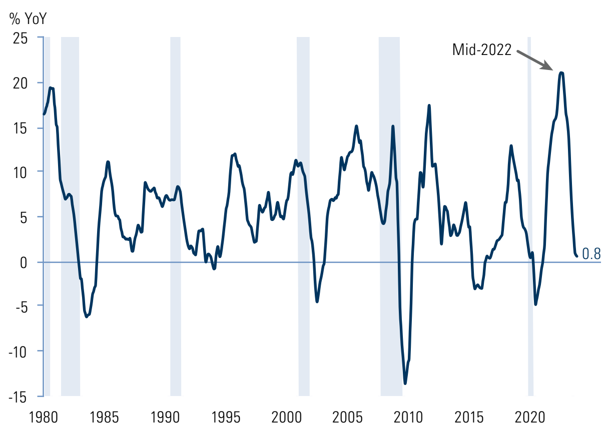
Against this backdrop, investors find themselves weighing the risk of loss that comes with remaining in the market against potential future gains that may be forfeited by exiting. Balancing the myriad factors at play, we still think it is premature to exit the market.

The cornerstone of this view is our projection for continued economic growth in the US. When the economy is expanding, investors have enjoyed 86% odds of a positive return and a much greater likelihood of large gains than of large losses (see Exhibit 103). Given that our forecast places a 30% probability on a recession this year—down from 45–55% in 2023—we think the economic backdrop remains favorable for stocks.

This close linkage between the economy and market performance is largely driven by earnings. Corporations are paid in nominal dollars, so their sales and earnings tend to track nominal GDP growth over time. Rising sales typically boost profit margins as well, since companies often have some fixed costs that do not increase with higher revenues. During past periods with positive sales growth, margins expanded about two-thirds of the time, even during the inflationary 1970s (see Exhibit 104).

Exhibit 106: Inventory Growth of Large-Capitalization Stocks

The inventory overhang that weighed on margins has run its course.

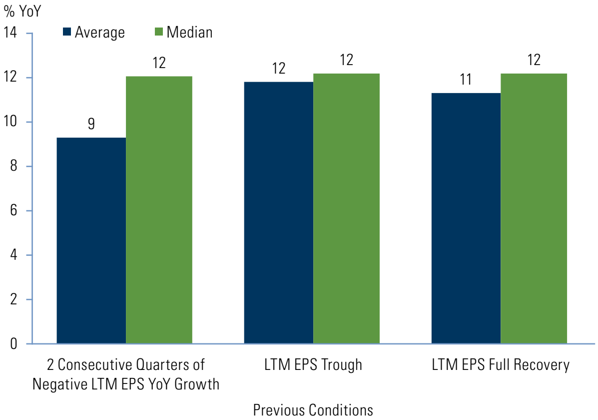


Data through December 2023.
Note: Excludes financials, REITs and utilities. Data smoothed on a trailing three-month basis. Shaded periods denote recessions.
Source: Investment Strategy Group, Empirical Research Partners Analysis, NBER.

Other historical parallels bode equally well for earnings in 2024. Previous periods that experienced a dip in profit margins like that seen in 2022 were followed by strong recoveries. In fact, nearly

Exhibit 107: 2024 Earnings Growth Implied by Past Earnings Paths Following Various Conditions

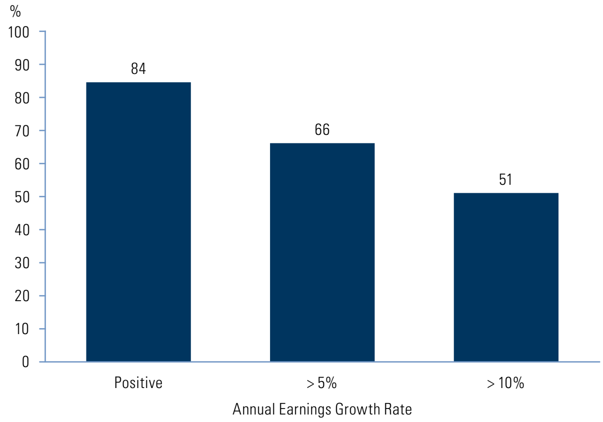
The typical recovery path of earnings during past cycles implies 9–12% earnings growth for the S&P 500 this year.



Data through 2023.
Note: Based on data since 1945.
Source: Investment Strategy Group, S&P Global.

Exhibit 108: Odds of Various S&P 500 Earnings Growth Rates During US Economic Expansions

Earnings growth topped 10% more than half the time in prior years that followed a similar path to the current episode.



Data as of Q3 2023.
Note: Based on data since 1945. Recession years are excluded. Early recoveries (defined as two years after recessions) are also excluded to remove outsize earnings growth caused by base effect from depressed starting earnings levels.
Source: Investment Strategy Group, S&P Global, NBER.

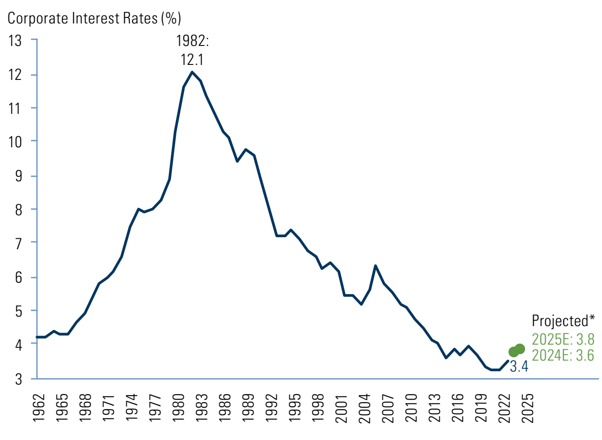
three-quarters of these episodes saw profit margins regain at least 60% of their declines in less than two years, making the consensus expectation for a comparable recovery by year-end quite plausible (see Exhibit 105). That expectation is reinforced now that the inventory overhang that weighed on margins has run its course (see Exhibit 106). Similarly, the typical recovery path of earnings during past cycles implies 9–12% earnings growth this year, in line with current consensus forecasts (see Exhibit 107). Keep in mind that in prior years that followed a similar path to the current episode, annual earnings growth topped 10% more than half the time (see Exhibit 108).

While some worry about the impact of rising borrowing costs on profitability, we are more sanguine. Only 8% of S&P 500 debt matures annually, and 92% of it is fixed-rate. As a result, it would likely take several years of high interest rates to meaningfully increase total borrowing costs (see Exhibit 109). Interest expense must also be netted against the interest income now being earned on the almost $2 trillion of cash held by non-financial firms.

A similar level of cautious optimism could extend to valuation concerns. History teaches us that high valuations alone are not a good reason to underweight stocks. Recall that the beginning P/E ratio has explained only 6% of

Exhibit 109: Weighted Average Interest Rate for S&P 500 Non-Financial Firms

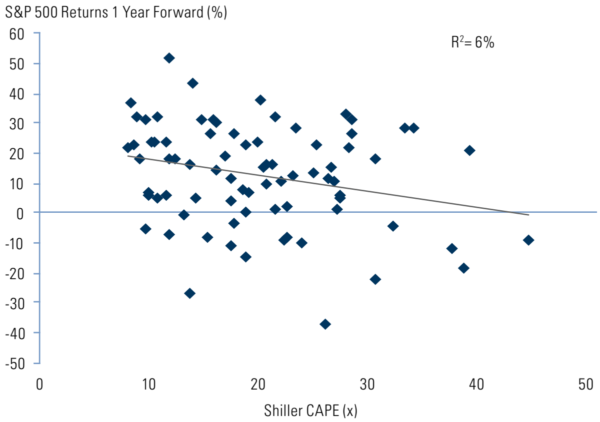
It would likely take several years of high interest rates to meaningfully increase total borrowing costs.



Data through Q3 2023. Forecasts through 2025.
Source: Investment Strategy Group, Bloomberg, Barclays.
* The projections assume that floating-rate debt reprices higher by 0.72pp than what was paid over the prior 12 months and assume the Federal Reserve holds the federal funds rate constant. For maturing fixed-rate debt, we assume it is refinanced at the current yield to worst of the Bloomberg Barclays Investment Grade Corporate Index (5.06% as of December 29, 2023).
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Indices are gross of fees and returns can be significantly varied. Please see additional disclosures at the end of this *Outlook*.

Exhibit 110: S&P 500 Shiller CAPE vs. Subsequent Calendar-Year Total Return

Starting valuation multiples tell us little about potential returns over the next year.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg, Robert Shiller.

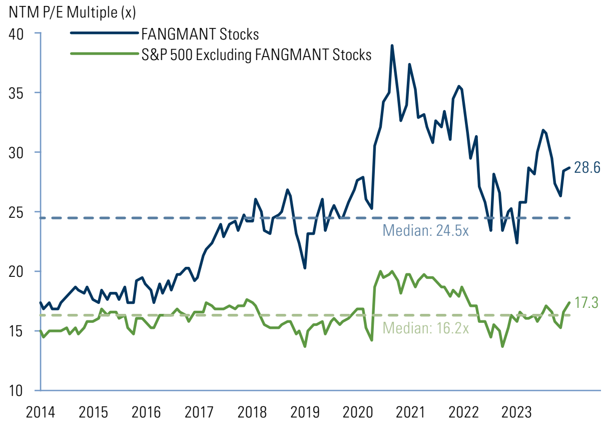
Exhibit 111: S&P 500 Total Returns After Crossing Into the 9th and 10th Deciles of Valuation

Equities continued to rally even after valuations became expensive in the past two bull markets.

Data through December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

Exhibit 112: Price to Next-12-Month EPS Multiples

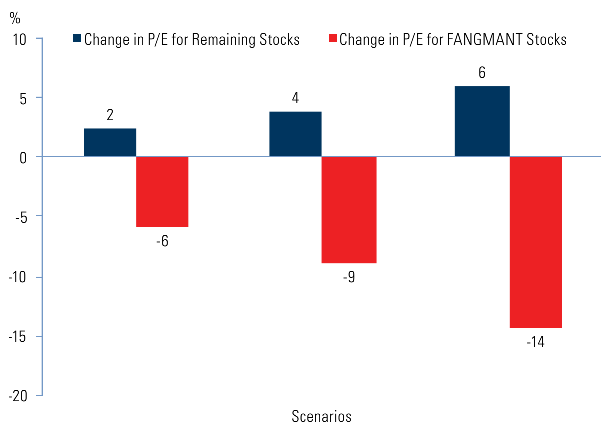
The remaining S&P 500 stocks excluding the FANGMANT shares trade at less demanding valuations.



Data through December 2023.
Note: FANGMANT stocks include Facebook/Meta, Apple, Netflix, Google/Alphabet, Microsoft, Amazon, Nvidia and Tesla.
Source: Investment Strategy Group, FactSet.

Exhibit 113: Change in Cohort P/E Ratios That Result in Flat S&P 500 P/E Ratio

A modest valuation increase in the remaining stocks could offset a material valuation decline in the FANGMANT stocks.

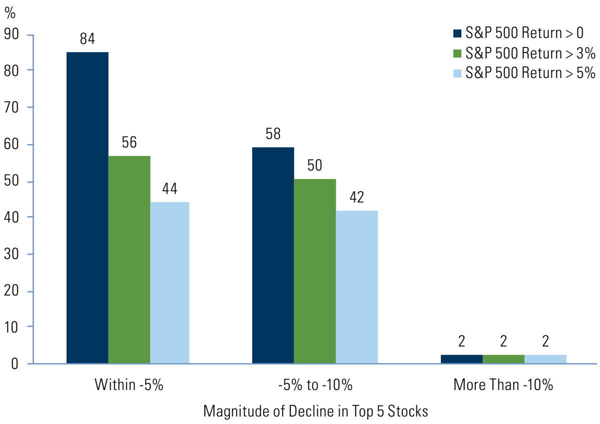


Data as of December 31, 2023.
Note: A -14% change in P/E for FANGMANT stocks implies that FANGMANT valuations decline back to the median level of the past decade. Based on price to next-12-month EPS multiple. FANGMANT stocks include Facebook/Meta, Apple, Netflix, Google/Alphabet, Microsoft, Amazon, Nvidia and Tesla.
Source: Investment Strategy Group, FactSet.

the variation in returns over the next year (see Exhibit 110). Moreover, an analysis by three London Business School professors found that a strategy of selling equities based on expensive valuations underperformed a strategy of remaining invested, across every one of the 20 countries they examined.[69] Finally, past periods with elevated valuations still saw substantial subsequent returns, highlighting the penalty for exiting equities prematurely (see Exhibit 111).

Exhibit 114: Percentage of Time S&P 500 Gained When the Top 5 Stocks Declined

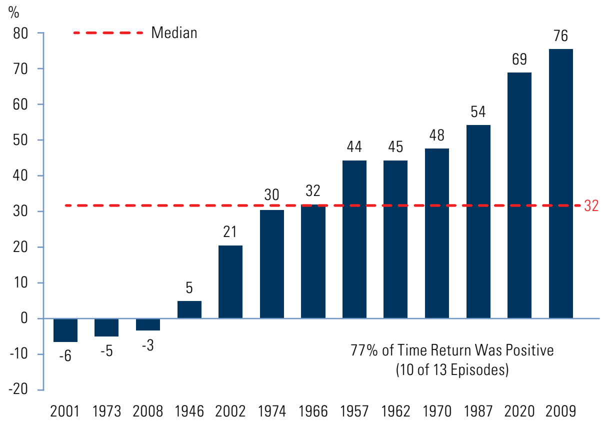
S&P 500 often posted gains even when its largest stocks underperformed and experienced losses of up to 10%.



Data as of December 31, 2023.
Note: Historical frequencies of S&P 500 gains are based on rolling 12-month windows since 1970 when the top 5 stocks declined and underperformed the remaining stocks. Historical S&P 500 returns are adjusted to reflect today's high market cap weight of the top 5 stocks so that the same decline magnitude of the top 5 stocks has a larger impact on the S&P 500 performance.
Source: Investment Strategy Group, Empirical Research Partners Analysis, Bloomberg.

Exhibit 116: S&P 500 Return in 24 Months After a 20% Pullback Within a Calendar Year

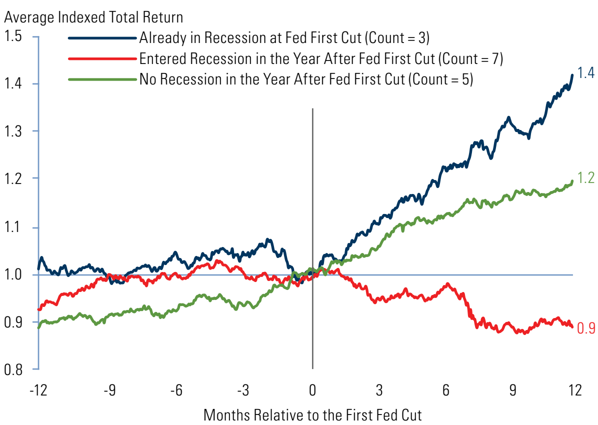
Equities have generated strong returns in the years following past bear markets.



Data through 2023.
Source: Investment Strategy Group, Bloomberg.
Note: Past performance is not indicative of future results.

Exhibit 115: S&P 500 Performance Around the First Federal Reserve Rate Cut

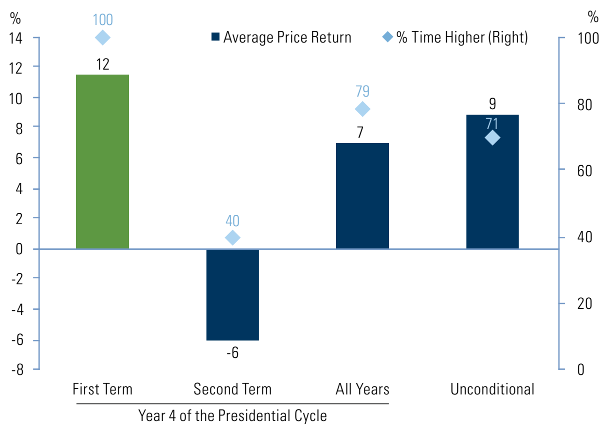
Equities generated robust returns in the past when the Fed cut rates and the US economy avoided a recession.



Data through 2023.
Note: Based on data since 1945.
Source: Investment Strategy Group, Bloomberg.
Note: Past performance is not indicative of future results.

Exhibit 117: S&P 500 Returns in Year 4 of the Presidential Cycle

Equity returns have been favorable in the election years of first-term presidents.

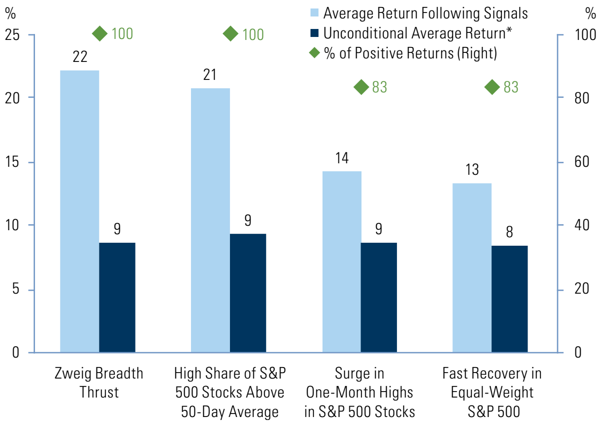


Data as of December 31, 2023.
Note: Based on data since 1946.
Source: Investment Strategy Group, Bloomberg.
Note: Past performance is not indicative of future results.

It is also important to highlight that most S&P 500 companies trade at less demanding valuations. While the P/E ratio is 17% above its historical median for the largest technology stocks, it is closer to its median level for the remaining 492 companies in the S&P 500 (see Exhibit 112). We see scope for valuations to increase in this latter group, which could counterbalance any potential valuation contraction in the pricier technology shares. A modest 6% increase in the valuations of the remaining stocks could absorb a decline back to median valuations for the largest technology

Exhibit 118: S&P 500 Price Returns in the Year Following Past Market-Based Technical Signals

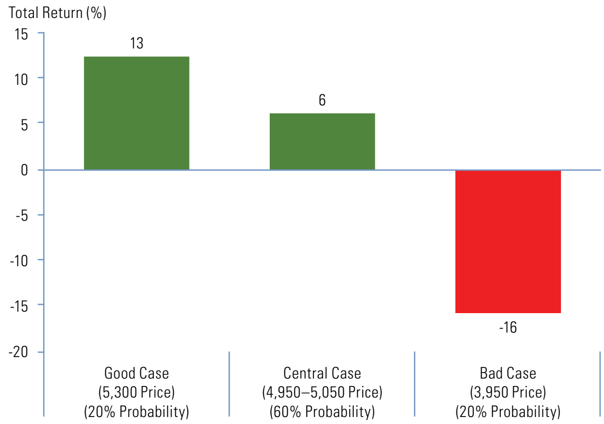
The broad participation of stocks in the rally late last year has preceded well-above-average equity returns.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg, SentimenTrader.
* Unconditional 1-year average returns may vary across signals because not all signals have the same length of historical data.
Note: Past performance is not indicative of future results.

Exhibit 120: ISG Total Return Forecast Scenarios for S&P 500—Year-End 2024

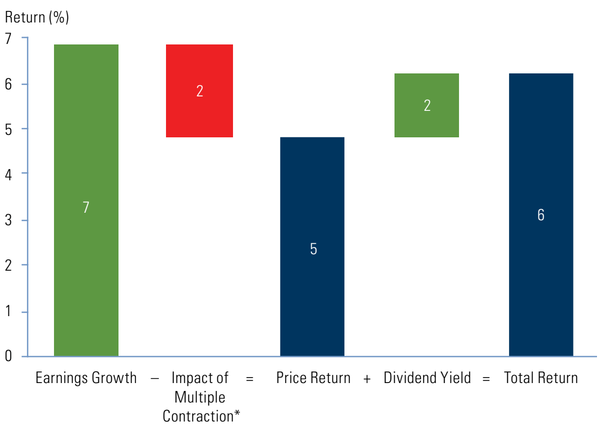
We see balanced risks around our base case.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Indices are gross of fees and returns can be significantly varied. Please see additional disclosures at the end of this *Outlook*.

Exhibit 119: Decomposition of ISG Central Case S&P 500 Return at Year-End 2024

We expect high-single-digit earnings growth to drive S&P 500 returns in 2024.



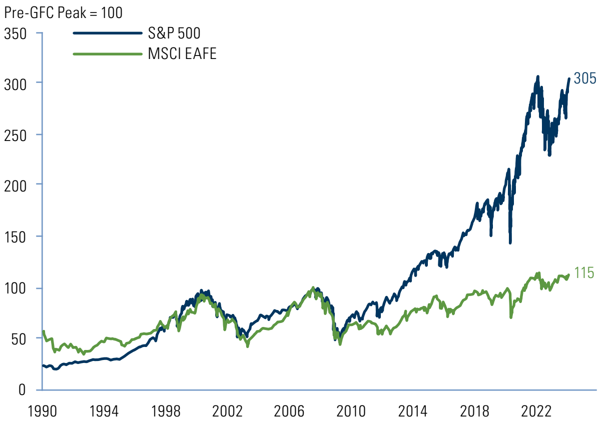
Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
* Includes the compounding effect between earnings and valuation multiples.
Note: The returns and decomposition are based on the midpoint of ISG's central case forecast range. Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Indices are gross of fees and returns can be significantly varied. Please see additional disclosures at the end of this *Outlook*.

stocks (see Exhibit 113). In fact, the S&P 500 has often posted positive returns even when its largest stocks underperformed the index and experienced losses of up to 10% (see Exhibit 114).

Other factors further bolster our expectation for continued market gains. Historical periods when the Federal Reserve reduced rates and the US economy avoided a recession—consistent with our forecasts for 2024—generated robust equity returns (see Exhibit 115). Similarly strong returns ensued in the years following bear markets and during the election years of first-term presidents, both of which apply to 2024 (see Exhibits 116 and 117). The broad participation of stocks, seen in the rally late last year, has also been a reliable harbinger of attractive equity gains (see Exhibit 118). Finally, cash and bonds received $1.5 trillion more in inflows than equities did last year, providing ample scope for rebalancing into equities going forward.

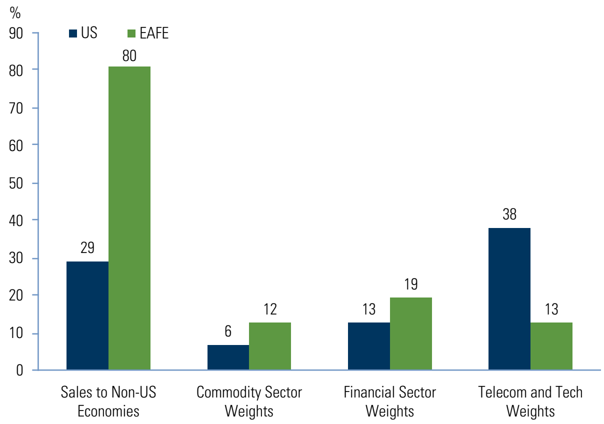
Consistent with the foregoing and our broader macroeconomic outlook, our base case projects the S&P 500 to reach 4,950–5,050 by the end of 2024. This equates to mid- to high-single-digit total returns, inclusive of a 1.5% dividend yield (see Exhibit 119). Our target range assumes a modest contraction in the P/E ratio and earnings of $239–

Exhibit 121: S&P 500 and MSCI EAFE Price Levels
In contrast to the S&P 500, MSCI EAFE prices remain close to their pre-GFC levels.



Data through December 31, 2023.
Note: Prices in local currency terms.
Source: Investment Strategy Group, Datastream.

Exhibit 122: US and Non-US Developed Equity Market Exposures
EAFE markets are particularly exposed to non-US economies and low-growth sectors.



Data as of December 31, 2023.
Source: Investment Strategy Group, FactSet, Datastream.

244, implying growth of 6–8%. We see balanced risks around our base case (see Exhibit 120). While the bad case accounts for markets pricing in a recession, our good case features stronger earnings growth and a further boost to P/E ratios due to optimism about artificial intelligence (AI).

To be clear, we are not Pollyannaish. There are many legitimate risks that could undermine our forecast, as discussed in Section I. We are also mindful of increasingly bullish sentiment, which has historically been a contrarian indicator. Although these factors could contribute to market volatility, we do not anticipate any of them being disruptive enough to reverse the ongoing economic expansion. Based on the weight of the evidence, we believe the odds still favor staying invested in US equities.

Non-US Developed Market Equities: Still Seeking Altitude

After a span of 16 years, non-US developed market equities have yet to fully spread their wings. As shown in Exhibit 121, the MSCI EAFE (Europe, Australasia and the Far East) index is perched just 15% above its 2007 high. In stark contrast, the S&P 500 has ascended more than 200% above its comparable peak.

Multiple factors have contributed to this relative underperformance (see Exhibit 122). The most salient of these reflect critical differences in the composition of the two indices. The MSCI EAFE index features:

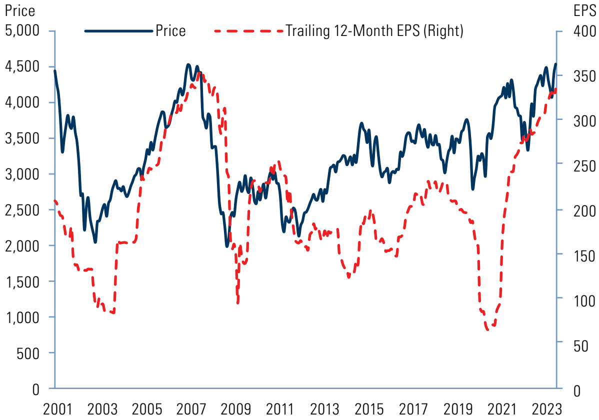
- Higher sales exposure to non-US regions, especially emerging markets, whose growth has slowed meaningfully in the last decade
- A smaller weighting in the fast-growing technology and communication services sectors
- A larger weighting in the financial sector, which has experienced slower growth in the post-GFC period due to tighter regulation and low interest rates
- A larger weighting in the commodity sectors, which have lagged all but the financial sector over this period

To be sure, many of these headwinds persist. Global growth is unlikely to pick up, and financial sector regulations are poised to tighten with the implementation of Basel III Endgame. In addition, our outlook for commodity prices implies downside risk to earnings in the commodity sectors. There are also some longer-term structural fault lines that underpin our rationale for not overweighting non-US equities (see Section I).

But none of these considerations preclude another year of positive returns. We see a

Exhibit 123: Euro Stoxx 50 Price and Trailing 12-Month Earnings per Share

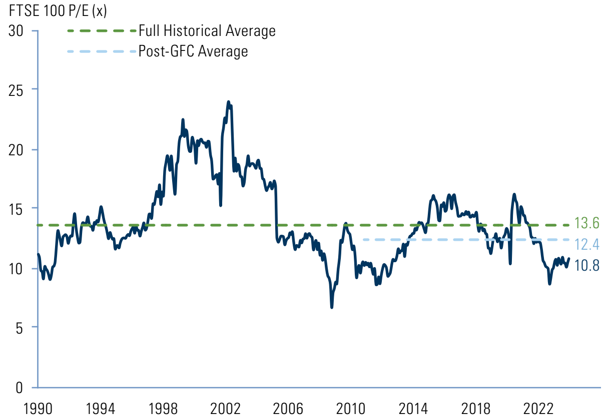
Eurozone equity prices and earnings are approaching their pre-GFC peaks.



Data through December 2023.
Source: Investment Strategy Group, Datastream.

Exhibit 124: FTSE 100 Forward Price-to-Earnings

The UK's P/E remains well below its historical average.



Data through December 2023.
Source: Investment Strategy Group, Datastream.

combination of earnings growth, stable valuations and attractive dividend yields supporting mid- to high-single-digit returns, similar to our forecasts for other global equities (see Exhibit 102).

Eurozone Equities: Climbing Out of a Valley

Eurozone equities gained 23% including dividends last year, an impressive feat for a region that, like other non-US developed markets, has struggled to gain much elevation. Eurozone equities have only just reached their 2007 peak. The same is true for Eurozone companies' earnings, which have yet to surpass their previous summit (see Exhibit 123).

But the prospects for a continued ascent this year are promising. Earnings are set to grow 5%—similar to last year—as we expect Eurozone GDP growth to be in line with 2023 coupled with trend-like global GDP growth. At the same time, interest rate cuts by the ECB in response to moderating inflation should support the region's P/E multiple. Combined with a 3% dividend yield, these forecasts translate into a high-single-digit total return for Eurozone equities this year.

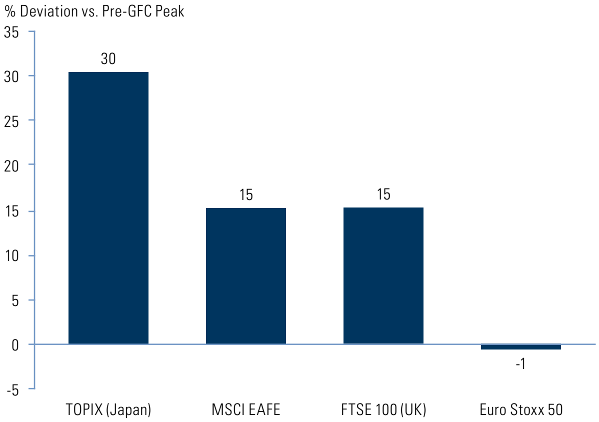
Other leading indicators corroborate our forecast. Various measures of consumer, investor and corporate confidence currently stand at low levels; historically, sour sentiment has been a contrarian indicator pointing to better future returns. The current level of these measures is consistent with high-single-digit equity gains this year, in line with our forecast.

UK Equities: An Unpolished Gem

The UK equity market last year was like a fogged crystal in a crown of sparkling jewels. Its 8% total return was the lowest among large developed market equities, which elsewhere registered double-digit gains in 2023. While several factors contributed to this underperformance, the primary culprit was the UK equity index's low weighting to last year's top-performing information technology sector.

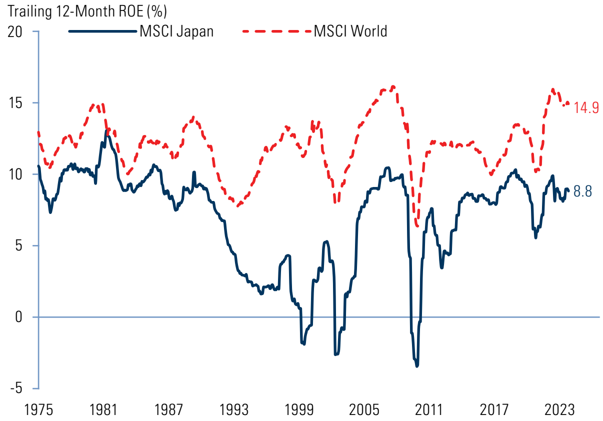
However, last year's shortcomings do not tarnish UK equities for 2024. UK valuation multiples are low relative to their historical levels, as well as in comparison to fundamental factors such as earnings growth and interest rates (see Exhibit 124). Although today's valuation discount partly reflects sector composition—the FTSE 100 has a large weighting to energy and financials, which typically trade at lower P/E ratios—other cyclical factors are also at play. As monetary policy eases this year, we see scope for UK valuations to rise. We also expect UK earnings to grow alongside global GDP this year. It is this combination of mid-single-digit earnings growth, slightly higher P/E ratios and a 4% dividend yield that underpins our high-single-digit total return forecast for UK equities this year.

Exhibit 125: Deviations from Pre-GFC Peak Prices
Among the large non-US developed markets, Japan has made the most progress rising above its 2007 peak.



Data through December 31, 2023.
Source: Investment Strategy Group, Datastream.

Exhibit 126: MSCI Japan and MSCI World Trailing 12-Month Return on Equity
Japan has historically generated a much lower ROE than other developed equity markets.



Data through December 2023.
Source: Investment Strategy Group, Datastream.

The current lackluster sentiment toward UK equities also supports our return projection. Investors have soured on the UK equity market in recent years, as is evident in cumulative outflows. While domestic political uncertainty may be a contributing factor, it does not tell the whole story, given that domestic revenues represent only 20% of FTSE 100 sales. We view today's depressed sentiment as setting a low bar for upside surprises from UK equities. History concurs, with past periods of pessimistic sentiment in the UK often heralding above-average equity returns.

Japanese Equities: Pulling Away from the Pack

Japan's 28% total return last year lifted it further above its 2007 peak and outpaced the performance of its non-US developed market peers. Among that group, Japan has now made the most progress surpassing its former high (see Exhibit 125). Several factors contributed to last year's strong performance. Chief among these were measures introduced by the Tokyo Stock Exchange (TSE) to address investors' long-standing concerns about corporate governance. Japan also benefited from resilient global growth, as 65% of the TOPIX market cap resides in cyclical sectors. Additional factors included significant yen depreciation and nascent signs that Japan's decades-long fight against deflation may be ending.

These factors should support another year of gains, albeit gains lower than last year's.

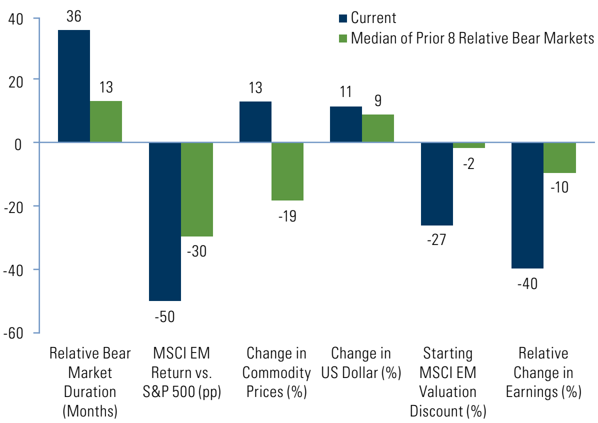
The key driver of our forecast is earnings, which we expect to rise by 6% this year alongside global growth. We see limited scope for higher P/E ratios, as they already appear fair relative to their historical levels, as well as compared to fundamental factors such as earnings growth and interest rates. It is this combination of mid-single-digit earnings growth, flat P/E ratios and a 2% dividend yield that underpins our high-single-digit total return forecast for Japanese equities.

Japan's corporate governance reform measures have the potential to propel the country's equity market even further ahead of those of its non-US developed peers. Although Japan trades at a significant valuation discount relative to this group, that discount is justified by Japanese firms' significantly lower profitability (see Exhibit 126). In response, the TSE is pressuring companies with low profitability and depressed valuations to implement reforms. If successful, these efforts could generate substantial returns for shareholders as both profitability and valuation multiples converge with those seen in other developed markets.

That said, Japan's reform efforts have encountered repeated setbacks in the past. The corporate governance code was initially introduced in 2015 as part of Abenomics; it underwent revisions in 2018 and 2021. Furthermore, it would take several years for the benefits of any successful

Exhibit 127: Characteristics of MSCI EM "Relative Bear Markets"

This long period of underperformance relative to the S&P 500 has been driven by weak EM earnings.



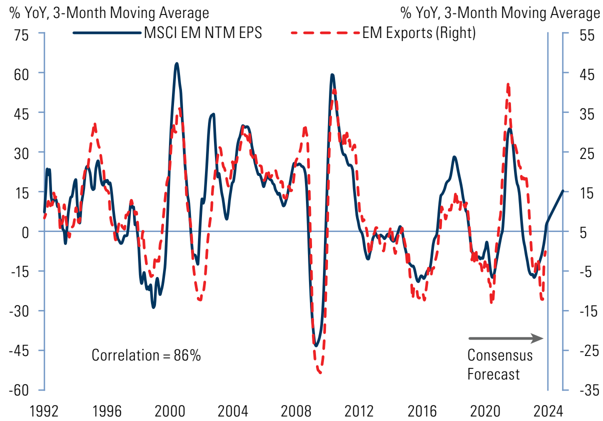
Data through December 31, 2023.

Note: A "relative bear market" is defined as an episode when MSCI EM underperforms the S&P 500 by 20pp or more. Based on data since the inception of MSCI EM on January 1, 1988.

Source: Investment Strategy Group, Bloomberg, Datastream, FactSet.

Exhibit 128: EM Export Growth and Annual Change in MSCI EM Forward Earnings

Consensus earnings estimates imply that EM exports will rebound sharply in 2024.



Data through December 2023.

Source: Investment Strategy Group, Datastream, FactSet.

reforms to materialize, given the structural nature of the corporate governance shortcomings. As a result, we did not incorporate any potential upside from such reforms into our 2024 return forecast.

Emerging Market Equities: It's All Relative

Emerging market stocks recorded a dubious milestone last year, as the ratio of their prices to the S&P 500 hit an all-time low. EM equities have now trailed their US counterparts by 50 percentage points over a period of nearly three years. This makes the current relative bear market—a period of at least 20 percentage points of underperformance—one of the most prolonged and severe in history (see Exhibit 127). Even worse, the current episode has been driven by comparatively weaker EM earnings, rather than more typical factors such as weak commodity prices or excessive valuations.

One path to reversing this underperformance would be a significant upturn in relative earnings growth. We think that is unlikely in 2024, as our forecast calls for higher forward earnings growth in the US than in emerging markets. For EMs specifically, we expect a combination of trend-like global growth, a waning drag from commodities and a rebound in semiconductor prices to lift forward earnings by 6% this year.

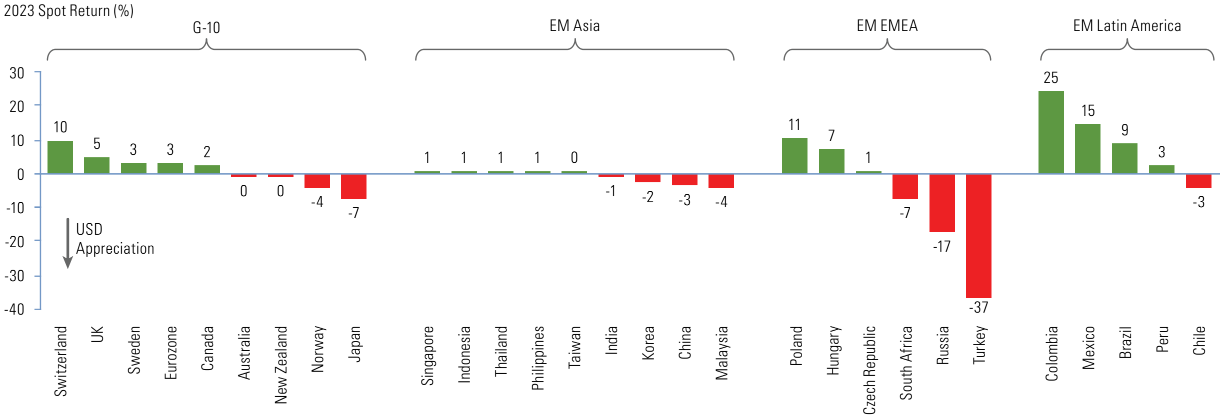
Another path would require investors to pay a significantly higher P/E multiple for EM equities. We find this scenario equally improbable this year. The P/E ratio for EM countries other than China has been higher than current levels only 8% of the time over the last two decades, suggesting limited scope for further upside. Meanwhile, structural headwinds are likely to continue weighing on Chinese companies' valuations.

Against this backdrop, we believe EM valuations will decline slightly this year despite the favorable impact from falling interest rates. Along with our expectation for 6% earnings growth and EM equities' 3% dividend yield, these elements imply a high-single-digit total return for MSCI EM in 2024. While this return is appealing on an absolute basis, there are several reasons we do not recommend a broad overweight to EM equities.

First, our expected returns across global equities are broadly similar this year. Second, China is likely to remain a persistent drag on EM assets until business and investor confidence is restored. Such a shift in sentiment is unlikely this year given ongoing concerns about China's economy, geopolitics and long-term challenges, such as demographics and debt. Third, we see downside risks to EM consensus earnings estimates, as they imply a rebound in exports that seems unlikely (see Exhibit 128). Fourth, the streak of outflows from EM equity funds over the past six months

Exhibit 129: 2023 Currency Performance (vs. US Dollar)

After two consecutive years of broad-based appreciation, the US dollar exhibited a more uneven performance in 2023.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

could persist until relative returns improve. Fifth, countries representing more than half of MSCI EM market cap have elections this year, which could foster market volatility. Finally, we still assign above-average odds to a US recession this year, and EM equities have typically underperformed US stocks during past US economic contractions.

Considering the above, we have limited our tactical exposure to a modest overweight to Brazilian equities. These stocks benefit not only from attractive valuations, but also from rising earnings expectations, continued monetary policy easing and accelerating equity inflows (see section I, Our Tactical Tilts).

Global Currency Outlook

After two consecutive years of broad-based appreciation, the US dollar exhibited a more uneven performance in 2023 (see Exhibit 129). Several factors contributed to these results. On the one hand, the dollar benefited from the most aggressive Federal Reserve hiking cycle in decades, resilient US growth relative to peers, and demand for safe-haven assets amidst conflicts in both Ukraine and the Middle East. On the other hand, several Latin American and Eastern European currencies outperformed, as policy rates in these regions significantly exceeded developed market alternatives.

Central bank policy was a key driver outside of emerging markets as well. The Bank of Japan's exceptionally accommodative monetary policy caused the yen to depreciate by 7% against the dollar last year, pushing it close to its weakest levels in 40 years. Meanwhile, intervention by the Swiss National Bank (SNB) to curb domestic inflation propelled the franc 10% higher against the dollar, making it the best-performing developed market currency last year. The British pound also performed well against both the dollar and euro, as the UK economy avoided a widely anticipated recession.

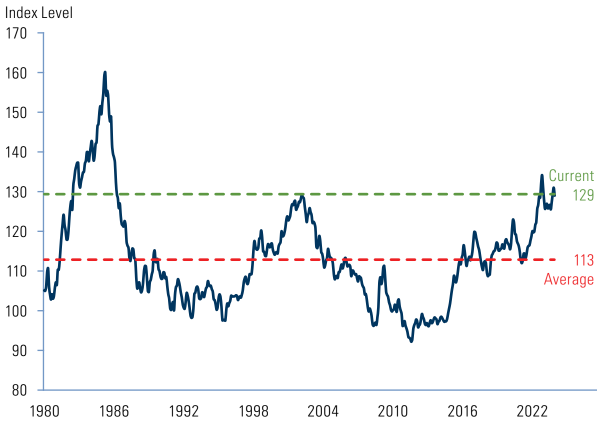
EM currency performance was similarly varied. High yielding currencies—like the Brazilian real, Mexican and Colombian pesos, Polish zloty and Hungarian forint—outperformed, while low yielding Asian currencies, including the Chinese renminbi and Korean won, lagged. Notably, the return difference between these two groups reached double digits last year.

For the year ahead, we expect the interplay of global growth and central bank policy to limit the dollar to modest gains. Most major central banks, including the Federal Reserve, are expected to lower their policy rates this year. In turn, interest rate differentials between the US and its developed market peers are unlikely to widen meaningfully.

Against this backdrop, we continue to recommend that clients fully hedge their offshore fixed income. We also recommend that clients hedge 50% of their non-local developed market equity holdings to reduce portfolio volatility and provide diversification. Tactically, we are long the euro versus the Swiss franc through an options structure, reflecting the pair's attractive valuation

Exhibit 130: US Dollar Real Effective Exchange Rate

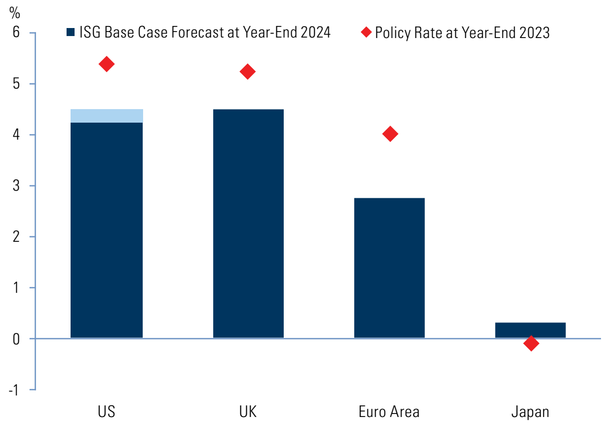
The dollar's valuation now stands well above its long-term average, making the greenback more vulnerable.



Data through November 2023.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 131: Policy Rates and Expected Cuts by Major Central Banks

Interest rate differentials are unlikely to widen against the dollar as most major central banks cut rates.



Data through December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
Note: Light blue area denotes ISG's forecasts for the federal funds target range at year-end 2024.
Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Indices are gross of fees and returns can be significantly varied. Please see additional disclosures at the end of this *Outlook*.

and our expectation that the SNB will end its tightening and currency intervention policies (see section I, Our Tactical Tilts).

US Dollar

Despite its mixed performance last year, the US dollar has maintained an impressive track record. It has appreciated in 10 out of the last 14 years and has risen by more than 40% since the lows of the financial crisis. But this strong historical performance, coupled with the dollar's failure to close at new highs last year, has raised questions among investors about whether the dollar's best days are behind it.

This concern is not without merit. Relative to its peers, the US dollar has benefited from the US's comparatively tighter monetary policy and stronger economic growth. While it is not our base case, an erosion or reversal of these drivers could lead to dollar depreciation. Such a decline could be magnified by the fact that the dollar's valuation stands well above its long-term average (see Exhibit 130).

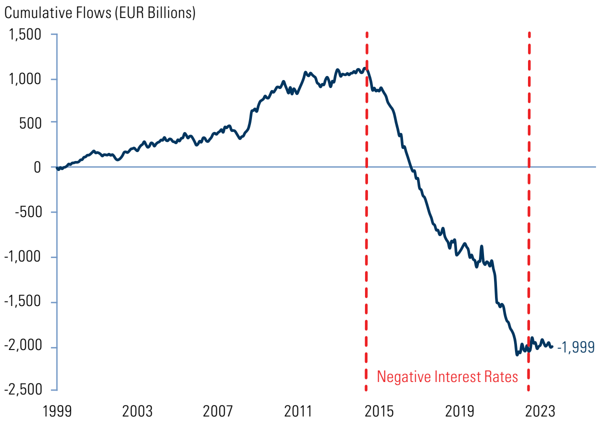
But these risks must be weighed against the key factors still supporting the dollar. US economic growth is again forecast to exceed that of most other major developed market peers this year. Moreover, interest rate differentials are unlikely to meaningfully widen against the dollar based on our expectation that most major central banks will lower their policy rates this year (see Exhibit 131). This mix of policy and growth differentials should continue enticing foreign investors to favor US assets at the expense of lower-yielding alternatives.

Other elements could also bolster the dollar. Noncommercial investors begin the year lightly positioned, providing scope for them to increase dollar exposure. The upcoming US presidential election and the possibility of new trade tariffs represent further upside risk. Recall the dollar

For the year ahead, we expect the interplay of global growth and central bank policy to limit the US dollar to modest gains.

Exhibit 132: Eurozone Cumulative Debt Portfolio Flows

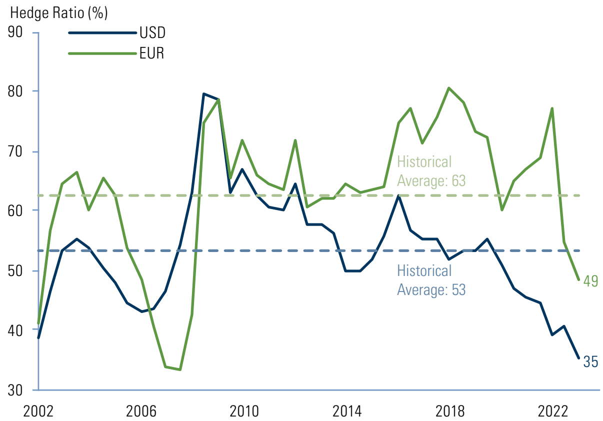
Eurozone net debt portfolio flows have failed to recover following the ECB's decision to end negative interest rates



Data through October 2023.
Note: Data shown is foreign net inflows minus domestic net ouflows.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 133: Major Japanese Life Insurance FX Hedge Ratios

Japanese life insurers may raise their FX hedge ratios, which currently stand at multiyear lows.



Data through September 2023.
Source: Investment Strategy Group, Nomura Group.

appreciated by more than 6% in the weeks following the 2016 presidential election as market participants digested the possibility of a destination-based tax system.

We expect the net impact of these factors to result in a low-single-digit gain in the US dollar this year, as well as another uneven performance relative to other global currencies.

Euro

The euro's 3% appreciation in 2023 brought an end to two consecutive years of mid-single-digit declines. This reversal was helped by the Eurozone economy's avoidance of a widely anticipated recession, as well as improved sentiment after China's reopening early last year. Both developments allowed the ECB to tighten monetary policy beyond investors' expectations, which benefited the currency.

Despite the recent recovery, the euro still faces many headwinds. Relative to its peers outside the Eurozone, the euro confronts unfavorable interest rate and economic growth differentials. The Eurozone's capital flows also pose a challenge. Domestic investors are incentivized to sell euro-denominated assets to purchase higher yielding offshore investments, while foreigners purchase fewer euro-denominated assets due to higher yielding alternatives. Exhibit 132 illustrates how Eurozone net fixed income portfolio flows have failed to recover following the ECB's decision to end its negative policy rate in 2022. Even with last year's aggressive monetary policy tightening, investors remain hesitant to increase their purchases of euro-denominated fixed income.

Still, several factors could help the euro sustain last year's reversal. For example, the yield advantage for euro-denominated assets could improve if stronger-than-expected economic activity tempers the ECB's plan to lower its policy rate. The reversal could also be sustained if an unexpected slowdown in the US forces the Federal Reserve to cut rates more aggressively than the ECB. Finally, the currency trades at a relatively low valuation relative to the US dollar.

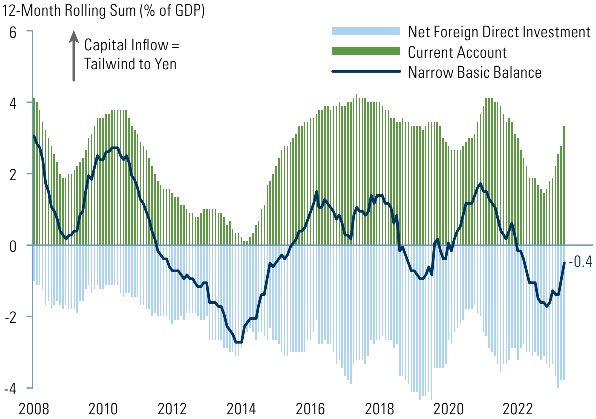
While this backdrop may not be universally bullish for the euro, we do think the currency can outperform other select crosses. On that point, we hold a long tactical position in the euro versus the Swiss franc (see Section I, Our Tactical Tilts).

Yen

Yen investors could be forgiven for experiencing a sense of déjà vu last year. In a move reminiscent of 2022, the yen rallied sharply in the final months of the year after falling 16% against the dollar and reaching its weakest level in more than three decades. Despite this rally, the yen still depreciated 7% in 2023, marking its third consecutive year as the worst-performing developed market currency.

Exhibit 134: Japan Narrow Basic Balance

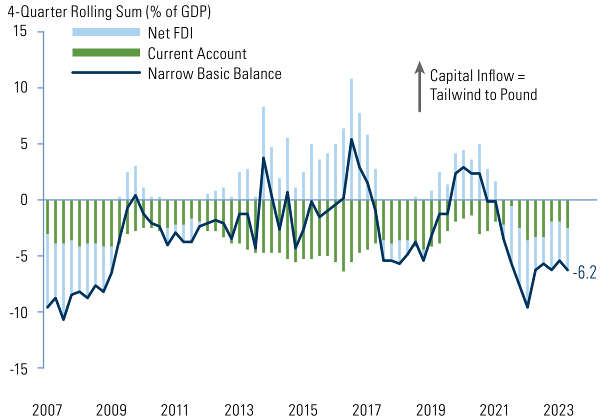
While Japan's narrow basic balance has improved, net FDI remains a source of capital outflows.



Data through October 2023.
Note: The narrow basic balance reflects the sum of the current account and net foreign direct investment.
Source: Investment Strategy Group, Haver Analytics.

Exhibit 135: UK Narrow Basic Balance

The UK's narrow basic balance stands at a weak level.



Data through Q3 2023.
Note: The narrow basic balance reflects the sum of the current account and net foreign direct investment.
Source: Investment Strategy Group, Haver Analytics.

With the Japanese currency having now lost approximately 45% in the 12 years since Abenomics was introduced, there is scope for the yen to break its losing streak. A key driver of the yen's weakness has been the ultra-accommodative monetary policy necessary to combat Japan's recalcitrant deflation. But with inflation projected to exceed 2% for the third consecutive year, the Bank of Japan is in a position to start withdrawing support. This development would help narrow Japan's interest rate differential with other developed countries—which are likely to be easing policy this year—and thereby reduce a key source of yen weakness. It would also reduce the cost of protecting portfolios from currency volatility. In turn, major Japanese life insurers holding ¥59 trillion of foreign currency-denominated assets may increase their currency hedging, which currently stands at multiyear lows (see Exhibit 133).

The improving backdrop for the currency is partially counterbalanced by Japan's balance of payments. While Japan's current account has improved alongside lower energy prices, its narrow basic balance remains in deficit. This implies that there is a structural shortfall in yen demand, which reflects persistent yen selling by Japanese corporations in search of higher yielding alternatives. Although these outflows slowed during the initial stages of the pandemic, they have since picked up and again represent a large share of GDP (see Exhibit 134). Narrowing rate differentials should eventually help arrest these outflows.

Taking these factors together, we see scope for a mid-single-digit rise in the yen, with the possibility of both long and short tactical trading opportunities throughout 2024.

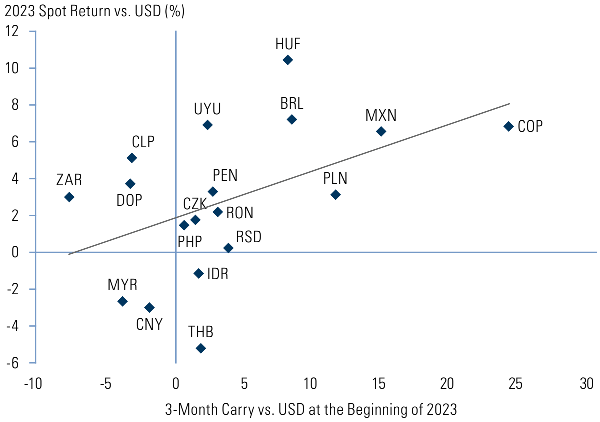
Pound

The pound posted its strongest annual performance against the dollar in a span of six years in 2023. This marked the end of a two-year streak of losses, which included a double-digit decline in 2022 following a budget crisis and the resignation of two prime ministers. The pound's 5% rise last year, which also made it the second-best-performing developed market currency, was supported by a variety of factors. Chief among these was the UK economy sidestepping a widely anticipated recession and the Bank of England (BOE) lifting its policy rate to the highest level in 15 years.

Notwithstanding its recent strength, the pound still faces several obstacles. The UK's sluggish economic growth compared to that of its peers dampens the appeal of pound-dominated assets. Moreover, Brexit has disrupted the UK's role as the English-speaking gateway to the Eurozone, making it harder to attract long-term investment without strong domestic economic growth. Indeed, foreign direct investment remains a source of capital outflows, with the UK's narrow basic balance deficit representing more than 6% of GDP

Exhibit 136: 2023 Return vs. Carry for EM Currencies

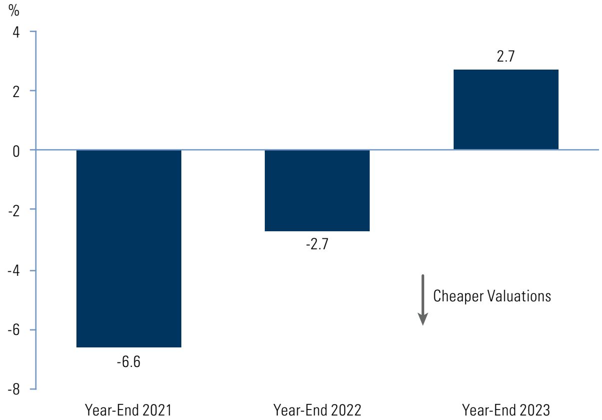
Returns of individual currencies were driven largely by "carry," or interest rate differentials between countries.



Data as of December 31, 2023.
Note: Carry is defined as 3-month forward implied yield (or policy rate if not available) net of US 3-month cash rate.
Source: Investment Strategy Group, Haver Analytics, Bloomberg.

Exhibit 137: EM Currency Valuations

Valuations are less of a tailwind entering 2024 compared with prior years.



Data as of December 31, 2023
Note: EM currency valuation is defined as the difference between the (log) effective real exchange rate and its 20-year average for members of JPMorgan's GBI-EM Global Diversified index. The EM aggregate is a weighted average of each country's valuation, using monthly index weights.
Source: Investment Strategy Group, Haver Analytics, Bloomberg.

(see Exhibit 135). In addition, market participants begin the year already positioned for continued pound strength, leaving the currency vulnerable to adverse developments.

Despite these challenges, we see several potential offsets. The BOE may not end up delivering all the rate cuts that are currently priced by the market, given lingering uncertainty around the path of inflation. The resulting increase in UK interest rates would make sterling-denominated assets more appealing to foreign investors, thereby supporting the currency. Moreover, if current polling for the upcoming general election proves prescient, the pound could benefit from a closer relationship between a new Labour government and the EU.

Given these competing dynamics, we expect the pound to remain range-bound throughout 2024.

Brexit has disrupted the UK's role as the English-speaking gateway to the Euro area, making it harder to attract long-term investment without strong domestic economic growth.

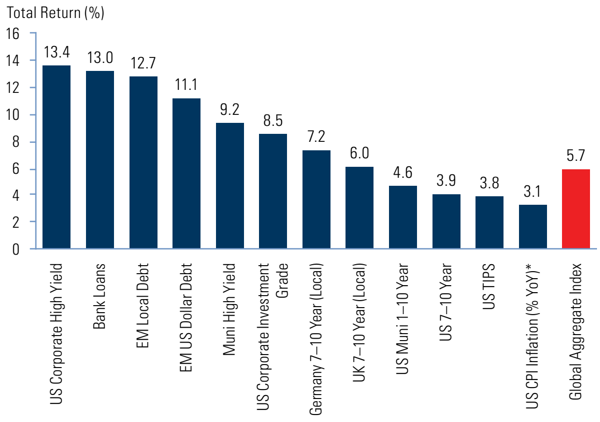
Emerging Market Currencies

After three consecutive years of losses, EM currencies posted a positive spot return against the US dollar last year. However, the modest 2% gain of the index belied significant variation in the returns of individual currencies, driven largely by "carry," or interest rate differentials between countries. As shown in Exhibit 136, high yielding currencies in Latin America and Eastern Europe outperformed low yielding currencies in Asia.

This nascent upturn in EM currencies still faces several potential challenges in 2024. While carry could support the asset class again this year, its impact will likely wane as regional central banks reduce their policy rates in response to steady disinflation. EM currencies could be similarly pressured by a rising US dollar, which continues to benefit from positive US growth and interest rate differentials compared to currencies of its developed world counterparts. It is also true that the once-attractive valuation offered by this asset class has been eroded by higher inflation and the nominal appreciation of these currencies against those of developed economies (see Exhibit 137). Other potential risks include the upcoming US presidential election and ongoing geopolitical tensions.

Exhibit 138: 2023 Fixed Income Returns by Asset Class

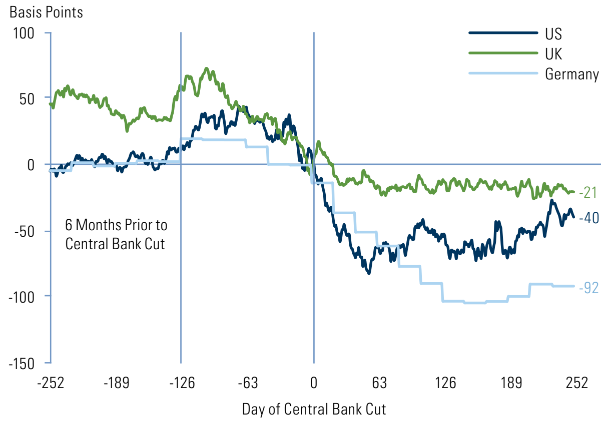
Global fixed income delivered positive returns, with credit outperforming.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
* Inflation data as of November 2023.

Exhibit 139: Performance of 10-Year Government Bond Yields Around the First Central Bank Cut

Bond yields tend to fall in the six months leading up to and following the first central bank cut.



Data through 2023.
Note: We take the first cut after the end of a tightening cycle. German 10-year yield data is monthly from the FRED database going back to 1965. All other data is daily.
Source: Investment Strategy Group, Bloomberg, FRED Database, Federal Reserve, ECB, Bundesbank, Bank of England.

Regardless of the asset class's direction this year, dispersion in the performance of individual EM currencies is likely to provide attractive tactical opportunities. These could arise from fluctuations in the valuations of certain currencies, as well as their interest rate differentials. Furthermore, currencies whose economies are experiencing cyclical recoveries and rebounding exports have room to appreciate, particularly in Asia, despite their carry disadvantage. Similarly, reforms in selected countries could draw capital inflows, potentially strengthening their exchange rates. We also see potential for EM currencies aligned with the US business cycle to benefit from our base case scenarios of a soft landing there.

As we await these opportunities, we are currently tactically neutral EM currencies.

Global Fixed Income Outlook

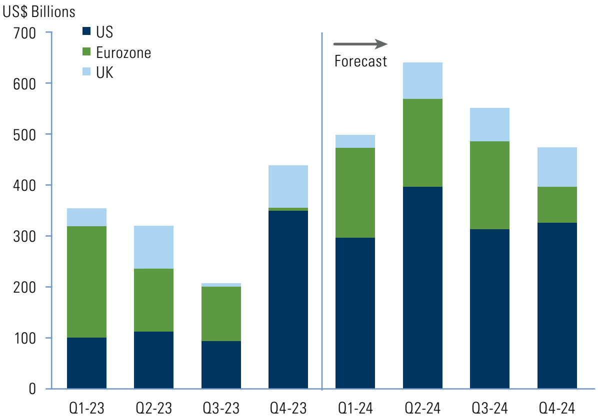
Bond investors experienced a notable reversal of fortune last year. Ten-year yields across developed markets reached their highest levels in more than a decade in October, only to experience a sharp decline in the final months of the year that erased those increases. This abrupt about-face reflected a combination of bond-friendly developments late in 2023, including a slowdown in economic growth and inflation, a dovish shift at the Federal Reserve and a slower pace of growth in US government bond supply. As a result, most fixed income assets swung from a loss to a gain for the year, with credit outperforming duration (see Exhibit 138).

We expect that the continued interplay of these factors will lead to a slight decrease in government bond yields in 2024. On the one hand, major central banks are projected to cut their policy rates for the first time in this cycle, a move that has traditionally been linked with lower yields (see Exhibit 139). Similarly, we believe current market pricing of the nominal neutral rate—the rate consistent with full employment and stable inflation in the medium term—is still too high in the US and UK. Other elements of our forecast should also support bonds, such as below-average growth, easing inflation pressures, and recession risks that, while decreasing, remain above the average.

On the other hand, the sharp decline in yields late last year has eroded the appeal of certain components of bonds' valuations. Short-term interest rate markets now reflect a pace of central bank cuts that exceeds our probability-weighted forecast. At the same time, the term premium—the extra yield investors demand for holding long-maturity bonds instead of a series of shorter-term

Exhibit 140: Expected Quarterly Net Supply to the Private Sector Across G3 Economies

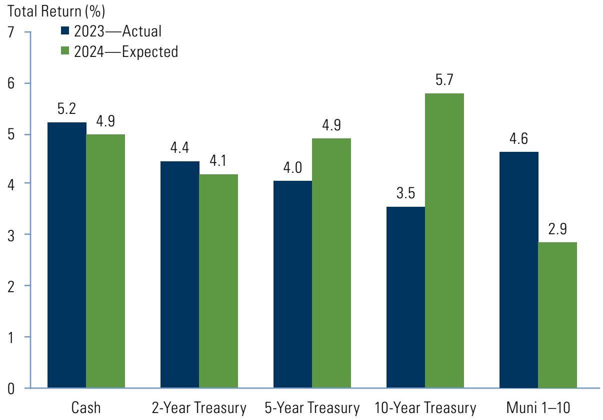
As central banks reduce their balance sheets, private markets will need to absorb record net issuance.



Data through Q4 2023. Forecast through Q4 2024.
Source: Investment Strategy Group, Goldman Sachs Global Banking and Markets, Bloomberg, US Treasury, European Treasuries, UK DMO.
Note: Based on estimates from Goldman Sachs Global Banking and Markets, adjusted for ISG central bank expectations, and converted using year-end 2023 exchange rates.
Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 141: 2024 US Treasury and Municipal Bond Return Projections

We expect longer-duration Treasuries will outperform cash.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
Note: Returns (both historical and forecast) for municipal bonds are nominal and not tax-adjusted.
Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

bonds—seems too low in comparison to our models, especially considering the anticipated increase in government bond supply in the first half of this year (see Exhibit 140).

Based on the foregoing, we expect intermediate-duration bonds to provide similar returns to cash in our base case (see Exhibit 141). Given this forecast and the fact that cash returns could be quickly eroded by faster-than-expected cuts by the Federal Reserve, we recommend client portfolios be at their strategic duration benchmark—which is four years for a US taxable moderate portfolio.

In the sections that follow, we review the specifics of each major fixed income market.

US Treasuries

US Treasury bonds were a key beneficiary of the abrupt reversal in interest rates last year. After reaching a peak just above 5% in October, the 10-year Treasury yield fell 114 basis points through year-end. A decline that large in such a short period has occurred less than 2% of the time in the past and was sufficient to turn the 10-year bond's 5.9% loss into a 3.5% gain for 2023.

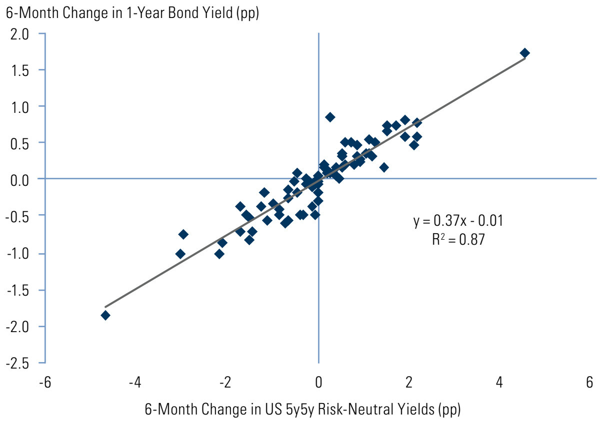
We see two key reasons for a further modest decline in US government bond yields in 2024. First, our forecast calls for economic growth to slow back to trend, with inflation continuing toward its 2% target. In this environment, the Federal Reserve is likely to pivot its attention toward reducing downside risks to growth rather than curbing upside risks to inflation. In turn, we expect the Federal Reserve to lower policy rates by 100 basis points. The resulting move lower in short-term yields likely will put about 15 basis points of downward pressure on 10-year yields.

Second, Federal Reserve rate cuts are likely to weigh on longer-term yields through an additional channel. Market pricing of the nominal neutral rate is more closely tied to Federal Reserve policy rate expectations than the structural factors that, in theory, determine an economy's actual equilibrium interest rate. As the Federal Reserve begins to implement cuts, we anticipate the 1-year rate will decline by 125 basis points. This implies a 50- to 60-basis-point drop in market pricing of the nominal neutral rate, all else equal (see Exhibit 142).

Of course, all factors are seldom equal. In recent years, there have been large shifts in the supply and demand balance for US Treasuries, which many fear will substantially boost bond term premium. On the demand front, the

Exhibit 142: Change in Policy Expectations (1-Year Bond Yield) vs. Risk-Neutral Yields

History shows that as the Federal Reserve cuts short-term policy rates, longer-term rates also tend to decline.



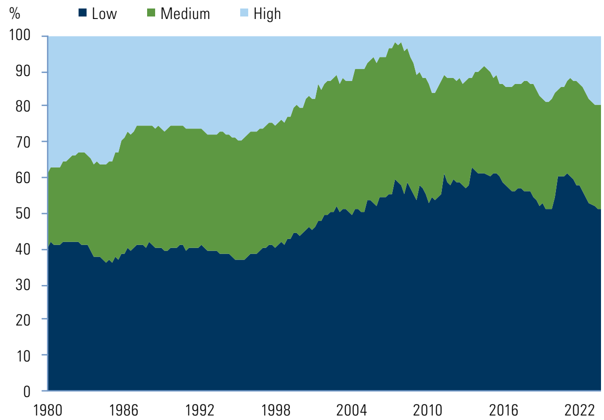
Data through Q2 2023.

Note: Chart shows 6-month change in 1-year bond yield, which reflects the average of 1-year policy rate expectations, vs. 6-month change in 5y5y risk-neutral yields.

Source: Investment Strategy Group, Bloomberg, Federal Reserve.

Exhibit 143: Composition of US Treasury Ownership Over Time by Price Sensitivity

An increasing share of the US Treasury market is owned by buyers considered to be highly price-sensitive.



Data through Q3 2023.

Source: Investment Strategy Group, Haver Analytics, US Treasury.

composition of Treasury buyers is increasingly shifting toward price-sensitive buyers—such as banks, households, and asset managers—and away from price-insensitive buyers, such as the Federal Reserve and official foreign institutions (see Exhibit 143). While it is intuitively appealing to conclude that growing supply and an increasingly price-sensitive buyer will meaningfully lift the term premium, our work shows that the composition of Treasury demand is not a significant driver outside of Federal Reserve purchases.

The impact of elevated supply is more material. The US fiscal deficit is likely to remain high in the foreseeable future, with limited prospects for fiscal consolidation. The resulting deficit will need to be funded by increased issuance of government bonds. That greater supply comes at a time when the Federal Reserve has stopped reinvesting the proceeds from up to $60 billion of maturing bonds per month. Although we anticipate a slowdown in this quantitative tightening in the third quarter, our estimates indicate that the net supply of Treasury bonds available to the private market after coupon repayments will total $1.3 trillion in 2024, a $700 billion increase from 2023.

Our analysis shows that these dynamics, coupled with fading recession worries, could push term premium higher by 70–75 basis points this year. However, this impact will be more than offset by the combined effects of Federal Reserve rate cuts and some widening in swap spreads as the pace of quantitative tightening eases. As a result, we expect a modest 20-basis-point decline in the US 10-year Treasury yield, bringing it to our target range of 3.50–3.90%.

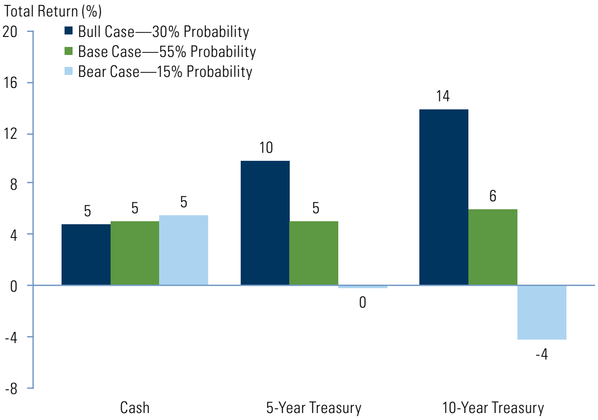
The midpoint of this range would imply mid-single-digit bond gains this year (see Exhibit 144). While returns are likely to be only modestly higher than cash this year, this gap should widen in favor of bonds as the Federal Reserve cutting cycle progresses. In addition, we believe that lower yields are more likely than the opposite outcome, given that the risk of a US recession is more elevated relative to history and Treasuries are the only asset class that has effectively hedged against deflationary shocks in the past.

Treasury Inflation-Protected Securities (TIPS)

TIPS matched the performance of Treasuries in 2023, as breakeven inflation rates closed the year broadly unchanged at around 2.2%, a level consistent with the Federal Reserve's 2.0% inflation target. We see two reasons that TIPS and Treasuries are likely to generate similar returns again this year. First, our model for estimating market-based US breakeven inflation expectations (BIEs) suggests TIPS are currently fairly valued. Second, short-term market inflation fixings only slightly underestimate the likely path of inflation based on our forecasts.

Exhibit 144: 2024 Cash and US Fixed Income Scenarios

The asymmetry around intermediate fixed income returns supports our 4-year target duration recommendation.

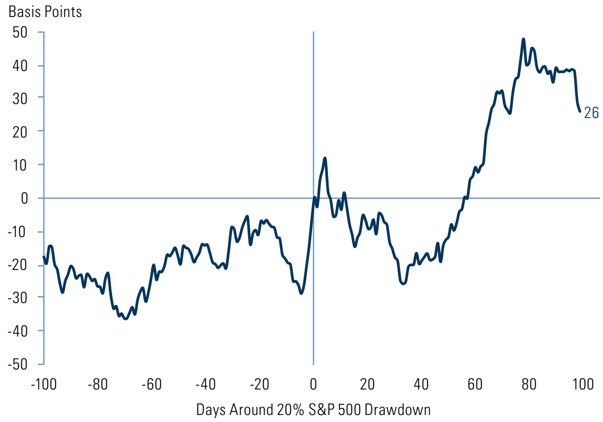


Data as of December 31, 2023.
Source: Investment Strategy Group.

Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 145: Performance of TIPS' Yields Around Major Equity Market Drawdowns

TIPS' yields tend to rise during equity drawdowns, diminishing their hedging appeal.



Data through 2023.
Note: We denote Day 0 as the day when the S&P 500 enters a 20% drawdown.
Source: Investment Strategy Group, Bloomberg.

While Treasuries and TIPS may exhibit similar performance this year, they differ significantly in other aspects. Unlike Treasuries, TIPS do not serve as a strong diversifier in cross-asset portfolios, largely because TIPS' yields tend to rise during major equity market drawdowns (see Exhibit 145). This counterintuitive result reflects the fact that inflation expectations tend to fall during cyclical downturns. TIPS are also less liquid than nominal bonds, which makes them particularly vulnerable when liquidity dissipates during equity volatility.

In the absence of a clear fundamental case for TIPS to outperform, we continue to advise US clients with taxable accounts to use municipal bonds for their strategic allocation.

US Municipal Bonds

Municipal bonds made a comeback last year after experiencing their most significant annual decline in 40 years in 2022. The broad Bloomberg Municipal Bond Index rose 6.4%, while the shorter-duration 1–10 Year Municipal Bond Index gained 4.6% (see Exhibit 146). This recovery was also evident in municipal bond flows. Outflows from mutual funds and ETFs slowed to just $19 billion last year, down significantly from $148 billion in 2022, which was the largest outflow since 1984 (see Exhibit 147).

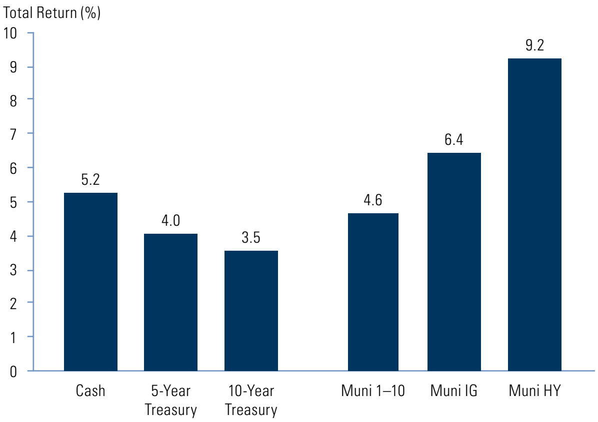
We expect municipal bonds to build on last year's recovery but deliver more modest returns in 2024. To be sure, municipal fundamentals continue to provide strong support for the asset class. Aggregate rainy day fund balances are near record highs, with 41 states reporting increases during fiscal 2023.

> We expect municipal bonds to build on last year's recovery but deliver more modest returns in 2024. To be sure, municipal fundamentals continue to provide strong support for the asset class.

Fiscal 2024 budgets tell a similar tale, as the median rainy day fund balance relative to general fund spending is also at record highs (see Exhibit 148). There are concerns about the transit sector because back-to-work indicators remain below pre-pandemic levels, but states such as New York, New Jersey and California are committing significant

Exhibit 146: 2023 Performance of Cash and Fixed Income Indices

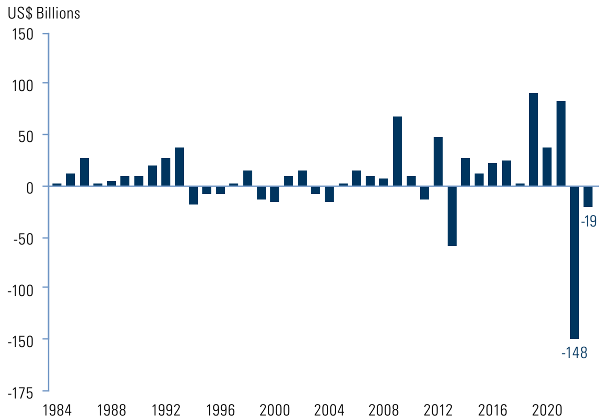
Municipal bonds outperformed Treasuries in 2023 after a rally late in the year.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg, Barclays.

Exhibit 147: Annual Flows Into Municipal Bond Mutual Funds and ETFs

Municipal bond outflows moderated last year after a record reading in 2022.



Data through December 27, 2023.
Note: Data prior to 2006 is composed of mutual funds only. For 2023, monthly data is used through November 2023 and weekly fund flows afterward.
Source: Investment Strategy Group, Haver Analytics, Investment Company Institute.

budget funds—supplemented by federal funding—to address these shortfalls. Meanwhile, pockets of strength in areas like transportation (excluding transit), local general obligation (GO) bonds, housing, utilities and charter schools provide a counterbalance to these worries.

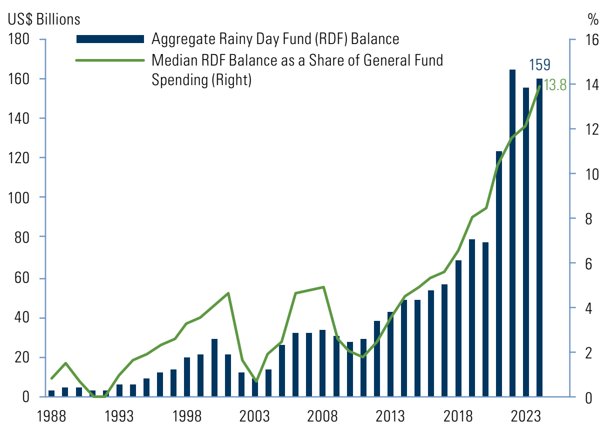
Less visibly, the assumptions underlying state budgets seem conservative, which provides a source of upside to fiscal finances. Personal income taxes—accounting for 42% of states' revenue budget—are assumed to decline more than 2% in 2024, a trend at odds with last year's strong market performance and robust labor market. Similarly, sales and use taxes—which account for a third of the revenue budget—are expected to grow just 1.3%, despite having grown 5–14% in the previous two years. The assumptions for corporate income tax—which accounts for 10% of the revenue budget—seem equally cautious, indicating an 8% decline in 2024 despite a 5% increase last year that exceeded forecasts.

The good health of the municipal sector is also evident in credit agency actions. Municipal bonds received 572 upgrades compared to 155 downgrades last year. The result was a 3.7x upgrade-to-downgrade ratio, which is among the highest readings on record (see Exhibit 149).

Still, the excess returns that might otherwise arise from these strong fundamentals will be constrained by already elevated valuations. The ratio of AAA municipal bond yields to Treasuries

Exhibit 148: Aggregate Rainy Day Fund Balances Among State Governments

State governments' rainy day fund balances as a share of expenditures stand near all-time highs.



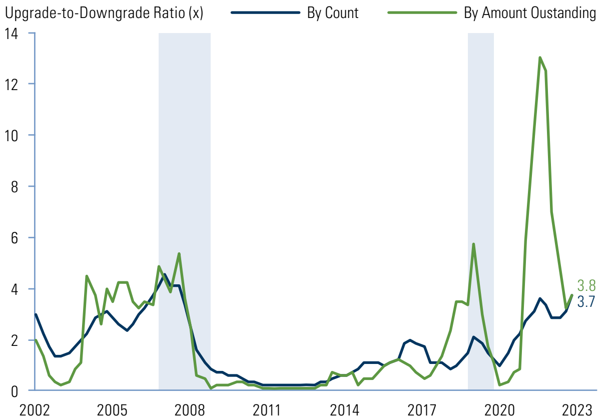
Data through June 2023. Forecast through 2024.
Source: Investment Strategy Group, National Association of State Budget Officers.
Note: Forecast based on preliminary state budgets as of spring 2023.

Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

is currently below long-term averages across maturities; this is also true when controlling for a level of 10-year Treasury yields like today's (see Exhibit 150). Incremental after-tax yields have also

Exhibit 149: Upgrade-to-Downgrade Ratios for Municipal Bond Issuers

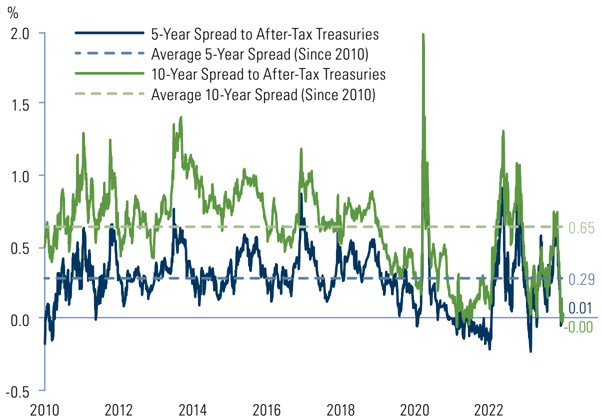
Upgrades significantly outpaced downgrades among municipal bond issuers last year.



Data through Q3 2023.
Note: Shaded periods denote recessions.
Source: Investment Strategy Group, Moody's Investor Service.

Exhibit 151: Incremental Yield of AAA Municipal Bonds Over Treasuries

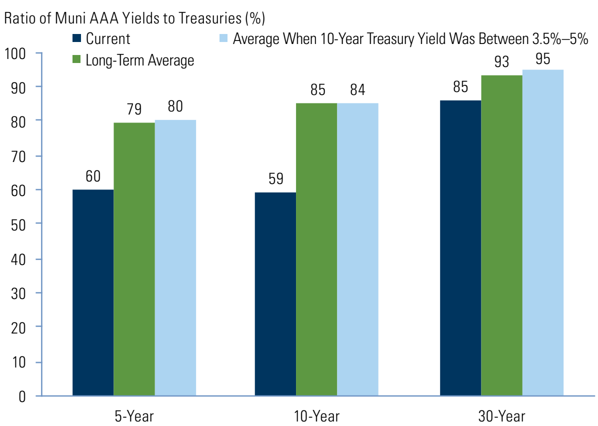
Municipal bond investors currently earn no incremental after-tax yield compared with holding Treasuries.



Data through December 31, 2023.
Source: Investment Strategy Group, Municipal Market Monitor, Bloomberg.

Exhibit 150: Ratio of AAA Municipal Bond Yields to Treasury Yields

Current municipal bond valuations relative to Treasuries are less attractive than their historical average.



Data as of December 31, 2023.
Source: Investment Strategy Group, Municipal Market Monitor, Bloomberg.

compressed substantially. In fact, investors taking some credit risk by buying a five-year AAA-rated municipal bond earn no incremental after-tax yield compared to holding Treasuries, a yield differential that has been higher 95% of the time in the past 35 years (see Exhibit 151).

Against this backdrop, we expect intermediate municipal bonds to generate a nominal return[70] of 2.9% in 2024. Our base case assumes municipal yields will fall less than 5-year Treasury yields, where we expect a 26-basis-point decline, as municipal spreads have already tightened significantly in the past two months (see Exhibit 152).

US High Yield Municipal Bonds

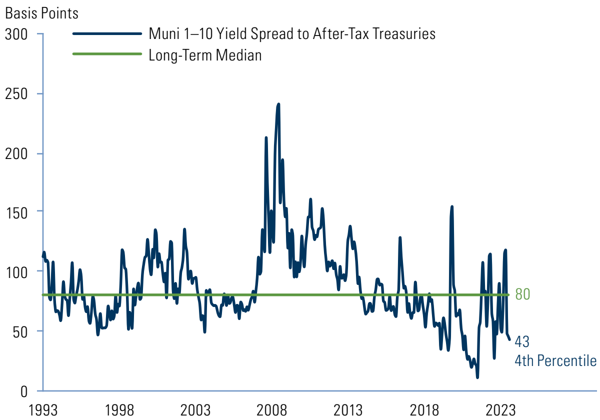
High yield municipal bonds returned 9.2% in 2023, considerably outperforming their investment grade counterparts. Despite the strong headline gain, last year saw wide dispersion in subsector performance. While Puerto Rican, transportation and special tax bonds outperformed, hospital, electric and housing bonds lagged.

As with its investment grade counterparts, the sector's fundamentals remain supportive. First-time municipal bond defaults remain well below levels seen in 2020 and 2021 (see Exhibit 153). Moreover, the slight uptick in defaults last year was not broad-based, as 88% of all defaults were concentrated in just three sectors—continuing care retirement centers (CCRCs), industrial revenue bonds (IDRs) and hospitals. Refinancing risk is also minimal, as just 8% of debt comes due in 2024 and 2025.

This healthy backdrop is evident in market pricing. Following the rally late last year, the yield on these bonds has fallen to 5.6%, a level that has been lower only a quarter of the time since 1995.

Exhibit 152: After-Tax Spread of 1- to 10-Year Municipal Bond Yields to Treasuries

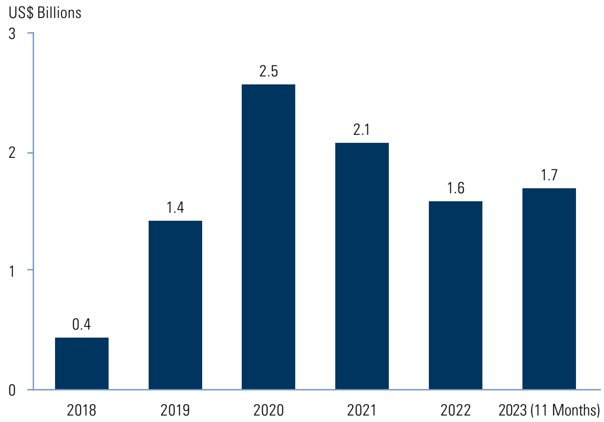
After-tax spreads are low relative to history.



Data through December 2023.
Source: Investment Strategy Group, Bloomberg, Barclays.

Exhibit 153: First-Time High Yield Municipal Bond Defaults

First-time high yield municipal bond defaults rose last year but remain below peak levels.



Data through November 2023.
Source: Investment Strategy Group, Barclays, Bloomberg.

Over the same period, spreads have been tighter than current levels only 30% of the time and now stand 66 basis points below their long-run median (see Exhibit 154). Moreover, only 1.7% of the sector's bonds trade at distressed levels, well below the 4.1% median since 2005 (see Exhibit 155).

For the year ahead, continued variation in subsector performance is likely, reflecting the combination of supportive fundamentals but tight spreads relative to history. We expect the sector to return 4% in nominal terms, as slightly wider spreads in response to declining Treasury yields erode a portion of these bonds' yield.

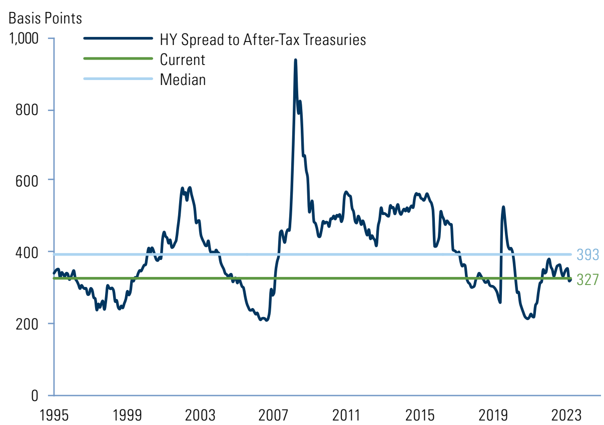
US Corporate High Yield Credit

Corporate credit made up for lost time in the final two months of last year (see Exhibit 156). High yield bonds generated most of their 13.4% annual return during this brief period, while investment grade bonds swung from a 2.5% loss for the year to a gain of 8.5%. Even leveraged loans—which feature a floating coupon—managed to rise in late 2023 despite the decline in rates over this period.

While the improving prospects for a soft landing were the proximate driver of last year's gains, supportive corporate fundamentals also played a role. Despite rising borrowing costs, interest coverage remains above its long-term median for both investment grade and high yield issuers. In fact, interest coverage for high yield issuers has been higher only 10% of the time

Exhibit 154: High Yield Municipal Bond Spread

The incremental yield above that of after-tax Treasuries is below the long-term median.

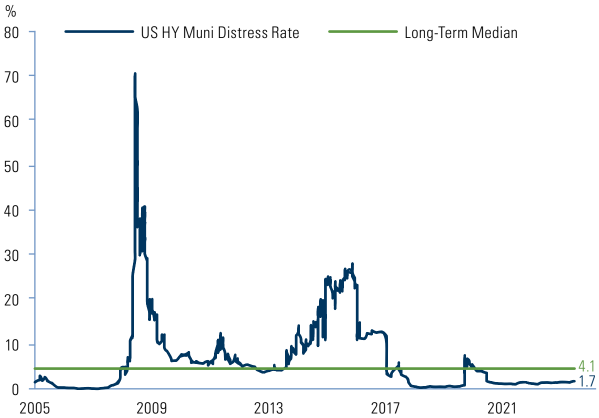


Data through December 2023.
Source: Investment Strategy Group, Barclays, Bloomberg.

since 1999 (see Exhibit 157). Financial leverage is equally benign, standing below its long-term average (see Exhibit 158) and continuing to benefit from the prudent use of funds by high yield issuers. Recent issuance has featured a greater share of refinancing and a lesser share of LBO, M&A and new bonds from low-rated companies (see Exhibit 159). Against this backdrop, credit agencies upgraded 1.3 times more US high yield bonds than they downgraded last year.

Exhibit 155: Distress Rate in the High Yield Municipal Bond Universe

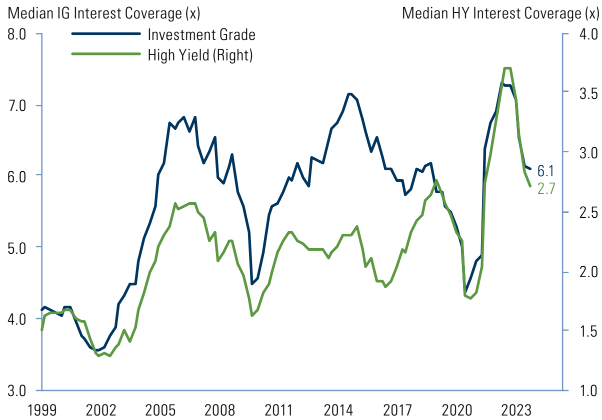
The share of distressed bonds in the high yield municipal bond universe is low.



Data through December 12, 2023.
Note: Distressed bonds are those with spreads above 750bps.
Source: Investment Strategy Group, Barclays.

Exhibit 157: Median Interest Coverage for Investment Grade and High Yield Issuers

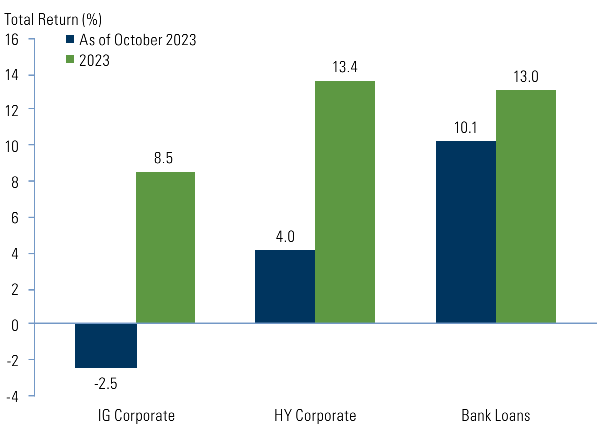
Interest coverage ratios declined last year but remain above their long-run medians.



Data through Q3 2023.
Note: Interest coverage is measured using the ratio of LTM EBIT to net interest expense.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research.

Exhibit 156: Performance of Corporate Fixed Income Assets in 2023

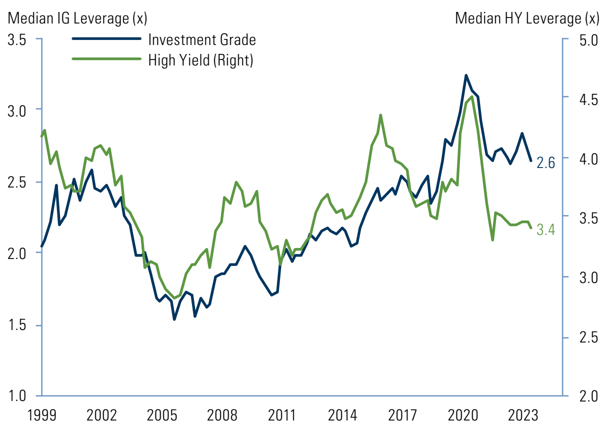
Corporate fixed income outperformed significantly in 2023, driven by a sizable late-year rally.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg, Barclays, Credit Suisse.

Exhibit 158: Median Leverage for Investment Grade and High Yield Issuers

The leverage ratio remains manageable, especially among high yield issuers.

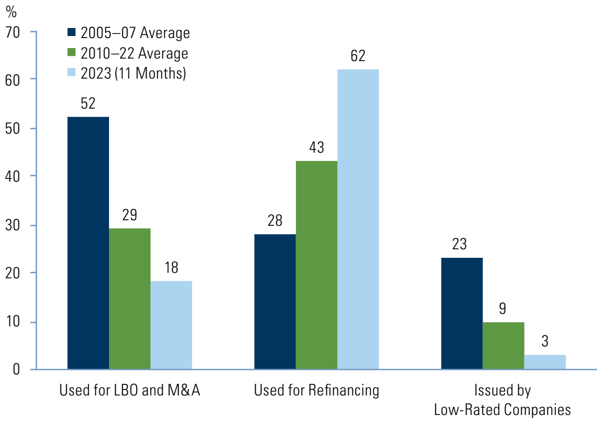


Data through Q3 2023.
Note: Leverage measured by the ratio of net debt to LTM EBITDA.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research.

Of course, investors are not oblivious to these supportive fundamentals. Credit spreads compressed significantly last year and now stand well below their long-term medians (see Exhibit 160). In high yield, spreads have been lower than current levels only 13% of the time in the last 36 years. Similarly, our models show that the incremental compensation for bearing default risk stands near the lowest levels on record (see Exhibit 161).

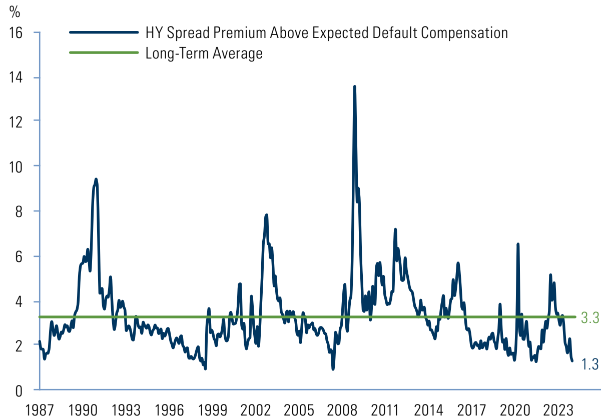
This smaller buffer to absorb losses arrives at a time when defaults have already begun to increase from historically low levels (see Exhibit 162). We expect this trend to continue in 2024, reflecting

Exhibit 159: Share of High Yield New Issuance
The quality of high yield issuance remains healthy relative to history.



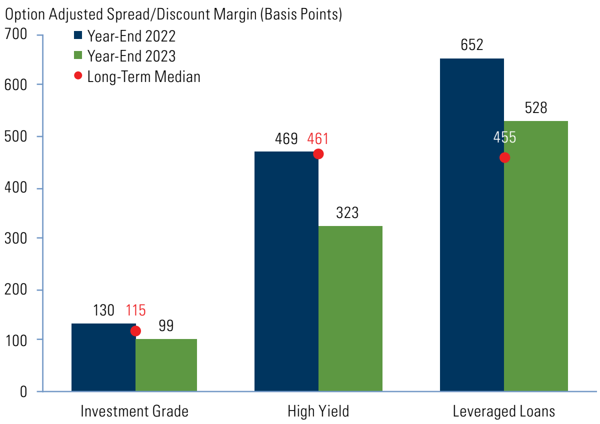
Data as of November 2023.
Source: Investment Strategy Group, JP Morgan.

Exhibit 161: Incremental Risk Premium of High Yield Spread in Excess of Default Costs
The credit risk premium offered by high yield spreads is close to historical lows.



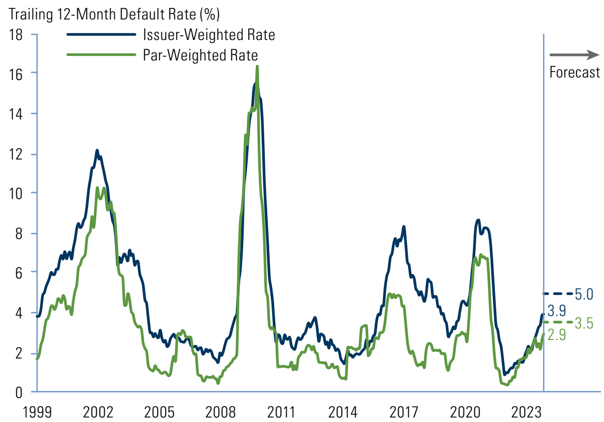
Data through December 2023.
Source: Investment Strategy Group, Haver Analytics, JP Morgan, Moody's Investor Service.

Exhibit 160: Change in Spreads for Corporate Credit During 2023
Investment grade and high yield spreads have compressed below their long-run medians.



Data as of December 31, 2023.
Note: Long-term medians based on data from June 1989, January 1987 and January 1992 for IG, HY and Bank Loans, respectively.
Source: Investment Strategy Group, Bloomberg, Barclays, Credit Suisse.

Exhibit 162: Trailing and Projected 12-Month Default Rates for US High Yield
Default rates rose last year, a trend we expect to continue in 2024.



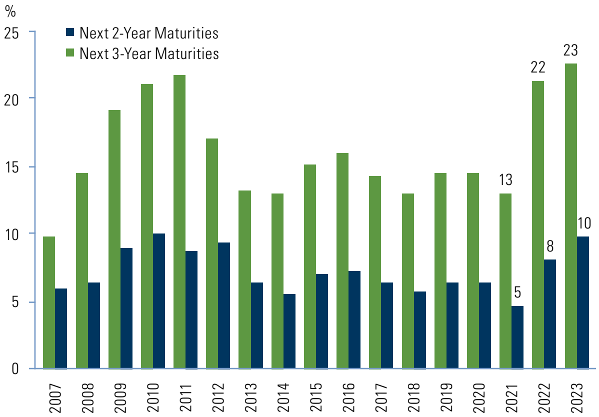
Data through November 2023. Forecast through 2024.
Source: Investment Strategy Group, JP Morgan, Moody's Investor Service, Haver Analytics.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

a combination of slower economic growth, an elevated level of distressed exchanges and higher borrowing costs. The last driver is increasingly important, as the share of debt maturing in the next few years is elevated relative to history (see Exhibit 163). For 2024, our models project a 5% issuer-weighted and a 3.5% par-weighted default rate.

While bank loans offer a 190-basis-point yield premium to high yield bonds today, and therefore a

Exhibit 163: Share of High Yield and Leveraged Loan Debt Maturing

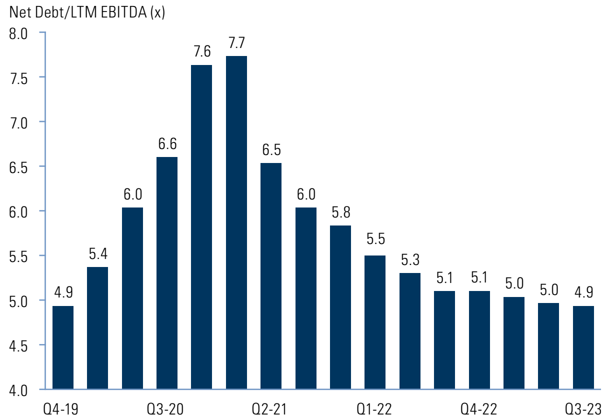
A historically high share of debt matures during the next two and three years.



Data through November 2023.
Source: Investment Strategy Group, JP Morgan.

Exhibit 165: Leverage Ratio for Leveraged Loan Issuers

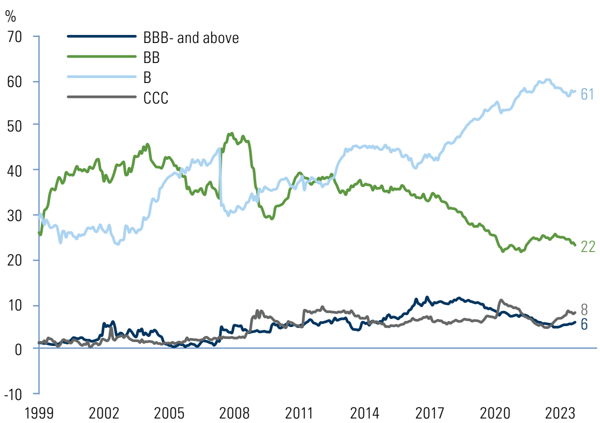
The pace of leverage reduction among bank loan issuers has slowed in recent quarters.



Data through Q3 2023.
Source: Investment Strategy Group, JP Morgan, S&P Capital IQ, Bixby Research and Analytics.

Exhibit 164: Share of Leveraged Loan Market by Rating

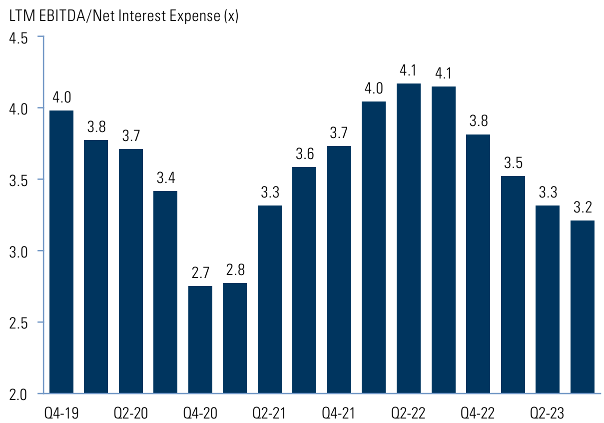
The credit quality of leveraged loan issuers has worsened over the past few years.



Data through October 2023.
Source: Investment Strategy Group, Barclays, PitchBook LCD.

Exhibit 166: Interest Coverage for Leveraged Loan Issuers

Interest coverage among loan issuers has deteriorated rapidly in recent quarters.



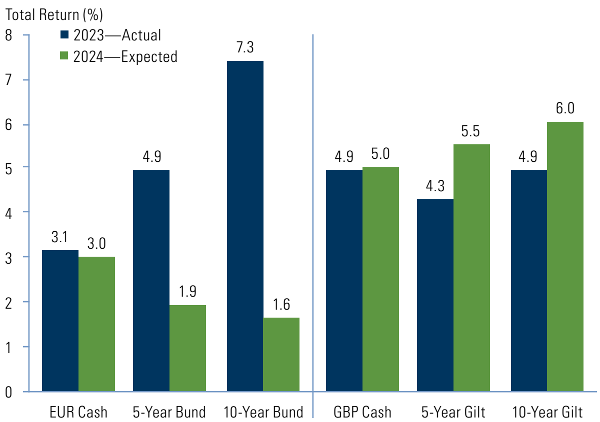
Data through Q3 2023.
Source: Investment Strategy Group, JP Morgan, S&P Capital IQ, Bixby Research and Analytics.

greater buffer to absorb default losses, that spread partly reflects weaker corporate fundamentals. Relative to the high yield index, the leveraged loan index has a much larger share of lower-rated B securities and a much smaller proportion of higher-rated BB instruments (see Exhibit 164). Bank loans also have higher absolute leverage than high yield bonds and have seen a slower pace of deleveraging and greater deterioration in interest coverage in recent years (see Exhibits 165 and 166). Not surprisingly, credit rating trends have been much worse for bank loans, with downgrades outpacing upgrades by nearly two to one.

The combination of rising defaults and today's scant credit risk premiums argues for wider spreads in 2024. Our forecast calls for high yield spreads to rise by 120 basis points this year, partially offsetting the returns from these

Exhibit 167: 2024 German and UK Government Bond Return Projections

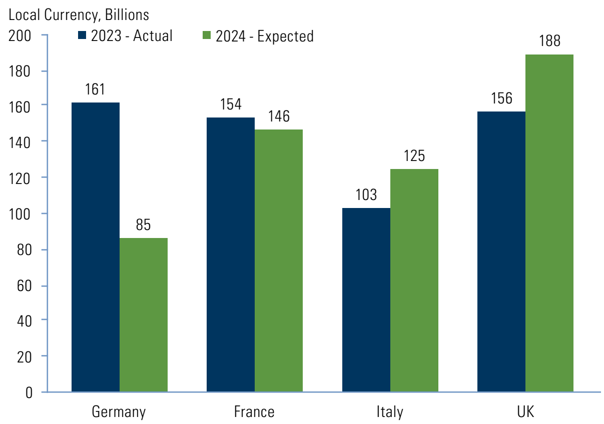
We expect UK bonds to outperform German bonds.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

Exhibit 168: Expected Net Government Debt Supply to the Private Sector

German issuance is set to fall sharply, while Italian and UK issuance is set to pick up further.



Data as of December 31, 2023.
Source: Investment Strategy Group, Goldman Sachs Global Banking and Markets, European governments, UK DMO.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

bonds' current 7.5% yield and the lower Treasury yields we expect. The net result is a low-single-digit total return this year. Despite their weaker fundamentals, leveraged loans are expected to deliver a mid-single-digit return, largely due to their higher current yield of 9.5%.

European Bonds

The Eurozone managed to evade a recession last year, but its tepid recovery kept recession concerns alive. This not only bolstered the hedging demand for European bonds and suppressed the term premium, but in combination with falling inflation, also resulted in markets pricing in a substantial 160 basis points of rate cuts by the ECB in 2024. Against this backdrop, German 10-year bond yields ended the year within our forecast range of 1.75–2.25%, helping European bonds outperform their US counterparts in 2024.

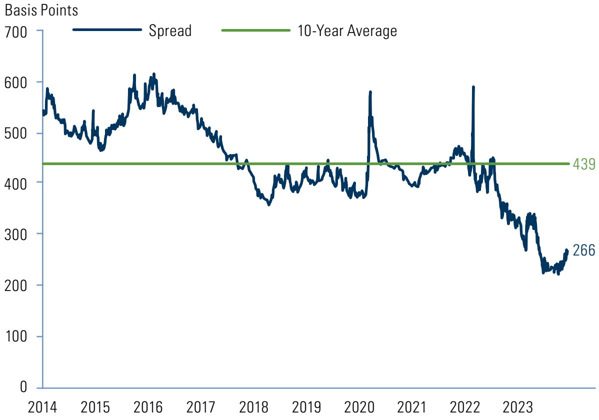
While the UK also avoided a widely anticipated recession, persistent inflation in the first half of last year led its government bonds to significantly underperform over this period. As inflation in the UK converged with that in other developed countries in the second half of last year, this underperformance was reversed. Along the way, investors priced an aggressive pace of rate cuts by the BOE into market prices, which now imply 140 basis points of cuts this year.

The path for European and UK bonds is anticipated to diverge in the coming year. For Europe, German bond yields are expected to remain largely range-bound due to various crosscurrents. The initiation of ECB cuts and a further slowdown in Eurozone inflation should support bonds. Conversely, elevated issuance of government bonds and the uptick in Eurozone growth we expect are likely to exert upward pressure on term premiums. We see these dynamics largely offsetting each other in 2024, with our 10-year forecast range of 1.90–2.30% implying a steeper curve, essentially unchanged German bond yields, and a low-single-digit return (see Exhibit 167).

Despite this range-bound forecast, we do not recommend overweighting peripheral bonds in search of higher yields. Two factors could potentially drive peripheral spreads modestly higher, diminishing their yield advantage. First is the increase in net government debt supply we expect will be concentrated in Europe's peripheral economies (see Exhibit 168). Second, the ECB plans to stop reinvesting securities from its Pandemic Emergency Purchase Programme (PEPP) in the second half of 2024. The PEPP has been able

Exhibit 169: Interest Rate Differential Between Emerging Markets and the US

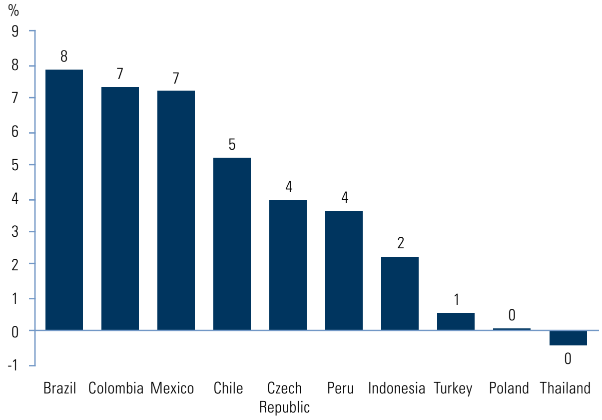
The narrow spread between the EMLD yield and similar-duration US yields tempers our return forecast.



Data through December 31, 2023.
Note: The spread is defined as the JP Morgan GBI-EM Global Diversified Index yield minus US SOFR 5-year rate, expressed in basis points.
Source: Investment Strategy Group, Bloomberg.

Exhibit 170: Emerging Markets Ex-ante Real Policy Rates

Countries offering high real rates are well positioned to outperform this year.



Data as of December 2023.
Note: Ex-ante real policy rates are obtained by subtracting 1-year inflation expectations (survey-based) from latest central bank policy rates.
Source: Investment Strategy Group, Haver Analytics, Bloomberg.

to channel the proceeds of maturing bonds into peripheral bond markets under stress, helping keep spreads contained. The absence of this safety net could result in some additional risk premium being priced into spreads.

In the UK, we see room for bonds to extend their rally. In our view, the 3.50% nominal neutral rate priced into the market today overstates future inflation concerns and does not adequately account for the UK's lackluster growth potential due to factors like Brexit, labor supply issues and increases in the UK's stock of debt. As inflation eases this year, we expect the market's neutral rate estimate to decline from 3.50% toward our 2.25% estimate. In turn, we see 10-year gilt yields falling this year, consistent with our target range of 3.10–3.50% and expected mid-single-digit return.

Emerging Market Local Debt

Emerging market local debt (EMLD) returned 13% last year, breaking a two-year losing streak.[71] The performance differences within this asset class were largely driven by interest rate differentials between countries. High yielding economies where central banks had proactively tightened monetary policies, like those in Latin America, outperformed. Meanwhile, low yielding Asian economies lagged amid mild inflationary pressures.

We expect EMLD to deliver another year of positive performance in 2024. This expectation is based on the anticipation of easier monetary policy, as declining inflation and decelerating activity likely justify lower policy rates by both EM and developed world central banks. However, the narrow spread between the EMLD yield and similar-duration US yields tempers our return forecast (see Exhibit 169). Furthermore, markets are already pricing in significant cutting cycles in many EM economies, which could negatively impact performance if not realized. Finally, we are closely monitoring upcoming elections in countries with fiscal concerns, as long-end yields may not be fully pricing in risks of fiscal slippage and increased bond supply.

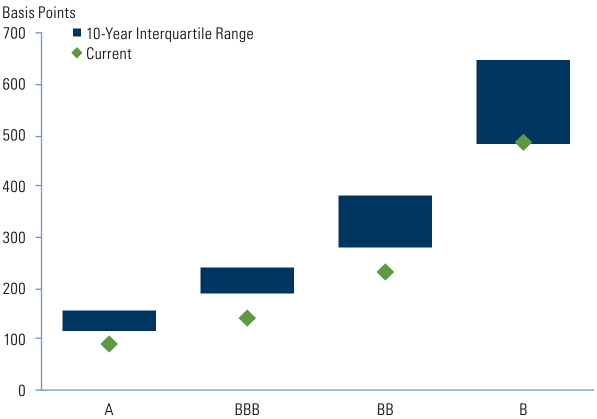
Considering the above, we expect mid-single-digit returns for EMLD this year, with limited yield compression from current levels and potential outperformance of countries featuring elevated ex-ante real rates (see Exhibit 170).

Emerging Market Dollar Debt

Emerging market dollar debt (EMD) gained 11% in 2023, slightly underperforming its local currency counterpart.[72] Returns were primarily driven by a tighter spread—one that ended the year at its lowest level in almost two years. The high yield segment of the index outperformed the high-grade component, as distressed countries such as Pakistan and Sri Lanka recovered strongly following IMF assistance packages.

Exhibit 171: Emerging Markets Credit Spreads by Rating Bucket

B-rated credits stand out as one area where spreads are not stretched outside their historical range.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.

We expect EMD to extend last year's gains with a mid-single-digit return in 2024. However, unlike last year, spreads are projected to slightly detract from total returns. This is due to a combination of factors, including wider US high yield spreads, neutral commodity prices, already tight spread levels and a stable US dollar index. As a result, duration is likely to be the more significant driver of returns this year, given the expectation of lower interest rates in the US.

B-rated credits within EMD are one area where spreads are slightly less tight compared to historical levels (see Exhibit 171). This group could potentially outperform in 2024 if the US avoids a recession, which is our base case.

Global Commodities Outlook

Last year reminded commodity investors that it's never wise to count chickens before they hatch. Following two years of strong performance that had reinforced investors' belief in a new supercycle, the GSCI instead fell 9% in 2023 (see Exhibit 172). The losses were broad-based, with negative price performance across energy, agriculture and industrial metals.

The high prices of commodities coming into last year proved to be the antidote for even higher prices, as they incentivized a mix of demand conservation, investment in supply capacity and productivity improvements. This dynamic was particularly visible in the oil patch last year, where production exceeded expectations in several countries despite producers' capital discipline. The resulting spare capacity is likely to limit upside again this year, barring major supply disruptions.

Outside of commonly traded commodity indices, there were a couple bright spots. Uranium saw a strong rally, gaining 90% last year. We continue to recommend a small overweight to uranium, a position we initiated in March 2022 based on our view that the widening gap between supply and demand would push prices higher. With supply being slow to respond despite last year's rally, we expect uranium prices to rise further this year.

Gold also stood out last year, posting a 13% return. However, we think the backdrop for gold is more challenging in 2024, given near-record prices and a more mixed fundamental outlook.

Oil: Threading the Needle

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't

Exhibit 172: Commodity Returns in 2023

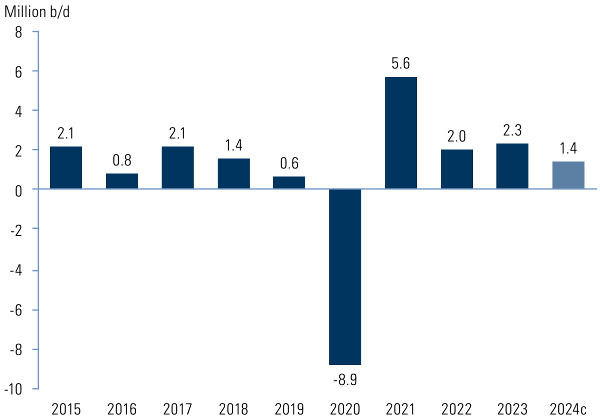
Commodities fell last year after two consecutive years of strong performance.

	S&P GSCI	Energy	Agriculture	Industrial Metals	Precious Metals	Livestock
Price Average, 2023 vs. 2022	-15%	-20%	-14%	-11%	8%	11%
Spot Price Return	-12%	-15%	-18%	-6%	12%	1%
Excess Return*	-9%	-10%	-13%	-9%	6%	-5%

Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
* Excess return corresponds to the actual return from being invested in the front-month contract and differs from spot price return, depending on the shape of the forward curve. An upward-sloping curve (contango) is negative for returns, while a downward-sloping curve (backwardation) is positive.
Past performance is not indicative of future results. Investing in commodities involves substantial risk and is not suitable for all investors.

Exhibit 173: Global Oil Demand Growth

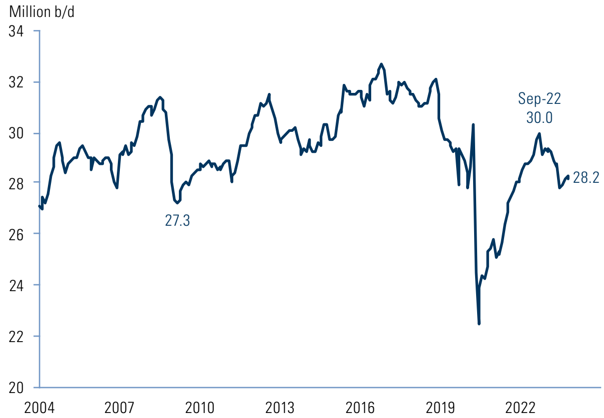
Consensus for 2024 global oil demand growth implies a meaningful slowdown relative to the past two years.



Data through 2023. Forecast through 2024.
Source: Investment Strategy Group, IEA, EIA, OPEC, Energy Aspects, S&P Global Commodity Insights, Goldman Sachs Global Investment Research, Morgan Stanley, JP Morgan, Citigroup.
Note: Forecasts are estimated, based on assumptions, are subject to revision and may change as economic and market conditions change. There can be no assurance the forecasts will be achieved. Please see additional disclosures at the end of this *Outlook*.

Exhibit 174: OPEC Crude Oil Production

OPEC production is already near 20-year lows, excluding COVID-19 emergency cuts.



Data through November 2023.
Source: Investment Strategy Group, Bloomberg.

so." That quote, often attributed to Mark Twain, proved apt for oil investors last year, as some widely expected developments failed to materialize. The almost universal expectation that oil prices would surge due to Russian sanctions limiting supply did not occur. Instead, Russia successfully redirected most of these sanctioned exports to China and India. Predictions of a slowdown in US production growth also missed the mark, as US producers recorded their fastest growth rate since 2019. With these bullish catalysts not happening the way people thought they would, oil prices ended the year with a modest 11% loss.

Oil begins the year trading at the lower end of its annual range. However, this does not negate the potential downside risks for 2024, as we anticipate challenges stemming from both demand and supply dynamics. Sustaining the recent demand growth rate will be challenging now that the post-pandemic recovery has largely run its course. We predict that demand growth will return to a trend-like pace of 1.0–1.5 million b/d this year in the absence of a recession, a significant deceleration from last year's 2.3 million b/d increase (see Exhibit 173).

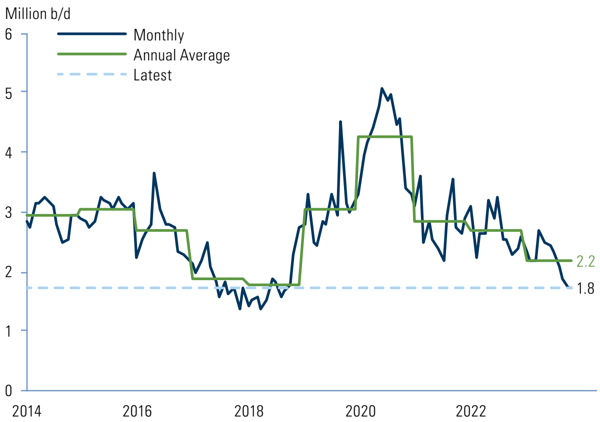
This slower demand growth will likely require restraint on the part of producers to keep the market in balance. For their part, US producers have consistently demonstrated discipline in their allocation of capital. Over the last 12 months, these producers have returned 49% of their cash flows to investors compared to 37% per year between 2014 and 2019. However, productivity has also improved in recent years, such that the same dollar of capital spending now generates more oil. As a result, US production is likely to continue growing despite ongoing capital discipline.

The potential for output restraint among other non-OPEC producers is just as dubious. Brazil, Guyana and Canada have all experienced a notable uptick in their oil output recently. What's more, their production is unlikely to be affected by oil prices, as it stems from years of investment in offshore and oil sands projects that are just now coming online. Ultimately, oil production from these projects could crowd out further expansion from US shale.

The high prices of commodities coming into last year proved to be the antidote for even higher prices.

Exhibit 175: Global Unplanned Oil Production Outages, ex-Russia

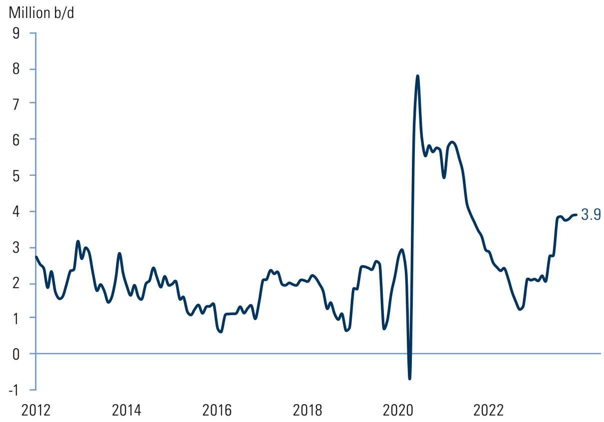
Today's low level of production outages implies greater risk of future supply disruptions.



Data through November 2023.
Source: Investment Strategy Group, IEA.

Exhibit 176: OPEC Spare Capacity

OPEC spare capacity is historically high, providing a buffer in case of supply disruptions.



Data through December 2023.
Source: Investment Strategy Group, Energy Aspects.

Against this backdrop, the burden of managing supply relative to demand rests with OPEC, where there is arguably little room for further reductions. OPEC production already stands at 10-year lows and has been higher than current levels 88% of the time in the past 20 years[73] (see Exhibit 174). Similarly, the production of Saudi Arabia—often considered the ultimate swing producer—has seldom fallen below its current level. Going forward, OPEC's determination to support prices could be tested if further production cuts become necessary. Indeed, at OPEC's November 2023 meeting, the decision to further reduce production sparked internal disagreements, leading to Angola's exit from the organization in protest.

Considering these challenges, we expect WTI prices to trade in a $60–80 range by year-end, implying minimal upside from current levels. That said, we are mindful of several risks that could potentially undermine our forecast. The likelihood of supply disruptions is growing given prevalent geopolitical uncertainty in the Middle East, as well as instability in countries like Libya and Nigeria. At the same time, global oil production outages excluding Russia currently stand near their lowest level in 10 years (see Exhibit 175). While any price spike would likely be temporary given OPEC's historically high spare capacity (see Exhibit 176), a spike could still cause significant disruptions in the short term. There are also legitimate downside risks to oil prices, including a US recession, an abrupt reversal of OPEC cuts or even a lack of production discipline among OPEC members.

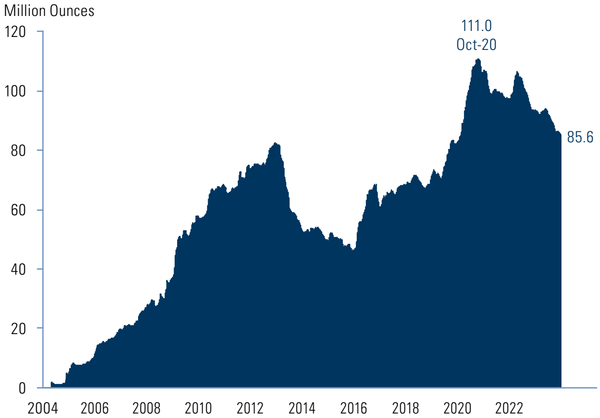
In light of these various crosscurrents, we do not have an active tactical allocation to oil. However, we continue to recommend a small overweight position to the US midstream sector, which benefits from strong cash flows, growing volumes and less direct exposure to oil price volatility.

Gold: Breakout Mania

There is nothing quite as captivating to investors as a new all-time high—like that reached by gold in late December last year, when its price hit $2,077. This milestone not only fueled expectations for further gains, but also reinforced investors' faith in several bullish catalysts for gold. These included so-called de-dollarization of central banks' reserves, falling interest rates and investors' search for safe-haven assets in times of global uncertainty.

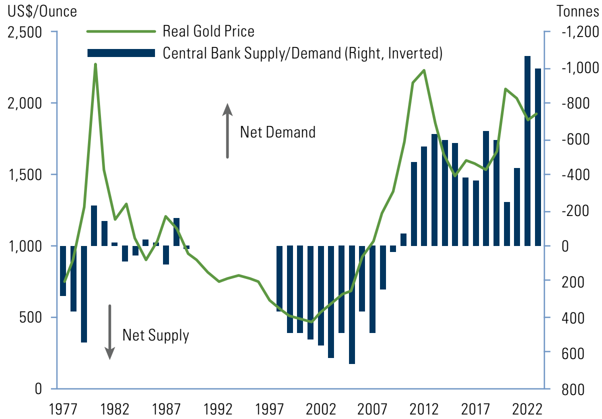
But as investors, we must avoid fitting a narrative to an asset's price movements. Gold did indeed rally alongside bonds late last year, but the catalyst for the bond move was signs of moderating inflation—whereas gold has the reputation of being an inflation hedge. Moreover, most assets rallied during last year's fourth quarter: gold's 11.6% return was similar to the 11.7% gain of US equities but higher than the 6.8% advance of the US aggregate bond index. It is also worth highlighting that this isn't gold's first time

Exhibit 177: Total Known ETF Holdings of Gold
Current holdings are more than 25 million ounces below their 2020 peak.



Data through December 31, 2023.
Note: Index of gold ETF holdings tracked by Bloomberg. See endnote 74 for details.
Source: Investment Strategy Group, Bloomberg.

Exhibit 178: Gold Price Perfomance vs. Central Bank Purchases
Central bank gold purchases have been elevated for some time, providing support for gold.



Data through 2023.
Source: Investment Strategy Group, Bloomberg.

surpassing $2,000. In fact, it also exceeded this level in August 2020 and March 2022, but reversed course shortly after on both occasions.

For the year ahead, we see several crosscurrents impacting the outlook for gold. To be sure, gold has a few supportive factors. There is scope for investors to increase their ETF exposure to gold, as current positions are more than 25 million ounces below their 2020 peak (see Exhibit 177). Emerging market central banks are also increasing their exposure, as they continue to diversify some of their reserves into gold. Based on data up to the third quarter of last year, these central banks added around 1,000 tonnes of gold to their balance sheets last year, accounting for nearly 30% of global gold production. However, this is not an incremental source of demand, as they purchased about the same amount the previous year (see Exhibit 178).

As was the case last year, our expectation for lower nominal interest rates could also benefit gold. Recall that lower rates reduce the opportunity cost of holding gold, which doesn't yield any income and needs to be stored, often at a cost. This interest rate dynamic can also be indirectly observed through gold's positive reaction to past Federal Reserve rate cuts. In fact, in the six months following the first rate cut of a cycle, gold prices have rallied 60% of the time, by a median of 6.2% (see Exhibit 179).

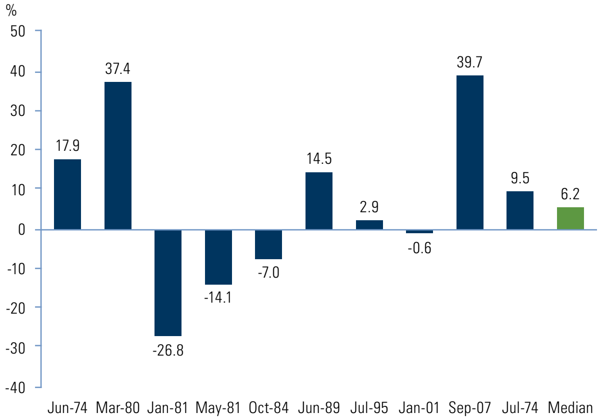
However, the fact that disinflation is pushing interest rates lower could weaken this dynamic. That has been the case historically, as real interest rates have been a more important driver of gold prices than nominal interest rates. Falling but positive real rates, which we expect this year, have historically been roughly neutral for gold prices compared to their unconditional performance. Capitalizing on these rate movements also requires precise timing, as the median gold return in the six months before the first Federal Reserve rate cut has been a 1.9% loss, with only a 50% chance of a gain.

There is nothing quite as captivating to investors as a new all-time high—like that reached by gold in late December last year.

We do not expect the US dollar to provide a clear catalyst to gold prices either. While there is a negative correlation between gold and the dollar, it has historically taken a large dollar depreciation to push gold prices meaningfully higher, which is not our central case. In fact, we expect the dollar to appreciate this year.

Exhibit 179: Gold Performance in the 6 Months Following a First Federal Reserve Cut

The median increase in gold prices following the first cut by the Federal Reserve has been 6.2%.



Data as of December 31, 2023.
Source: Investment Strategy Group, Bloomberg.
Note: Past performance is not indicative of future results.

In short, we do not believe these conflicting factors convincingly justify today's already high gold prices, leaving us neutral until a clearer opportunity presents itself.

Abbreviations Glossary

AI: artificial intelligence
APEC: Asia-Pacific Economic Cooperation
ASEAN: Association of Southeast Asian Nations

b/d: barrels per day
BIES: breakeven inflation expectations
BOE: Bank of England
BOJ: Bank of Japan
bps: basis points
BRICS: Brazil, Russia, India, China and South Africa

C&I: commercial and industrial [loans]
CAGR: compound annual growth rate
CAPE: cyclically adjusted price-to-earnings
Capex: capital expenditure(s)
CCRC: continuing care retirement center
CO2: carbon dioxide
COP28: 2023 United Nations Climate Change Conference

DXY: Dollar Index

EAFE: Europe, Australasia and the Far East
EBIT: earnings before interest and taxes
EBITDA: earnings before interest, taxes, depreciation and amortization
ECB: European Central Bank
EM: emerging market
EMD: emerging market dollar debt
EMEA: Europe, Middle East and Africa
EMLD: emerging market local debt
EPS: earnings per share
ETF: exchange-traded fund
EU: European Union

FANGMANT: Facebook/Meta, Apple, Netflix, Google/Alphabet, Microsoft, Amazon, Nvidia and Tesla
FDI: foreign direct investment
FX: foreign exchange

GDP: gross domestic product
GFC: global financial crisis
GIR: [Goldman Sachs] Global Investment Research
GO: general obligation [type of bond]

Ha: hectares
HEU: highly enriched uranium

ICOR: incremental capital output ratio
IG: investment grade
IEA: International Energy Agency
IMF: International Monetary Fund
ISG: Investment Strategy Group

Latam: Latin America
LBO: leveraged buyout
LNG: liquefied natural gas
LTM: last 12 months

M&A: mergers and acquisitions
MLP: master limited partnership
MOU: memorandum of understanding

NASBO: National Association of State Budget Officers
NTM: next 12 months

OECD: The Organisation for Economic Co-operation and Development
OPEC: Organization of the Petroleum Exporting Countries

PCE: Personal Consumption Expenditures [price index]
P/E ratio: price-to-earnings ratio
PEPP: Pandemic Emergency Purchase Programme
PMI: Purchasing Managers' Index
P/NTM: price of the equity market divided by consensus earnings over the next 12 months

RDF: rainy day fund
REIT: real estate investment trust
ROE: return on equity
RRR: reserve requirement ratio
SNB: Swiss National Bank
SOE: state-owned enterprise
SOFR: secured overnight financing rate
SONIA: Sterling Overnight Index Average

TIPS: Treasury Inflation-Protected Securities
TSE: Tokyo Stock Exchange

USDA: United States Department of Agriculture
USGS: United States Geological Survey

VIX: Chicago Board Options Exchange Volatility Index

WTI: West Texas Intermediate [oil price]
WTO: World Trade Organization

YCC: yield curve control

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