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MARKET PERSPECTIVES
REVIEW & OUTLOOK

FOURTH QUARTER 2023

FOURTH QUARTER 2023 REVIEW & OUTLOOK

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FOURTH QUARTER 2023 REVIEW & OUTLOOK
EXECUTIVE SUMMARY

12 January 2024

PORTFOLIO THEMES

- We believe the new bull market cycle continues in 2024 and likely brings double-digit gains for global equities.
- Positive global economic growth, easing inflation, and improving sentiment should support markets.
- Growth will likely continue to lead early in the year, but 2024 may usher in a shift to value leadership, which typically leads early in a market cycle.

MARKET OUTLOOK

- **A Resilient New Bull Market:** Young bull markets are stunningly hard to derail. Those that reach one year old almost always reach two.
- **Improving Sentiment:** While sentiment has perked amid equities' late-year surge, most remain sceptical—providing ample room for upside surprise and big gains in the new year.
- **Politics is a Tailwind in 2024:** Since 1925, US equities ended positive in 83.3% of presidential election years. Globally, political uncertainty likely fades throughout the year supporting stronger returns later in the year.

Global equities ended 2023 positively erasing the 2022 downturn and rising to new bull market highs. On the year, the MSCI ACWI Index rose 22.2%.[i] Emerging markets also rallied in Q4 and finished the year with a 9.8% positive return.[ii] This bull market turned one-year-old in October, and bull markets that reach one year almost always make it to two. We think this year will prove no exception. The current economic, sentiment and political drivers have the potential to deliver a good-to-great 2024.

Last year played out largely as we expected, with slowing inflation, no global recession, a gradual return to prepandemic trends and deep post US-midterm gridlock. Large growth equities—particularly in Tech and Tech-like industries—led as we anticipated. Yet contrary to popular belief, the rally was much broader than Tech and the so-called "Magnificent Seven" companies. 348 of the S&P 500's constituents rose last year, with 192 up 20% or more.[iii] Similarly, nearly two-thirds of the MSCI ACWI Index's 2,894 constituents rose, with 1073 up 20% or greater.[iv] This bull market isn't being driven by one or two sectors, in our view. It is a real rising tide.

i Source: FactSet. MSCI ACWI performance data as of 31/12/2023. USD.

ii Source: FactSet. MSCI EM performance data as of 31/12/2023. USD.

iii Source: FactSet. S&P 500 constituent performance data as of 31/12/2023.

iv Source: FactSet. MSCI ACWI constituent performance data as of 31/12/2023.

Politics added major tailwinds. After 2022's US midterms deepened gridlock, Congress did nothing beyond delaying a real resolution on the debt ceiling in June and a government shutdown in September and November. Partisan rhetoric rang throughout, but equity markets prefer inaction, ultimately exceeding presidential year three's average returns and extending the long history of positive post-midterm runs.

While less strong, these tailwinds typically extend into the fourth year. Their average 11.4% return and 83.3% frequency of gains are the second strongest in the presidential cycle compared to year three's 18.7% average return and 92.0% frequency of gains.[v] Even better, and something few see: When year two dropped like 2022, year four rose every time except 1932—amid the Great Depression.

The US general election is a major factor in presidential cycle fourth years' bullishness, adding to gridlock and lifting sentiment as uncertainty falls. So it should be in 2024. The prospect of a 2020 election repeat seemingly tires voters—polls show both parties' voters want someone fresh. Yet the longer this goes on, the lower the likelihood of a change. 2024 dawns with November's contest likely to pit President Joe Biden against former President Donald Trump. Opinions of both are hardened and net negative, which could hit sentiment and spark volatility—elections often bring volatile moments. But eventually we will get a winner, and sentiment will coalesce around them—society will realise the outcome isn't as bad as feared no matter who wins. The victor is often accepted more than feared early on, sparking a post-vote rally.

This does not suggest that 2024 will be a late-year rally exclusively. Yes, averages say election years are back-end loaded. But a few negative first halves under an incumbent Republican presidents bear the blame. Further, six of eight negative election years were under sitting Republican presidents. Five of those occurred during or just after recessions—a recipe for a party switch. Investors have long cast Republicans as pro-business and Democrats anti (a view unsupported by historical market returns). Hence a looming flip from Republican to Democrat sparks fears of less market-friendly policy. But 2024 features an incumbent Democrat, which either extends the status quo or sets up a transition to an administration perceived as pro-business. Under Democratic presidents' fourth years, S&P 500 returns have been more evenly distributed—6.4% in the first half and 7.1% in the second.[vi]

Better still, gridlock extends globally. In the UK, deep internal divisions and an election due by 2025 will keep the government from doing much. Japan's government is reeling over a financial scandal—also a recipe for little happening. Spain's weak coalition government is very fragile. The Netherlands could take months to form one after November's election. Germany's coalition argues endlessly over budgets. Upcoming elections in several major EM countries, including India, Taiwan, Indonesia and Mexico, suggest political risk will be heightened early in 2024, however this risk should wane as the outcomes become apparent. While many scrutinise the wars in Ukraine and Gaza as market risks, whatever power they had over equities is likely accounted for. It is a noisy landscape but one likely devoid of big policy shifts. That extends the status quo worldwide, helping businesses plan and invest.

v Source: Global Financial Data, Inc. Data pulled on 03/01/2024. S&P 500 total return in presidents' third and fourth years.

vi Ibid.

Reinvigorated business investment should be a major theme in 2024. For nearly two years, businesses cut back to survive a widely forecast recession that never came. Expect them to gradually turn up the dial, emboldened by recovering earnings and large gross profit margins. Their investment should contribute to a strengthening economy as recessionary thinking gives way to a growthy mindset. Globally, markets are already looking past the sluggish UK and other pockets of weakness in Europe. Meanwhile, widely feared China is merely reverting to its prepandemic trend of steadily decelerating growth, acceptable for the global economy and equities.

A reheating economy could create the conditions for a late-year leadership shift from growth to value. We are watching for this. Value usually leads when yield curves steepen and economies accelerate, typical in an early bull market. This early bull has been unusual, with slow growth and an inverted yield curve—funneling more capital to large, growth-oriented firms that can use their pristine balance sheets and size to their advantage. If the economy were to upshift and a re-steepened yield curve boosted lending, value firms would be the prime beneficiaries, though growth equities would continue to benefit as well.

GLOBAL UPDATE AND MARKET OUTLOOK

5 February 2024

MARKET RECAP

A GOOD-TO-GREAT 2024

As a strong 2023 unfolded—shocking most forecasters—recession expectations faded. So did inflation. Global and US equities entered 2024 nearing new all-time highs, powered by Tech. The rally started as 2022 midterm elections boosted gridlock, preventing major, divisive legislation.

The world we envisioned a year ago became reality. Now the trends boosting 2023 returns—gridlock, economic resilience, a brighter-than-appreciated corporate backdrop—should extend into 2024, if less strong. As Sir John Templeton famously said, "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria." Last year's excessive pessimism warmed to scepticism but remains far from a euphoric top. In our view, a second bull market year delivering good-to-great returns likely awaits in 2024.

THE BOUNCE EFFECT IN 2023

As we anticipated, 2023 was the year of the bounce—continuing the bull market's surge off October 2022's lows. Tech led, which many forecasters attributed to AI hype alone. They missed the point: 2023 was a new bull market starting. The areas that fall the most typically bounce the biggest. That was the overarching investment theme few saw.

Many forecasters assumed *typical* market behavior was *necessary*. They presumed a bear market, Fed rate hikes and inverted yield curves meant recession, which *typically* follows a bear market. Pundits noted they *typically* end in frantic selling—capitulation—which we didn't see in 2022.

But typical doesn't mean necessary. We made this point entering 2023, envisioning a recovery like 1967's—the first year after 1966's shallow bear market. 1966 was a US midterm year with high inflation, war fears, sour sentiment and a mild bear market starting in Q1.[vii] That bear market ended in October without recession or capitulation. A new bull market rose more than 30% in its first 12 months.

The recovery in 2023 was similar to 1967. Inflation faded—quelling fears of a 1970s redux—and the midterm election delivered bullish gridlock. Recession fear eased as forecasts proved faulty.

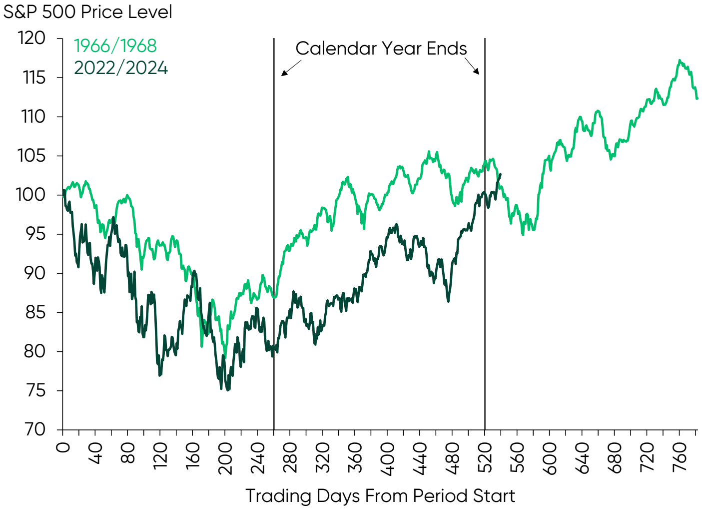
After its first birthday, the late-1960s' bull market carried on to reach its second in 1968, returning 11.0%—nearly matching election-year averages.[viii] But we think the comparison starts breaking down here. While we anticipate this bull market running into 2024, there are numerous differences. In US politics, no incumbent sought re-election in the 1968 presidential election, as Lyndon B. Johnson sat out. The challenger—Republican candidate Richard Nixon—wasn't a former president.

This speaks to the 2024 election's oddities, which we discuss in the US commentary section. Regardless, our historical example was illustrative, cited mostly to disprove late-2022 theories you *couldn't* get a bull market before a recession and capitulation. Markets have now echoed that point.

vii Source: FactSet, as of 04/01/2024. S&P 500 price return, 09/02/1966 – 07/19/1066.

viii Ibid.

EXHIBIT 1: THEN AND NOW REVISITED



Source: FactSet, as of 25/01/2024. S&P 500 price index. Indexed to 100 at period start, 31/19/1265 – 31/19/1268 and 31/12/2021 – 25/01/2024.

Many bears overlooked another core point: Markets are forward-looking discounters of widely known information. Widespread recession expectations increased the likelihood markets pre-priced weakness. Fear generated anticipation, and anticipation is mitigation. Some businesses acted, quelling hiring or otherwise cutting costs. We got the effect of the recession—curtailing potential excess—without reaching actual broad contraction. Regardless, though, the widespread expectation of recession muted its ability to impact equities materially.

SCEPTICISM ENTERING 2024

As noted earlier, sentiment warmed in late Q4 after the correction ended, lifting markets near all-time highs. Now scepticism appears dominant—perhaps most noticeably among professionals. One way to see this? Our forecast bell curves.

Professional forecasts both tend to reflect and influence market sentiment, helping indicate the degree to which various scenarios are priced in. These forecasts are widely discussed and weighed. Hence, common forecasts get pre-priced—rendering them largely unlikely to occur. As Exhibit 2 shows, the average difference between actual results and the median forecast were in the double-digits every year since 2018.

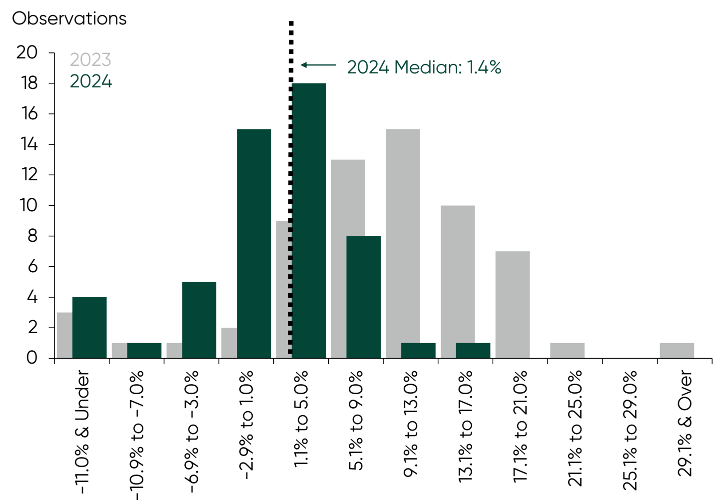
EXHIBIT 2: ACTUAL RESULTS DEVIATE WIDELY FROM PROFESSIONAL FORECASTS

	Median Forecast	Actual S&P Returns	Difference
2018	5.3%	-6.2%	11.5%
2019	15.8%	28.9%	13.1%
2020	2.1%	16.3%	14.2%
2021	6.5%	26.9%	20.4%
2022	4.9%	-19.4%	24.3%
2023	9.4%	24.2%	14.8%
2024	1.4%	?	?

Source: Fisher Investments Research and FactSet, as of 04/01/2024.

But median forecasts aren't sufficient to know which views are common. Hence, we take a broad view of professional annual forecasts for S&P 500 closing index levels and impute a return. We then plot them on a bell curve to find clusters—and voids, as Exhibit 3 shows.

EXHIBIT 3: 2023 AND 2024 SENTIMENT BELL CURVES



Source: Fisher Investments Research, as of 04/01/2024.

Last year's median outlook (9.4%) was near markets' long-term average, and only 2 of 63 projected over 21%—a relative void. More (3) expected declines exceeding -11.0%. Most who were too dour last year haven't become bullish. This fits our longstanding observation: Professional forecasters, when wrong, often dig in.

Hence, this year's outlooks are even *weaker*. The median calls for just a 1.4% increase in the S&P 500 price level. Of 53 forecasts, 33 cluster between -2.9% and 5.0%. Only two call for double-digit returns. The bell curve has a relative void starting around the market's historical average annualised return.

A SHIFT TO VALUE?

As potential reacceleration nears, value equities may anticipate it and assume leadership. Growth has worked well thus far, but nothing leads forever.

Credit access will likely be critical for this. Value companies have messier balance sheets and can't use their size to get cheap funding in capital markets. Hence, they rely more on bank lending, which the yield curve traditionally influences. The yield curve dictates lending's profitability—and banks' willingness to extend credit.

Currently, the yield curve in the US and many developed markets is inverted. Global loan growth has been decelerating from its recent high. If the curve re-steepened, it could encourage banks to lend more, driving a value resurgence. Central bank rate cuts may do that.

Of course, this isn't certain. Total loan growth continues despite a long-inverted yield curve, likely tied to banks' ample deposits and reserves. This kept their funding costs from rising with fed-funds. A steepening yield curve may not sway things much, either. However, we think a yield curve shift is worth watching for a rotation to value.

GLOBAL REACCELERATION

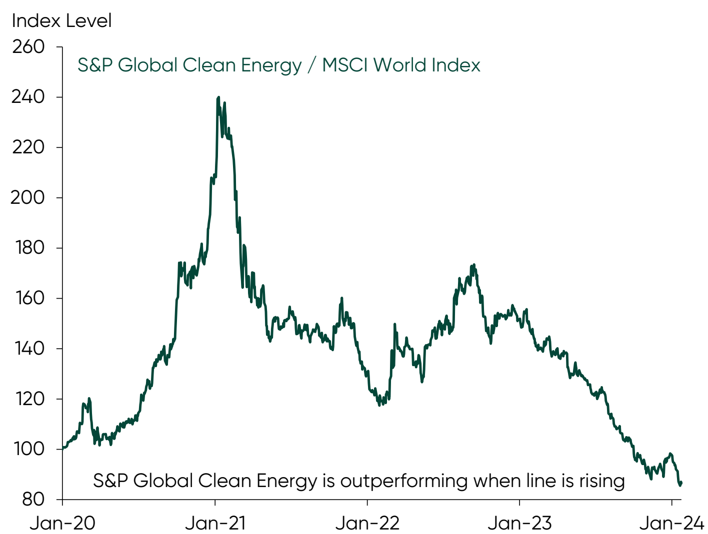
A pickup in Britain and Europe is another possible value driver. Both are value-heavy, featuring Industrials, Chemicals, Energy and Financials firms. UK GDP has been flattish for several quarters, with monthly data hinting at a Q4 2023 contraction after Q3's slight decline. Eurozone growth has also been tepid, with Germany long near recession. But cooling inflation should ease rate fears—which may lower long-term rates and spur loan demand, aiding value.

So we watch and wait, knowing any leadership shift will be gradual and inconsistent. We are wary of getting fooled by false starts and won't try to time a potential inflexion point precisely. We seek to identify broader, more durable trends.

CLEAN ENERGY REALITY UNDERSHOOTS EXPECTATIONS

Pundits have long touted clean energy equities' potential, citing future prospects of a "Green New Deal" and the EU's launch of various initiatives targeting "net zero" greenhouse gas (GHG) emissions. To many, the upside with all the government money flooding the space seemed clear. But following a brief run through early 2021, clean energy shares have massively underperformed global equities. In our view, this is because the reality of clean energy profits has fallen far short of their promise, which looks unlikely to change in the foreseeable future. Hype didn't match reality.

EXHIBIT 4: CLEAN ISN'T ALWAYS SO GREEN



Source: FactSet, as of 25/01/2024. S&P Global Clean Energy and MSCI World Indexes returns with net dividends, indexed to 100 at period start, 31/12/2019 – 25/01/2024.

While we are hopeful that there is meaningful future progress in clean energy, markets move most on the gap between reality and expectations. From that perspective, we think clean energy expectations rose too high. During the S&P Global Clean Energy Index's 2020 runup, there was increasingly widespread belief a wholesale energy transition was imminent and would be every bit as transformative as the coal/oil-driven Industrial Revolution. Renewable energy firms had already endured a shakeout in the 2010s amid intense Chinese competition. But with survivors emerging leaner and meaner, unsubsidised solar and wind costs (allegedly) becoming competitive with fossil fuels and US and European governments promoting clean energy adoption, renewed optimism had many anticipating lofty long-term returns—and bidding up the index accordingly. Over the next three years, however, reality proved unable to meet 2020's elevated expectations, erasing the earlier growth.

In our view, there were a number of reasons why. Although clean energy can be cheaper than fossil fuels at times, electricity generation from wind and solar remains intermittent—and utility-scale energy storage systems (e.g., batteries, pumped-storage hydroelectric or other means) ensuring grid reliability have yet to mature, adding to costs. Hence, many clean energy projects require subsidies to build—and remain operational. But this makes their economics dependent on political backing—often uncertain.

The Biden administration's Build Back Better Plan proposed sweeping clean energy incentives when it was introduced in 2020, but it was later broken apart and, for elements not dropped altogether, watered down substantially. The part that became 2021's Infrastructure Investment and Jobs Act was less than a third of the original $2 trillion proposal—and its roughly $550 billion in new spending over five years is subject to reappropriation by later Congresses. Funding isn't guaranteed.

Or take the UK government's efforts to develop offshore wind capacity. In September, it held an auction to award contracts for generating 5 gigawatts of electricity from offshore windfarms over 15 years at 44 pounds per megawatt-hour. But there were no bidders, as prospective windfarm builders/operators cited too-low pricing to make it worth their while. Although the government has since upped its strike price to 73 pounds per megawatt hour and will reopen the auction in March, wind power's escalating costs speak to the challenges the clean energy industry faces.

Back in the US, for example, the world's largest offshore windfarm developer announced a potential $2 billion writedown on projects off the East Coast last August and warned it may end them entirely because of supply chain delays and higher interest rates. To the extent private firms fund these projects, many of them tend to be very credit-sensitive. Thus, we had a bad combination over the last few years: Fast-rising interest rates and excessive hype over clean energy's prospects.

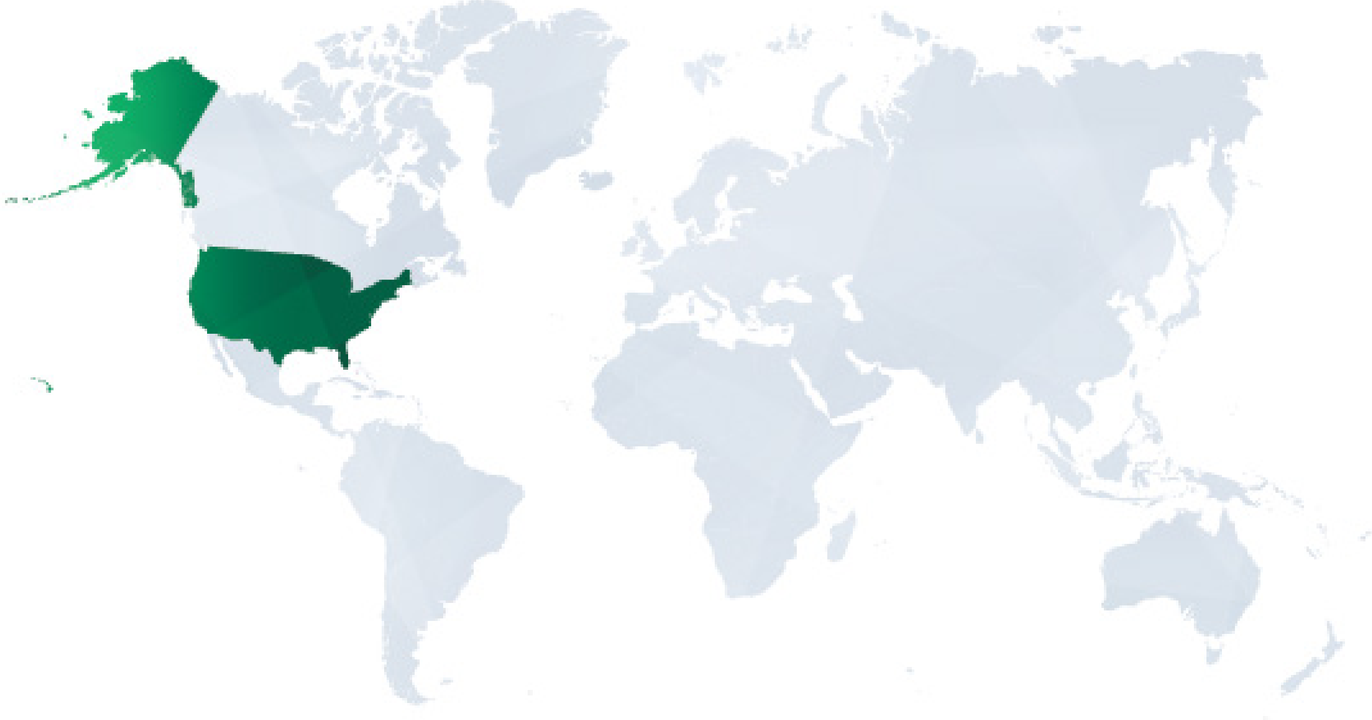
Part of the fallacy behind the rush of investors into clean energy: Whatever any potential energy transition ultimately looks like, it is highly unlikely to happen fast. Besides uncertain government pricing and cost overruns, obtaining the necessary permits can take years—especially when it is through multiple agencies and jurisdictions. Typically the larger (and more impactful) the project, the longer it will take. And that isn't even taking into account local—and vocal—opposition that can add still years more of court challenges, environmental reviews and the like. Many solar and wind projects have recently run into "not-in-my-backyard" sentiment, forcing planners to regroup. Furthermore, the amounts of copper and other metals needed for electrification is so large scale that it will require many years of mining to meet.

In the meantime, the economics of clean energy—versus fossil fuels—could also change. Burgeoning US natural gas production and infrastructure to ship it globally through liquefied natural gas (LNG) terminals and tankers appears likely to extend the relatively clean-burning fuel's use for decades to come. Europe's switch largely to LNG—rather than wind or solar—after Russia cut off its gas supplies suggests the clean energy transition may be further out than most imagine, despite popular rhetoric.

It is possible the global economy decarbonises completely by 2050, but markets look only 3 – 30 months ahead. Plus, it is far from certain that wind and solar will be the big long-term winners many suppose today. Perhaps instead of these sources, nuclear energy through small modular reactors, which can use economies of scale to drive costs down, ushers in the Atomic Age science fiction promised 80 years ago. There are also several well-funded startups working to commercialise fusion energy, which could theoretically provide near limitless power without the intermittency issues green energy faces. Or not. Maybe none of these are the winners long term. Point being, beyond a few years out, anything can happen. But in the timeframe markets consider, clean energy has yet to match the headline lofty expectations.

Even though it continues to regularly feature in financial publications as the "Next Big Thing", we doubt clean energy's returns match expectations in the foreseeable future. Many still have hope. But hope isn't a great thesis for investment, which is largely the story of clean energy over the past three years.

UNITED STATES COMMENTARY



FEDERAL RESERVE AND "SOFT LANDING"

When recession didn't materialise in 2023, many retrospectives debated who deserved "credit." Most agreed on the Fed for "engineering" a "soft landing" of cooler inflation without recession. We disagree with this narrative. While the Fed did absorb some of the excess money supply it unwisely created in 2020 during lockdowns, we see limited effects. Crediting the Fed solely ignores supply chain issues way outside the Fed's control and the Ukraine war's temporary impact on oil, gas and some materials prices. Those issues' resolving are both important and underappreciated. We think the "soft landing" narrative is just forecasters' fruitlessly grasping at why their "hard landing" fears of a deep recession didn't come true. In reality, there is no "landing" at all.

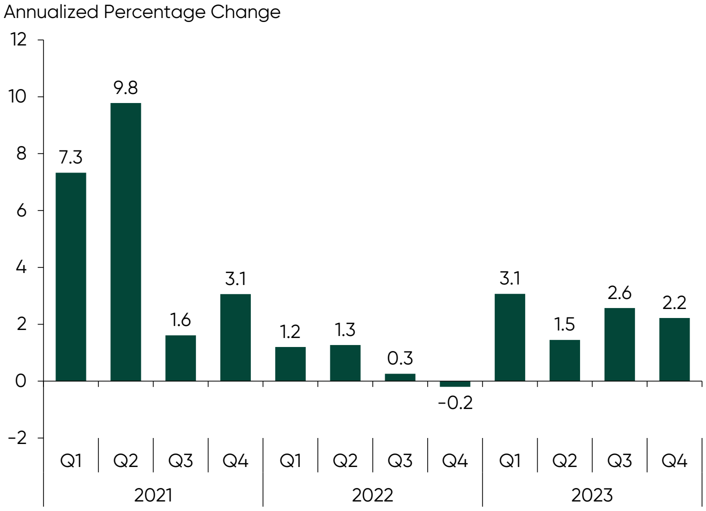
Q3 REACCELERATION

US Q3 GDP grew 4.9% annualised, accelerating from Q2's 2.1%.[ix] Now, rising inventories added 1.3 percentage points (ppt), which is open to interpretation. Government spending added another 1.0 ppt. So it is fair to say 4.9% overstates reality. But still: Consumer spending, business investment and residential real estate investment all grew. (Exhibit 5) The same is true for Q4 2023 where US GDP positively surprised, showing broad-based expansion at 3.3% annualised— although somewhat lesser than Q3.[x] Regardless, these key factors didn't cool to a "soft landing" in 2023. They accelerated.

ix Source: Bureau of Economic Analysis, as of 09/01/2024.

x Source: Bureau of Economic Analysis, as of 25/01/2024.

EXHIBIT 5: TOTAL CONTRIBUTIONS OF CONSUMPTION, BUSINESS INVESTMENT AND REAL ESTATE



Source: Bureau of Economic Analysis, as of 25/01/2024.

Q3 was real estate's first rise since Q1 2021—a notable upturn. However, it isn't a huge economic swing factor, at just 3.9% of US GDP.[xi] Regardless, this doesn't stop pundits from overrating its importance, calling it a source of weakness tied to rates. But weakness is old news. Residential investment tumbled -26.4% annualised, -24.9%, -5.3% and -2.2% in the four quarters before Q3 2023 *without* declines in headline output.[xii]

MARKETS AND RATE-HIKE SENSITIVITY

Economic expectations remain too dour. Many talk of rate hike pain merely delayed. Rate-sensitive pockets of the US's economy, like real estate, have shown weakness. So has Silicon Valley, whose startup shakeout persists. Utilities equities, highly credit-sensitive, lagged big in 2023. So did clean energy, falling more than -50% between 8 January 2021's high and yearend 2023 on credit reliance and a hangover from hype tied to governments' policy pushes.[xiii]

Rising rates' impact happened, yet the economy grew. People miss the simple point that, again, anticipation was mitigation. Businesses made cuts presuming bad times were ahead, rather than waiting until trouble struck. Soon we will likely start seeing firms move from defense to offense, fostering an eventual reacceleration. Businesses should get more assertive after mitigation from prior anticipation, starting them down the path to future elation. That elation, in our view, will be the euphoric endpoint of Templeton's quote. But this warming process is just beginning, far from overheating.

INTEREST RATES AND THE FEDERAL RESERVE

Treasurys had a volatile 2023 as inflation and Fed moves drove uncertainty. The 10-year yield started at 3.88%, then rose as high as 4.99% on 19 October—tied mainly to talk of higher-for-longer Fed rates and US deficit worries.[xiv] But as with equities' parallel correction, yields' rise was overdone. By yearend, 10-year yields were down where they started: 3.88%.[xv]

We don't have a strong opinion on long-term interest rates' direction in 2024. They will likely stay rangebound, perhaps with volatility. Inflation expectations are a key driver, but slowing inflation is well known—likely pre-priced. As for deficit worries, we think they were fleeting. Rates rose in not only US Treasurys, but nations with small, shrinking deficits—and *surpluses* like Australia and Norway.

INTEREST RATES AS A MARKET DRIVER

Interest rates received plenty of attention in 2023, with many deeming them major swing factors for equities. That heightened attention probably continues in 2024. We also saw lots of confusion from retail investors on how rates work—which probably persists, too. Here is a summary on various interest rates and what they mean (and don't mean) for equities.

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xi Source: Bureau of Economic Analysis, as of 09/01/2024.

xii Source: Bureau of Economic Analysis, as of 09/01/2024.

xiii Source: FactSet, as of 09/01/2024. S&P Global Clean Energy Index, 08/01/2021 – 31/12/2023.

xiv Source: FactSet, as of 09/01/2024. US 10-Year Treasury Yield on 02/01/2023 and 19/10/2023.

xv Ibid. US 10-Year Treasury Yield on 29/12/2023.

POLICY RATES

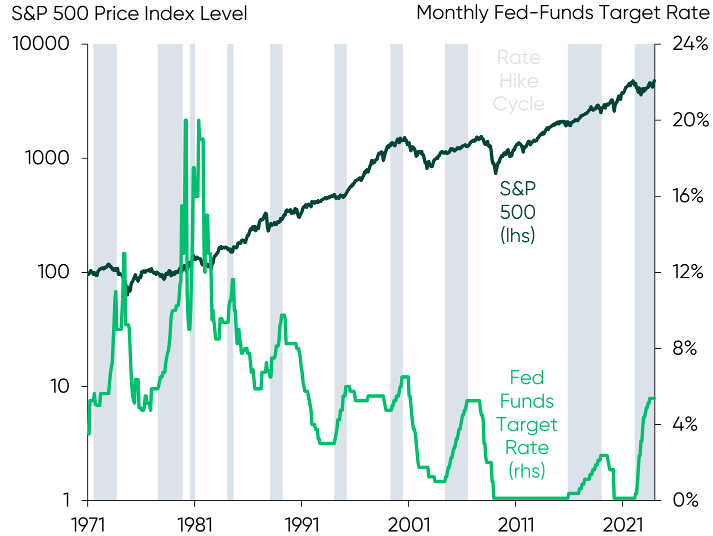
The interest rates set by a country's central bank are *policy rates*. The fed-funds target rate is the US policy rate, which the Fed sets as a range. When headlines discuss Fed hikes or cuts, this is what they refer to, though the Fed has other rates.

Fed-funds can influence many consumer rates, like savings accounts, certificates of deposit, money market fund yields and variable-rate mortgages. They may have some influence on credit cards, auto loans and new mortgages, too. (Importantly, existing fixed-rate mortgages are largely unaffected.) They can also influence the rates at which business borrow and save. Banks' funding costs usually compete with other short-term rates, so policy rates have historically dictated how much it costs banks to do their core business of borrowing at short rates and lending at long—which influences their willingness to lend, influencing money supply growth.

But reality doesn't always match the theory. After adjusting to the Fed's rapid reversal on rate hikes in early-to-mid 2022, markets began rallying that October despite aggressive rate hikes' continuing. Why? For one, banks had a deposit glut, which kept their funding costs low and boosted lending profits as mortgage and other loan rates jumped. Furthermore, the Fed's hikes became widely known—sapping surprise power.

Rate hikes have no pre-set market impact and are usually pre-priced. Most come during expansions and bull markets, while rate cuts usually happen as bear markets and recessions form. But these aren't hard and fast rules, and they don't predict market inflection points.

EXHIBIT 6: NO SET RELATIONSHIP BETWEEN POLICY RATES AND EQUITIES



Source: FactSet, as of 08/01/2024. Monthly fed-funds target rate (rhs) and S&P 500 Price Index Level (lhs), 29/01/1971 – 31/12/2023.

SHORT-TERM TREASURY YIELDS

Short-term US bond yields are interest rates on Treasury bills, usually with maturities between four weeks and one year. Three-months is typically called the short end of the yield curve and tends to be a market-based indicator of banks' funding costs. These yields usually pre-price Fed moves, giving short rates a stronger directional link with Fed rates than long-term Treasurys.

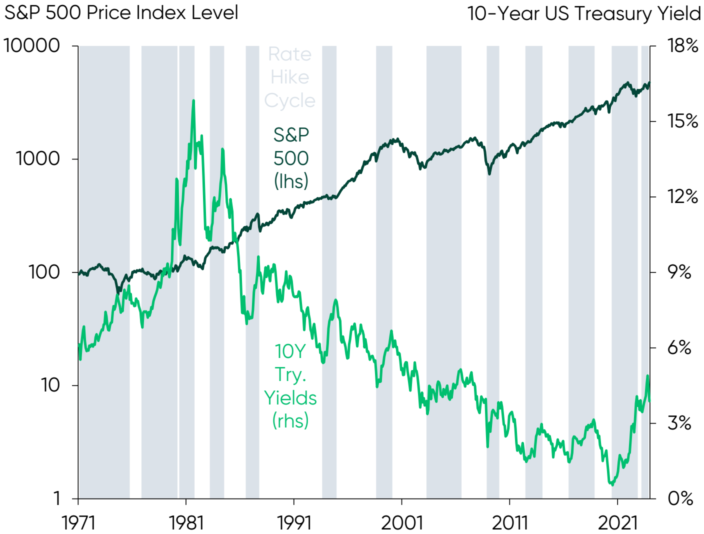
LONGER MATURITIES

Most financial commentary referring to long-term rates centers on US 10-year government bond yields. These are a reference rate for business loans, mortgage rates and other private-sector borrowing costs. No one entity determines them—they are market-set. Most of the time, inflation expectations are the primary driver: Perceptions of future prices will determine the yield investors require as they seek to maintain purchasing power over the bond's maturity.

Fed rate moves can factor in, but there is no set relationship. See the past five years. In 2019, the Fed cut the target range from 2.00% - 2.25% to 1.50% - 1.75% between August and October. Treasury yields also fell for much of the year, from 2.78% in January to 1.46% in September.[xvi] Contrast that with the trend since November 2022: With the yield curve inverted, the 10-year bounced around mostly sideways as the Fed hiked fed-funds.

Long rates and equities generally don't have a strong relationship. Sometimes they rise together, as in 2021. Other times they fall together, like the early 2000s after the Tech bubble. During the 1990s, equities enjoyed a decade-long bull market while yields largely fell—a contrast to the early 1970s, when Treasury yields rose as equities struggled.

EXHIBIT 7: NO SET RELATIONSHIP BETWEEN LONG RATES AND EQUITIES

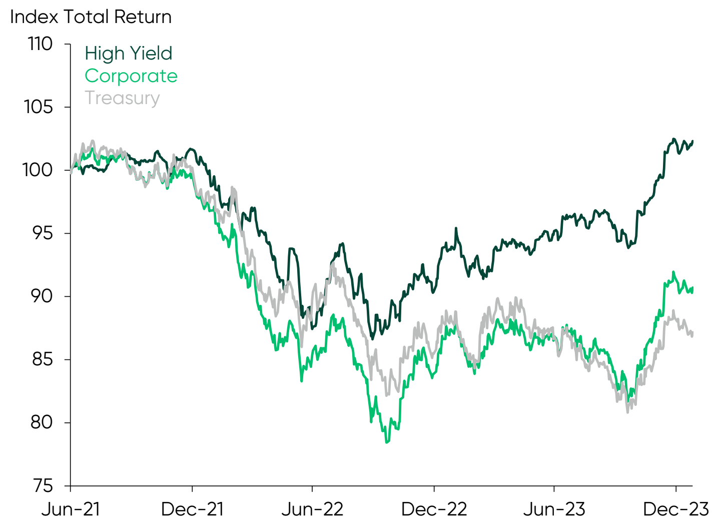


Source: FactSet, as of 08/01/2024. 10-Year US Treasury Yield (rhs) and S&P 500 Price Index Level (lhs), monthly, shading indicates when yields were generally rising, 29/01/1971 – 31/12/2023.

THE YEAR IN BONDS

After bonds' negative 2022, they endured a back-and-forth 2023 alongside interest rates. Yet full-year returns finished up, led by high-yield and corporates—typical of a young bull market.

EXHIBIT 8: BONDS BOUNCE BACK SOME



Source: FactSet, as of 25/01/2024. ICE BofA US Cash Pay High Yield (7 – 10 Year) Index, ICE BofA US Corporate (7 – 10 Year) Index and ICE BofA US Treasury (7 – 10 Year) Index total return, Indexed to 100 at period start, 30/06/2021 – 25/01/2024.

FED FORECASTS AND MARKET REALITIES

Today, many fixate on the prospect of rate cuts. The "higher-for-longer" rate fears contributed to 2023's late-summer correction, but expectations soon swung. Fed forecasts backed this, shifting from projecting two 2024 rate cuts at September's meeting to three at December's.

Since this accompanied equities' rally, many argue equities depend on rate cuts. Pundits tied early January's volatility to rumors that the Fed might not meet rate cut expectations this year. We don't think this matters for equity markets. Fed rate forecasts are often wrong. It and other central banks defy their own guidance frequently.

xvi Ibid. US 10-Year Treasury Yield, 21/01/2019 – 04/09/2019.

POLITICAL DRIVERS IN A US ELECTION YEAR

As always, our political commentary aims solely to assess market impacts. We favour no candidate nor any political party.

The dawning US election year already spurs angst. Both parties dwell on social and cultural implications. These matter, of course, and the emotion they generate is understandable. Yet when assessing this or any election's market impact, it is vital to shut out these emotions and focus on the aspects that matter to markets—without partisan bias or candidate preference. In our view, the election is a key bullish driver for 2024—regardless of who wins.

HOW EQUITIES REALLY VIEW POLITICS

It is too early to assess the election's likely outcome. We will return to that as the primaries play out and the general election takes shape. But the outcome isn't what matters to equities in 2024. The next government's makeup and Congressional clout will factor in 2025 and beyond. This year, the key is equities' long history of positive election years, which points to a good-to-great year regardless of November's winner.

Investors seem hard-wired to believe their party is best for markets and the other is bad. More US investors lean Republican than Democratic, but we have seen the mentality on both sides. Republican-leaning folks emphasise the GOP's business-friendly rhetoric and Democrats' talk of regulations and redistribution. Democratic investors see federal investments and subsidies as necessary to kick-start growth and innovation—and portray Republicans as austerity-focused and bad for investment. There is some logic in both viewpoints, but they are rooted in bias, personalities and campaign rhetoric. Neither party has a monopoly on policies that are good or bad for equities and the economy. Bull markets have started and run under both parties. So have bear markets.

Equities are agnostic toward the White House. What matters is legislative risk. How likely are sweeping bills that create winners and losers, raising uncertainty over an investment's profitability? Gridlock is the swing factor. When Congress does little, businesses don't need to fear future rule changes. Falling uncertainty aids risk-taking—great for equities. But an active Congress raises uncertainty, making businesses risk-averse. Swift, severe regulatory changes can contribute to bear markets. The bipartisan Sarbanes-Oxley Act of 2002, which put draconian compliance burdens on publicly traded companies' executives, is one example.

ELECTION YEARS' BULLISH HISTORY AND NOT-SO-LITTLE SECRET

Election years feature heavy gridlock, extending the status quo that usually follows midterm elections. Politicians tend not to pass much before a vote, lest they alienate centrists or lose a key issue for campaigning and fundraising. Hence, election years are usually very nice for equities. (Exhibit 9) Not as robust as year three, but strong nonetheless.

Better still, equities have a not-so-little secret: When year two was down, like 2022, year four rose all but once, in 1932. Conditions then, in the Depression, are nothing like now. (Exhibit 10)

EXHIBIT 9: THE PRESIDENTIAL TERM ANOMALY

Party	President	First Year		Second Year		Third Year		Fourth Year	
R	Coolidge	1925	29.5%	1926	11.1%	1927	37.1%	1928	43.3%
R	Hoover	1929	-8.9%	1930	-25.3%	1931	-43.9%	1932	-8.9%
D	FDR -- 1st	1933	52.9%	1934	-2.3%	1935	47.2%	1936	32.8%
D	FDR -- 2nd	1937	-35.3%	1938	33.2%	1939	-0.9%	1940	-10.1%
D	FDR -- 3rd	1941	-11.8%	1942	21.1%	1943	25.8%	1944	19.7%
D	FDR / Truman	1945	36.5%	1946	-8.2%	1947	5.2%	1948	5.1%
D	Truman	1949	18.1%	1950	30.6%	1951	24.6%	1952	18.5%
R	Ike -- 1st	1953	-1.1%	1954	52.4%	1955	31.4%	1956	6.6%
R	Ike -- 2nd	1957	-10.9%	1958	43.3%	1959	11.9%	1960	0.5%
D	Kennedy / Johnson	1961	27%	1962	-9%	1963	23%	1964	16%
D	Johnson	1965	12.4%	1966	-10.1%	1967	23.9%	1968	11.0%
R	Nixon	1969	-8.5%	1970	4.0%	1971	14.3%	1972	18.9%
R	Nixon / Ford	1973	-14.8%	1974	-26.5%	1975	37.3%	1976	23.7%
D	Carter	1977	-7.4%	1978	6.4%	1979	18.4%	1980	32.3%
R	Reagan -- 1st	1981	-5.1%	1982	21.5%	1983	22.5%	1984	6.2%
R	Reagan -- 2nd	1985	31.6%	1986	18.6%	1987	5.2%	1988	16.6%
R	Bush	1989	31.7%	1990	-3.1%	1991	30.5%	1992	7.6%
D	Clinton -- 1st	1993	10.1%	1994	1.3%	1995	37.6%	1996	23.0%
D	Clinton -- 2nd	1997	33.4%	1998	28.6%	1999	21.0%	2000	-9.1%
R	Bush, G.W.-- 1st	2001	-11.9%	2002	-22.1%	2003	28.7%	2004	10.9%
R	Bush, G.W.-- 2nd	2005	4.9%	2006	15.8%	2007	5.5%	2008	-37.0%
D	Obama -- 1st	2009	26.5%	2010	15.1%	2011	2.1%	2012	16.0%
D	Obama -- 2nd	2013	32.4%	2014	13.7%	2015	1.4%	2016	12.0%
R	Trump	2017	21.8%	2018	-4.4%	2019	31.5%	2020	18.4%
D	Biden	2021	28.7%	2022	-18.1%	2023	26.3%	2024	
	Frequency of Positive Returns		60.0%		60.0%		92.0%		83.3%
	Average Return for Republicans		4.9%		7.1%		17.7%		8.9%
	Average Return for Democrats		17.2%		7.9%		19.6%		14.0%
	Average Return for All Periods		11.3%		7.5%		18.7%		11.4%

Source: Global Financial Data, Inc., as of 10/01/2024. S&P 500 total returns.

EXHIBIT 10: DOWN SECOND YEAR, UP FOURTH

President	Second Year		Fourth Year	
Hoover	1930	-25.3%	1932	-8.9%
FDR (1st Term)	1934	-2.3%	1936	32.8%
FDR/Truman	1946	-8.2%	1948	5.1%
Kennedy/Johnson	1962	-8.8%	1964	16.4%
Johnson	1966	-10.1%	1968	11.0%
Nixon/Ford	1974	-26.5%	1976	23.7%
Bush	1990	-3.1%	1992	7.6%
Bush, G.W. (1st Term)	2002	-22.1%	2004	10.9%
Trump	2018	-4.4%	2020	18.4%
Biden	2022	-18.1%	2024	?
Percent Positive		-		88.9%
Average Return		-12.9%		13.0%
Average Positive Return		-		15.7%

Source: Global Financial Data, Inc., as of 10/01/2024. S&P 500 total returns.

On average, election years are back-end loaded, often leading investors to argue for sitting out until more clarity emerges. This would be a mistake. The average has big skew from Republican incumbents. Six of eight down first halves came under a GOP president. Five occurred during or just after a recession, nearly always spurring a party switch. This increases fear of a switch from the perceived pro-business party controlling the White House to a presumably hostile one.

Today, we have a Democratic incumbent. Under them, returns average 6.4% in the first half and 7.1% in the second.[xvii] The election has a high likelihood of returning either a re-elected Democrat or a re-elected Republican. Both are very well-known and familiar to equities, sapping surprise power. If 2024 is anything like average, waiting for clarity is costly.

NARROWING THE FIELD

As primaries get underway, we are close to knowing who the candidates are. November seems set to pit President Joe Biden against former President Donald Trump, but this isn't guaranteed. President Biden's health and unpopularity could spur a realistic challenge. Former President Trump's legal issues and comportment could redirect Republican primary voters to a competitor. A saleable third party candidate could siphon votes from either main party candidate. Yet the longer we go without changes or primary victories for the competition, the likelier a Trump/Biden contest becomes.

This has people on both sides unhappy. Polls show both parties' voters prefer an alternative candidate, but they don't seem to like other names much. Fatigue and annoyance could hit sentiment, potentially causing volatility—even a pullback or correction. But eventually we will get a winner, and sentiment will coalesce around them like always, regardless of how much voters disliked them earlier in the campaign. The headwinds flip to tailwinds.

THE GENERAL ROADMAP

While we don't know who will win, the roadmap is clear. To win, the Democratic candidate likely needs a three point-plus popular vote margin—the typical spread to translate a popular vote win into an electoral college victory. Democrats' lopsided support in high-population California and New York gives them a natural popular vote edge. A three-plus point national margin would probably win enough electoral votes in swing states to get to 270. If national polls are within the margin of error, the Republican could have a strong chance of winning.

Yet polls may be little help. To boost accuracy, polls emphasise likely voters. But folks who don't normally vote know who they think both candidates are, and they may be likelier to vote now—potentially making non-likely voters the swing factor. If they are underweighted or excluded, their influence won't show.

xvii Source: Global Financial Data, Inc., as of 28/12/2023. Average S&P 500 total return in first and second half of election years with a Democratic sitting president, 1932 – 2016.

This is a very unusual election, with two very unliked known candidates. This has a big silver lining. It reduces the likelihood of major surprises unless former President Trump or President Biden isn't the nominee. Presuming both make the final cut, either would be a devil-you-know situation for markets, helping them price the outcome and move on quickly.

Arguably as important: House and Senate races, which determine gridlock. The Senate is 50-50 and the Republicans have a tiny House majority. We don't expect much change either way, but it wouldn't take a lot to flip party control. Incumbency gives the Republicans a minor House edge, given their slight majority. But retirements and resignations could alter that landscape.

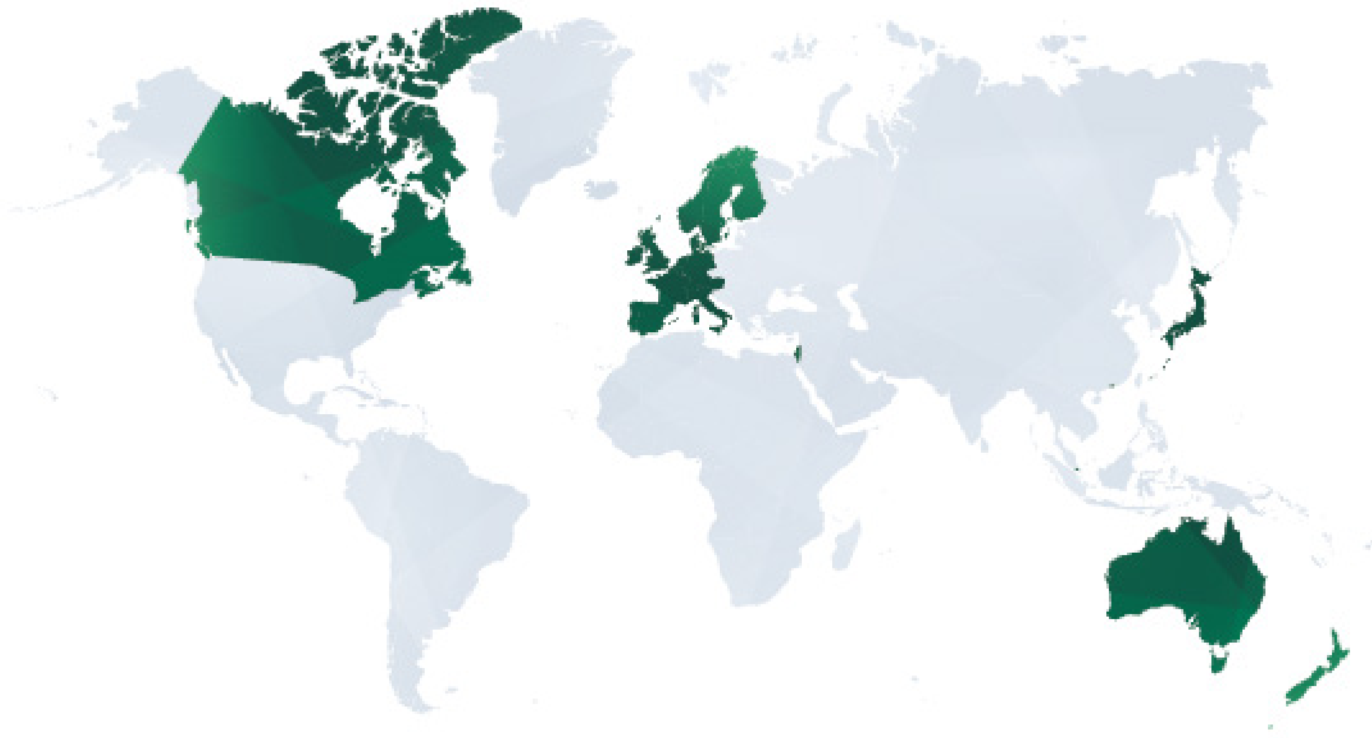
Incumbency matters in the Senate, too, but the six-year structure in which only a third of seats are up adds a wrinkle: Including three independents that caucus with them, Democrats have more seats up this year (23) than Republicans (10). Three Democratic seats are in traditionally GOP states, including Democratic West Virginia Senator Joe Manchin's seat. Barring a reversal of his plans, his exit seems near-certain to flip one seat to the GOP. One (Arizona Senator Kyrsten Sinema's seat) is in a purple state. So Democrats seem to have more seats at risk of flipping. Hence, the Republicans could take the chamber, but not by much and certainly not enough to overcome a veto or filibuster. Gridlock looks like the real winner.

EXHIBIT 11: 2024 SENATE RACES' STRUCTURAL BACKDROP

			Percentage of Vote for Republican Presidential Candidate			
State	Incumbent	Party	Trump - 2020	Trump - 2016	Romney - 2012	McCain - 2008
VT	Sanders	I	30.7%	30.3%	31.0%	30.5%
MA	Warren	D	32.1%	32.8%	37.5%	36.0%
MD	Cardin*	D	32.2%	33.9%	35.9%	36.5%
CA	Butler*	D	34.3%	31.6%	37.1%	37.0%
HI	Hirono	D	34.3%	30.0%	27.8%	26.6%
NY	Gillibrand	D	37.8%	36.5%	35.2%	36.0%
RI	Whitehouse	D	38.6%	38.9%	35.2%	35.1%
WA	Cantwell	D	38.8%	36.8%	41.3%	40.5%
CT	Murphy	D	39.2%	40.9%	40.7%	38.2%
DE	Carper*	D	39.8%	41.7%	40.0%	37.0%
NJ	Menendez	D	41.4%	41.4%	40.6%	41.7%
NM	Heinrigh	D	43.5%	40.0%	42.8%	41.8%
VA	Kaine	D	44.0%	44.4%	47.3%	46.3%
ME	King	I	44.0%	44.9%	41.0%	40.4%
MN	Klobuchar	D	45.3%	44.9%	45.0%	43.8%
NV	Rosen	D	47.7%	45.5%	45.7%	42.7%
MI	Stabenow*	D	47.8%	47.5%	44.7%	41.0%
PA	Casey	D	48.8%	48.2%	46.6%	44.2%
WI	Baldwin	D	48.8%	47.2%	45.9%	42.3%
AZ	Sinema	I	49.1%	48.7%	53.7%	53.6%
FL	Scott	R	51.2%	49.0%	49.1%	48.2%
TX	Cruz	R	52.1%	52.2%	57.2%	55.5%
OH	Brown	D	53.3%	51.7%	47.7%	46.9%
MO	Hawley	R	56.8%	56.8%	53.8%	49.4%
MT	Tester	D	56.9%	56.2%	55.4%	49.5%
IN	Braun*	R	57.0%	56.9%	54.1%	48.9%
MS	Wicker	R	57.6%	57.9%	55.3%	56.2%
UT	Romney*	R	58.1%	45.5%	72.8%	62.6%
NE	Fisher/Ricketts	R	58.2%	58.8%	59.8%	56.5%
TN	Blackburn	R	60.7%	60.7%	59.5%	56.9%
ND	Cramer	R	65.1%	63.0%	58.3%	53.3%
WV	Manchin*	D	68.6%	68.5%	62.3%	55.7%
WY	Barrasso	R	69.9%	68.2%	68.6%	64.8%

Source: US Senate, 270 to Win, as of 10/01/2024. Red shading means majority voted Republican, blue indicates Democrat, white is within 1% either way. *Incumbent isn't seeking re-election. The three indicated Independents typically poll with Democrats.

GLOBAL DEVELOPED EX-US **COMMENTARY**



POLITICAL TAILWINDS EXTEND OUTSIDE THE US

Falling uncertainty and gridlock are global tailwinds. Consider Spain and Holland, which voted in 2023. Both returned hung Parliaments. In Spain, incumbent center-left Prime Minister Pedro Sánchez eventually required support from several other parties—including the controversial Catalan separatists—to stay in power. His government is weak and unpopular, extending gridlock. Meanwhile, right-wing populist Geert Wilders' Freedom Party was Holland's top vote getter, but it won only 37 of 150 seats, splitting the rest among 14 parties. Coalition talks are crawling. A multiparty coalition will probably emerge, but it could take months. More gridlock.

Portugal votes 8 March, after center-left Prime Minister António Costa stepped down in November amid corruption allegations. His Socialist Party's new leader, former infrastructure minister Pedro Nuno Santos, has a reputation as a left-wing ally. Yet as PM Costa's chosen successor, he would likely extend the status quo in office. But the Socialists are virtually tied with the center-right Social Democrats, with the right-wing Chega Party in third. With no party likely to win an outright majority, a coalition is likely, breeding more gridlock.

In Britain, Prime Minister Rishi Sunak has earmarked 2024's second half for a general election. His goal: pass some tax cuts in hopes the economy and paychecks improve enough to win folks over.

That hope may prove far-fetched. The Labour Party—led by Keir Starmer—is polling at 43% to the Conservatives' 25%.[xviii] Mr. Starmer has undone much of the reputational damage Labour endured under his predecessor, leftist Jeremy Corbyn. Additionally, the grassroots Reform Party has siphoned support by touting traditional conservatism. They are polling at 9%. The UK votes by constituency, with the leading candidate needing only a plurality to win, so if Reform splits the conservative vote, it could vault Labour into office easily.

So uncertainty is high, and on paper, there is a chance the UK could lose its bullish gridlock. Yet this isn't a foregone conclusion even if Labour wins a large majority. The Tories won a landslide in 2019 yet passed little as internal divisions stymied legislation. This could easily happen to Labour, which has intraparty divides of its own. Many of Mr. Corbyn's allies remain on the backbenches, and it isn't clear whether Mr. Starmer has the clout to pass major legislation.

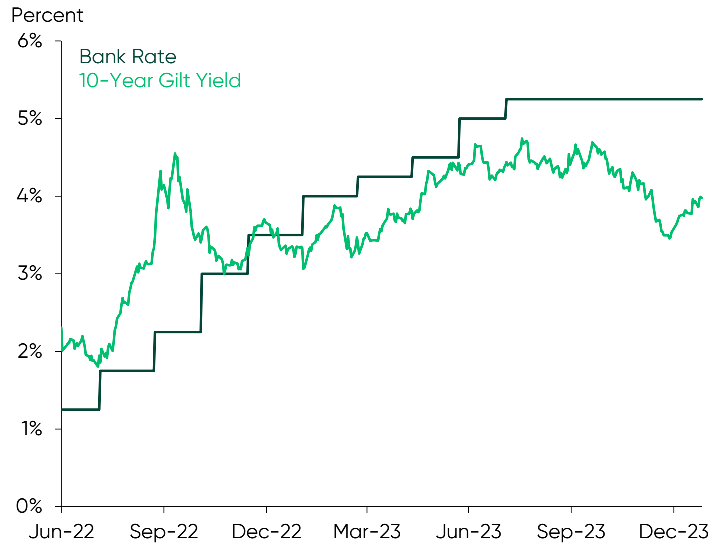
But we will gradually get clarity on all of this, enabling markets to digest and pre-price the outcome. This falling uncertainty is a bullish force, though hot campaign rhetoric could make investors nervous at times.

Finally, while Japan's next election isn't due until late 2025, Prime Minister Fumio Kishida is fighting for survival as a campaign finance scandal within his Liberal Democratic Party (LDP) escalates. It has already felled four cabinet ministers and is upending the LDP's internal factions, which function like parties within the country's main party. The biggest, named after late Prime Minister Shinzo Abe, looks likely to fall, jeopardizing PM Kishida's staying power as it was his key support. Hence, PM Kishida may have to resign, triggering an LDP leadership contest. This may bring noisy uncertainty, but it also means little legislation should pass.

UK AND EUROZONE INTEREST RATES

Rate speculation is equally rampant in the UK, and we can understand why. After two years of rate hikes, the UK yield curve is deeply inverted, and money supply and lending have weakened. Long-term gilt yields' drop has many speculating that the market is pricing in rate cuts, leaving observers rather frustrated most BoE officials continue alluding to a "higher-for-longer" bank rate. Q3 GDP's revision to a -0.5% annualised contraction ratcheted up the angst, driving speculation that the UK is already in a recession caused by high rates.[xix]

EXHIBIT 12: THE UK'S INVERTED YIELD CURVE, DECONSTRUCTED



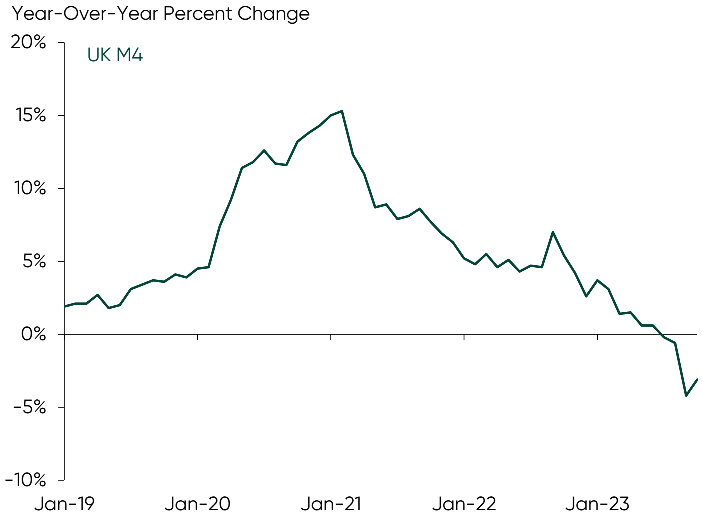
Source: FactSet, as of 25/01/2024. Bank Rate and Benchmark 10-Year Gilt yield, 30/06/2022 – 25/01/2024.

We do think UK credit markets warrant bear watching, but we don't think the weakness in lending or money supply are major impediments to the economy for now. As Exhibits 13 and 14 show, both have fallen off extremely high bases skewed by COVID-era monetary policy—the same policies that spiked money supply and fueled 2022's hot inflation. Even with the recent falls, both remain above their pre-COVID levels on an absolute level, suggesting the UK economy isn't suddenly in jeopardy.

xviii Source: Politico, as of 27/12/2023.

xix Source: FactSet, as of 29/12/2023.

EXHIBIT 13: MONEY SUPPLY IS FALLING FROM A HIGH BASE



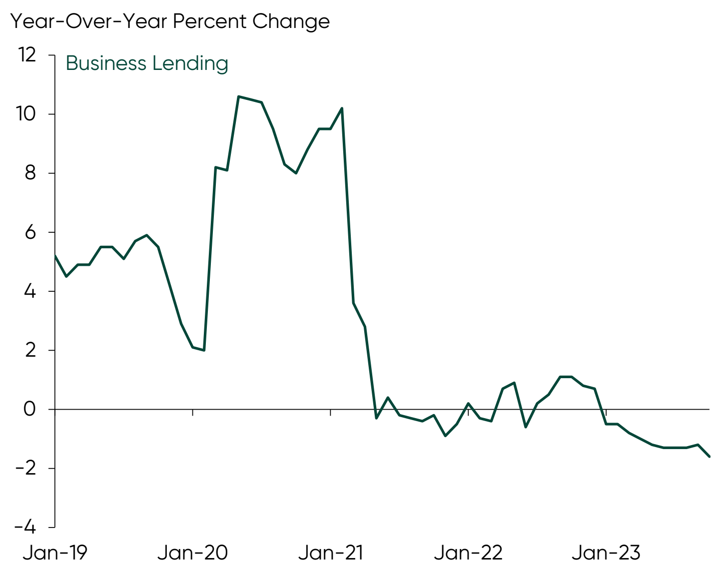
Source: Bank of England, as of 29/12/2023. M4 Excluding Intermediate OFCs, 31/01/2019 – 31/10/2023.

EXHIBIT 14: … AND SO IS LENDING

Source: Bank of England, as of 29/12/2023. M4 Lending Intermediate OFCs, 31/01/2019 – 31/10/2023.

At the same time, we do think this is a headwind, as weakness is concentrated in business lending. (Exhibit 15) Growth in mortgage lending and consumer credit remains robust. Business lending does remain above its pre-COVID absolute levels as well, but it has been falling for over a year and a half, so we would expect some fallout. Business investment's -12.3% annualised drop in Q3, which shaved -1.4 percentage points off the headline quarterly growth rate—an even larger detraction than consumer spending's -1.2 percentage points—probably stems in part from the tighter credit environment.[xx] Yet it is also worth noting, based on numerous reports, much of the drop in lending stems from banks' being more judicious toward less creditworthy companies, which we can see in the rising number of firms going into administration. Businesses kept on artificial life support via low rates in recent years are now going under. This is unpleasant but also an example of the economy working as it is supposed to, and it clears the way for new, more competitive companies to take their place and power the UK economy forward.

EXHIBIT 15: KEEP AN EYE ON BUSINESS LENDING



Source: Bank of England, as of 29/12/2023. Sterling net lending to private sector, 31/01/2019 – 31/10/2023.

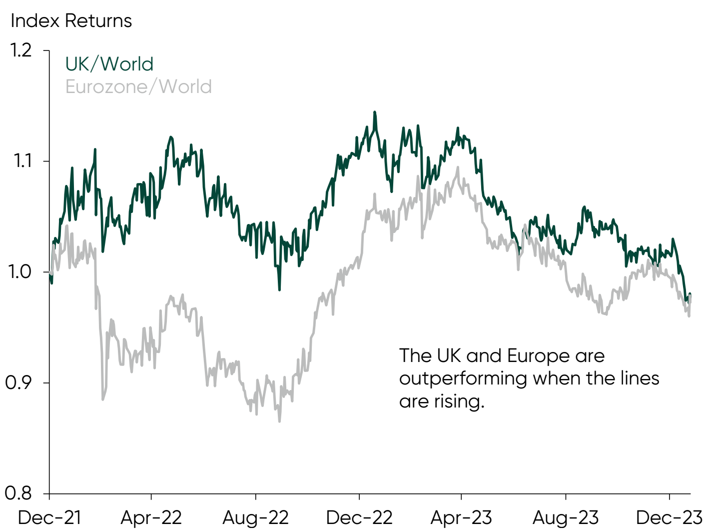
xx Ibid.

It is also worth noting that weaker lending could be down to demand as well as supply, as businesses—already dealing with high costs—hesitate to lock in funding at high rates. With gilt yields down considerably in Q3, it wouldn't shock us if demand picked up. As for the arguments that lower gilt yields depend on rate cuts, we think the UK's situation mirrors the US's: Long rates endured a sentiment-driven spike in the summer and early autumn, overreacting to Fed forecasts, and now seem to have moved on. They are down despite policymakers on both sides of the Atlantic alluding to higher-for-longer policy rates, suggesting the potential for delayed rate cuts isn't lost on markets, which discount all widely known information. Falling inflation expectations are probably a more meaningful driver for long rates, making a sharp and sustained reversal unlikely.

POTENTIAL VALUE LEADERSHIP IN THE UK AND EUROZONE

A leadership shift from growth to value would likely also affect returns at a country and regional level, potentially benefiting the UK and eurozone in particular. Both participated in the new bull market but lagged global equities in 2023, as Exhibit 16 shows, due primarily to their value-heavy tilts.

EXHIBIT 16: THE UK AND EUROZONE'S RECENT UNDERPERFORMANCE



Source: FactSet, as of 25/01/2024. MSCI World, UK IMI and EMU returns with net dividends, Indexed to 1 at period start, 31/12/2021 – 25/01/2024.

A look at each index's sector makeup illuminates both the underperformance and the opportunities that await if value outperforms. As Exhibit 17 shows, both have severe underweights to Tech and the Tech-like parts of Communication Services, with the UK's near-blind spot particularly glaring. That was a major headwind for both in 2023, a year dominated by Tech.

EXHIBIT 17: A SPOTLIGHT ON SECTOR WEIGHTINGS

	UK	Eurozone	World
Financials	18.1%	18.6%	15.0%
Energy	11.5%	4.6%	4.4%
Materials	9.7%	5.6%	3.9%
Industrials	13.8%	16.8%	11.0%
Real Estate	2.5%	1.0%	2.4%
Utilities	4.0%	6.3%	2.6%
Consumer Staples	16.1%	7.8%	6.9%
Health Care	11.9%	7.4%	12.5%
Consumer Discretionary	7.6%	15.1%	10.7%
Communication Services	3.0%	4.4%	7.3%
Information Technology	1.8%	12.4%	23.3%

Source: FactSet, as of 17/01/2024.

When Tech leads, the UK and eurozone often struggle to match MSCI World Index returns. But Tech doesn't always lead. It didn't in 2022's bear market, when the UK's big Energy overweight cushioned it during the downturn. And whenever value regains leadership, Tech will have more competition.

In this scenario, the UK and eurozone would both probably benefit from their Financials overweight, especially if a re-steepened yield curve contributed to value's leadership. When the yield curve is steep, with long rates well above short, it points to higher net interest margins—and more profitable lending. Like the US, UK and eurozone banks' funding costs didn't rise fully hand-in-hand with central bank rate hikes, as deposit gluts kept banks from needing to compete fiercely with one another for new customers. But there were some funding pressures all the same, and rate cuts would ease that, helping profits.

An economic reacceleration in the UK and eurozone would also help, as it would likely boost their more cyclical sectors—namely, Industrials, Energy and Materials. The latter two would benefit the UK disproportionately due to its high exposure to raw materials. Meanwhile, the eurozone's Industrial sector would benefit from economic reacceleration in Germany in particular, as the country's relatively weak economy weighed on German Industrials relative to global Industrials over the past year.

On the Consumer front, things are a bit more mixed. The eurozone's high exposure to Consumer Discretionary—particularly the large, growth-oriented Luxury Goods industry—could be a headwind if value leadership emerges. And the UK's high Consumer Staples weighting may not help returns much even if value leads, as this sector tends to be more defensive, with its best relative returns coming during spells of economic weakness. The same logic applies to the UK's relatively higher Utilities weighting. But these are likely only modest headwinds to relative returns compared to the potential boosts that would come from other sectors during a spell of value leadership. While that shift isn't underway now, in our view, it is a possibility we are monitoring as 2024 develops. It isn't assured to happen, but if it does, it is a potential case for a regional leadership shift, too.

EMERGING MARKETS COMMENTARY

EMERGING MARKETS ELECTION PREVIEW

Entering 2024, the US presidential election and a possible UK vote dominate headlines. But several votes in major Emerging Markets (EM) nations are happening as well. The following is a brief look at those elections.

TAIWAN

The Democratic Progressive Party (DPP) won reelection as expected, with former Vice President Lai Ching-te named President. The DPP earned 40% of the vote, beating the Kuomintang (33%) and the Taiwan People's Party's (26%), to earn its third consecutive term in power. That said, the DPP's share of the vote is down from 2020's election—when it won 57%. The party also lost its legislative majority.

The DPP historically is pro-independence, which some argue could foment worse ties with the mainland. But Taiwan's politics have drifted toward the center in recent years, and most voters want to maintain current mainland relations. Overall, there is little here to suggest a significant change from recent years, or that this makes a mainland invasion of Taiwan any more likely than it has been over the last 10 years or more. The broad attention paid to cross-Strait relations lately says more about sentiment than it does an actual risk to equities, in our view—and this election doesn't really change that.

INDONESIA

Indonesia's general election is set for 14 February, and popular President Joko Widodo isn't running after reaching the two-term limit. The coming presidential change has stirred some uncertainty, with some wondering if pre-Widodo politics—marred by corruption, patronage and dynastic rule—will return.

The race for the presidency is between former governor of Central Java Ganjar Pranowo and current Defense Minister Prabowo Subianto. Mr. Pranowo, a member of Widodo's PDI-P party, was the early favourite. However, Defense Minister Subianto, leader of the Gerindra party—the third largest in parliament—is now leading polls after naming President Widodo's son as his vice-presidential candidate. The move stirred some concerns of creeping dynastic politics.

Both claim they will continue President Widodo's policies, indicating an extension of the status quo. However, Indonesian politics were historically volatile before President Widodo's relatively stable rule over the past decade. It is worth watching if those campaign pledges fade after the election and the country returns to weaker legal standards and more corruption, which would be negative for the economy and equities.

SOUTH KOREA

A parliamentary election is provisionally scheduled for April 10. January attacks on politicians—from an assassination attempt on opposition party leader Lee Jae-myung of the Democratic Party of Korea to an early January attack on a lawmaker of the ruling People Power Party (PPP)—have marred the campaign trail. With the Democratic Party and PPP nearly tied in the polls, it is possible recent violence swings voter sentiment.

The Democratic Party currently controls the legislature, so a PPP win could break that gridlock. However, the Democratic Party could form an alliance with other parties (*e.g.*, the left-leaning Justice Party), which would more or less continue the status quo. Now, a do-little legislature isn't necessarily the same positive for Emerging Markets equities as it is in developed markets. In South Korea, gridlock has hindered reform plans—*e.g.*, reducing the *chaebol*'s, corporations run by families, influence and allowing greater market influence and competition. Generally speaking, though, South Korean markets are familiar with lack of progress on *chaebol* reform, so decreasing likelihood of major legislative change elsewhere is probably a net positive.

INDIA

India is expected to hold a general election between April and May, and Prime Minister Narendra Modi of Bharatiya Janata Party (BJP) looks poised to win reelection. The BJP won three major state elections in December, and PM Modi's personal popularity is high. However, it isn't clear now whether the BJP will earn the same sweeping parliamentary majority it did in 2019. Many speculate about the implications of a third term for PM Modi, especially in light of last year's market and economic performance. India was one of the world's fastest-growing economies, and its equities outperformed the MSCI Emerging Markets last year—spurring excitement over the country's prospects.[xxi]

xxi Source: FactSet, as of 22/01/2024. MSCI India Index and MSCI Emerging Markets Index returns with net dividends, 31/12/2022 – 31/12/2023.

We agree India's economic fundamentals remain solid, though they are also well known at this point. But from a political perspective, the positive surprise power on the legislative front looks limited. PM Modi has already accomplished most of his targeted economic reforms (e.g., tax cuts and bond market liberalization), and his policy focus has shifted to sociology, Hindu nationalism and geopolitics. Moreover, an ongoing headwind remains: India's haphazard approach to foreign investment. Though the country has allowed more foreign investment in some industries (e.g., manufacturing in 2019), it also restricted some Chinese investment and new card issuance from several US payments firms. This is a long-running, well-known issue for Indian markets, but it is still a headwind—and one rising optimism toward the country seemingly disregards.

MEXICO

Mexico will have a general election in June, and incumbent President Andrés Manuel López Obrador (AMLO) of the Morena party will not seek an (unconstitutional) second term. AMLO's successor, former Mexico City mayor Claudia Sheinbaum, and Xóchitl Gálvez, an independent nominated by political alliance Fuerza y Corazón por Mexico (which includes the traditional main parties), have emerged as the two main candidates—and current polling shows former Mayor Sheinbaum favoured.

Historically, political uncertainty tends to increase as elections approach. The economic environment during AMLO's time in power has been uncertain, as his administration has implemented price controls, canceled projects and centralised power away from local and private groups. This uncertainty may increase if the Morena Party pushes major legislation to curry voters' favour. The closer to election day, the better markets can pre-price the probable outcomes and move on, though it is worth keeping an eye on potential legislative actions that can renew uncertainty.

CHINESE POLITICAL SCENE

China's equity market decline continued in 2023—and weakness has extended into early 2024. Many blame a litany of widely known alleged economic risks, like slowing growth or real estate. However, Chinese economic expansion defied pundits' pessimism and continued contributing to global growth, helping propel global equities' rise to new highs. Yet Chinese equities haven't participated. The big reason, in our view: political uncertainty from shifting regulatory sands and myriad attempts to quell the effects. This yields an uncertain path forward.

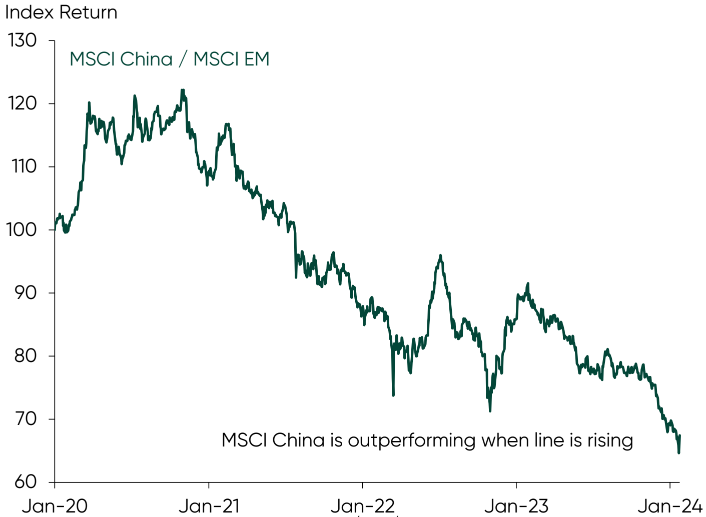
The MSCI China Index has been in an extended bear market since February 2021. Initially in 2021, EM equities fell alongside Chinese markets. Developed equities did so in 2022, as well. But in 2023, China diverged from virtually everywhere else. Whereas the MSCI EM and World Indexes rose 9.8% and 23.8%, respectively, MSCI China fell -11.2%.[xxii] Notably, there was also a big difference between Chinese Tech (-3.4%) and the MSCI World Tech sector, which rose 53.3%, leading the rebound.[xxiii] Moreover, the divergence has stretched into 2024, with the MSCI China down -6.8% through 24 January against EM's -4.0% and the World's small gain.[xxiv]

xxii Source: FactSet, as of 25/01/2024. MSCI ACWI, EM and China returns with net dividends, 31/12/2022 – 31/12/2023.

xxiii Source: FactSet, as of 25/01/2024. MSCI World and China Information Technology returns with net dividends, 31/12/2022 – 31/12/2023.

xxiv Source: FactSet, as of 25/01/2024. MSCI World, EM and China returns with net dividends, 31/12/2023 – 24/01/2024.

EXHIBIT 18: CHINA'S THREE-YEAR UNDERPERFORMANCE



Source: FactSet, as of 25/01/2024. MSCI China and MSCI EM returns with net dividends, indexed to 100 at period start, 31/12/2019 – 25/01/2024.

Political uncertainty toward business appears to be the main factor driving Chinese underperformance. While government gridlock is prevalent in most of the world, that doesn't apply to China—setting up a stark contrast. In our view, the less active legislatures are, the more stable the business environment is. This allows firms to plan ahead and invest, knowing rules and regulations are unlikely to shift under them—a tailwind for global markets as it keeps a lid on potentially upsetting legislation.

But attitudes toward China have gone the other direction the last three years, as perceptions of political uncertainty have risen. The drivers of that swing are well known at this point: Forced technology transfers; on-again, off-again regulatory crackdowns on Tech, video games, foreign financial firms, IPOs and more; and several other factors. Many businesses seem to be pulling back on early views of China, reducing engagement and investment. We think this in part explains why net foreign direct investment flows into China turned negative in Q3 for first time on record.

Even efforts to stop the slide could add uncertainty. On 23 January, Chinese regulators announced a series of measures attempting to curb Chinese equities' rout, including a 2 trillion yuan ($278 billion) "Equity Stabilization Fund," amassed from state-owned enterprises' offshore cash piles, for buying mainland shares. In addition, Premier Li Qiang ordered more "forceful" measures, citing tighter capital market regulations and more consistent macro policies to further economic growth. It isn't clear whether recent regulatory guidance asking insurance companies to avoid net equity sales or brokerage firms to disallow clients' short selling is part of the latest push to calm markets.

While such efforts can boost sentiment temporarily, history shows market interventions like this have proved feckless and could easily foment more fear than they quell. In 2015, a similarly sized stabilization fund drained $240 billion that summer without turning equities around. China's securities regulator also introduced circuit breakers that year aimed at reining in daily volatility, only to exacerbate it as investors panicked. This time, Chinese equities seemed to enjoy at least an initial boost from these announcements, but we doubt they do much longer term as they don't address the underlying issues to begin with.

Now, we have seen a sharp turn in sentiment in early 2024. While many pundits still argue valuations are cheap and reason to re-invest in Chinese equities, but valuation alone is never a great reason to invest. There is also a growing crowd noting the sharp, persistent decline and suggesting there is little end in sight. This indicates to us there is an increased likelihood that political uncertainty and sour sentiment are too extreme. It could be part of the bottoming process. And after a bear market of unusual length, this isn't out of the question.

CHINA ISN'T CRASHING … OR TAKING OVER

In addition to political instability, broader concerns around China represent another brick in the global bull market's wall of worry. As often happens with false fears, much of the worry is contradictory. People fear China's economy crashing as real estate troubles take their toll. Simultaneously, they worry China will usurp the US as the world's pre-eminent power, putting the two nations on a collision course. In our view, this is backward. China's economy is growing fine, while its geopolitical importance is in decline.

CHINA IS THE NEW JAPAN

Growing economically isn't the same as ascending internationally in terms of clout, might and global influence. They cite Chinese real estate investments here, including farmland and the Waldorf Astoria, as well as programmes sponsored at universities. China's global economic development programme, the Belt and Road Initiative, added fears it gave Beijing leverage over other nations at the UN while leaving them with high debt.

This is a striking rerun of what everyone said about Japan in the 1980's. Then, like China now, Japan was the world's second-largest economy. Flush with cash from a Tokyo real estate and equity market bubble, Japanese investors went on a US shopping spree, snapping up trophy assets including Rockefeller Center and Pebble Beach, as well as cultural touchstones like MCA (owner of Universal Studios) and Columbia Pictures. Japan's purported takeover was a plot point in Hollywood blockbusters from *Die Hard to Rising Sun*. Ubiquitous Toyotas, Hondas and Nissans were allegedly an existential threat to the US's Big Three automakers. The trade deficit with Japan scared many as well.

Fears lingered after the Nikkei bubble burst. Japanese equities peaked in 1989, but nervous Americans still projected a Japanese financial invasion. A *Harvard Business Review* analysis published in mid-1990 noted total cumulative Japanese purchases of US assets were projected to nearly double, from $53 billion to $100 billion, by the end of 1992.[xxv]

Yet the country's decline was beginning and soon became unmistakable. Japan's equity market suffered and GDP stagnated. By 1991, Japanese investors' US annual property purchases were down to 1985 levels—pre-boom.[xxvi] By 1993 they were net sellers, and soon an all-out exit rush was underway. The Sazale Group sold the Hotel Bel Air for less than 60 cents on the dollar in 1995.[xxvii] That same year, Mitsubishi defaulted on Rockefeller Center. Clint Eastwood, Arnold Palmer, Richard Ferris and Peter Ueberroth led the effort to put Pebble Beach back in US hands in 1999.

Japan's exit from US assets stemmed from its domestic struggles—the famous "lost decade" of stagnant GDP and deflation in the 1990s, which became two decades by the end of the 2000s. Japanese equities only returned to prior highs last year, a more than 30-year round trip. Many of its vaunted conglomerates struggled at home and abroad, hampered by bad governance, weak financing and stiff competition from South Korea. Some eventually found ways to thrive, but other well-known names never recovered. When Toshiba delisted in a private-equity deal last month, its equity price was just one-third of its 1989 peak.[xxviii]

Now China has crested. History doesn't predict perfectly, and all parallels have differences, including China's single-party rule and economic system. But history helps determine probabilities. Japan's history shows China has a high probability of shrinking on the world stage.

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xxv "Power From the Ground Up," Robert L. Cutts, Harvard Business Review, May – June 1990.

xxvi"Japan's US Real Estate Buying Plunges," James Bates, The Los Angeles Times, 21/02/1992.

xxvii"Japanese Are in Rush to Sell Their Real Estate in US," James Sterngold, The New York Times, 09/06/1995.

xxviii ....Source: FactSet, as of 20/12/2023.

Despite big ups and downs along the way, China's equity market is flat since 2007 (Exhibit 19). After mounting an initial recovery from a bear market that began in early 2021 late last year, the MSCI China had a sour 2023. Economic fundamentals may be stable, but China's equity market has never connected tightly to economic drivers—regulatory concerns and state heavy-handedness are a much larger influence, and lately these influences are powerful and negative.

EXHIBIT 19: CHINA FLATNESS

Source: FactSet, as of 25/01/2024. MSCI China Index returns in USD with net dividends, 31/12/2006 – 25/01/2024

Again, China likely isn't crashing. Its economy is still growing, just at slower rates, and it remains an important global economic contributor. It is still the second-largest economy in the world and likely remains so—just as Japan remains important to global growth.

SAME OLD NORMAL

As an asset manager, we focus principally on China's economy and markets. The rest may gain more attention, but equities look past sociological matters. They are important to society, but in most cases they don't sway corporate earnings, which is what markets reflect most.

Because China's market is meaningfully restricted to foreign investors—and Chinese investors are mostly blocked from developed-world markets—its correlation with developed markets is weak—just 0.57 over the past 20 years.[xxix] While 0.57 implies some tendency for China and the MSCI World Index to move together, it pales next to the 0.83 correlation between US and non-US developed markets.[xxx]

A Chinese economic crash would be a drag, hitting profits for many US, European and developed Asian firms. But crash fears exaggerate reality. Yes, China's real estate sector has been troubled for years. Developers including Evergrande, which received a Hong Kong court liquidation order in late January 2024, have been collapsing since 2021 alongside some of the financing arms, like Hywin. Yet Chinese property markets aren't a huge economic driver. Through Q3, property investment was down -9.1% year to date versus 2022's first three quarters, yet year-to-date GDP rose 5.2%.[xxxi] Interestingly, construction output grew year-over-year, a sign builders continue making progress on a big backlog of sold-but-uncompleted housing units.

Some argue property troubles will ripple more broadly, hurting consumption. But activity in the wholesale and retail trades rose 6.1% year to date through Q3 versus the same stretch in 2022.[xxxii] Heavy industry is also faring fine, with manufacturing up 4.1% year to date.[xxxiii]

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xxixSource: FactSet, as of 19/12/2023. MSCI China and MSCI World Index weekly price returns in local currencies, 19/12/2003 – 15/12/2023.

xxx Source: FactSet, as of 20/12/2023.

xxxiSource: FactSet, as of 19/12/2023. MSCI China and MSCI World Index weekly price returns in local currencies, 19/12/2003 – 15/12/2023.

xxxiiIbid. S&P 500 and MSCI World Ex. USA Index weekly price returns in local currencies, 19/12/2003 – 15/12/2023.

xxxiii ....Source: National Bureau of Statistics of China, as of 19/12/2023.

All are in line with China's prepandemic growth rates, which were acceptable for global markets. The lockdown-skewed ups and downs since 2020 can obscure this. But Chinese GDP slowed gradually throughout the 2010s, culminating in 2019's 6.0%, as its economic base increased.[xxxiv]

There was also some central planning behind the slowdown from earlier double-digit booms. China's government has long sought a shift away from infrastructure and export-led growth to more sustainable services and consumption. This has borne fruit: Services is now more than half of annual GDP, and it is so much more broad than real estate.

Overall, well-capitalised Chinese consumers, moderate government policy support, and a recovery in the global manufacturing system should ultimately keep the country modestly contributing to global growth—helping global and emerging market equities in the process. China's economic diversification is an underappreciated source of its resilience, just as its slower growth rate is another return to the old, pre-COVID normal.

xxxiv... Source: FactSet, as of 19/12/2023.

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