

Principal Equities



Equity market recap

FOURTH QUARTER 2023

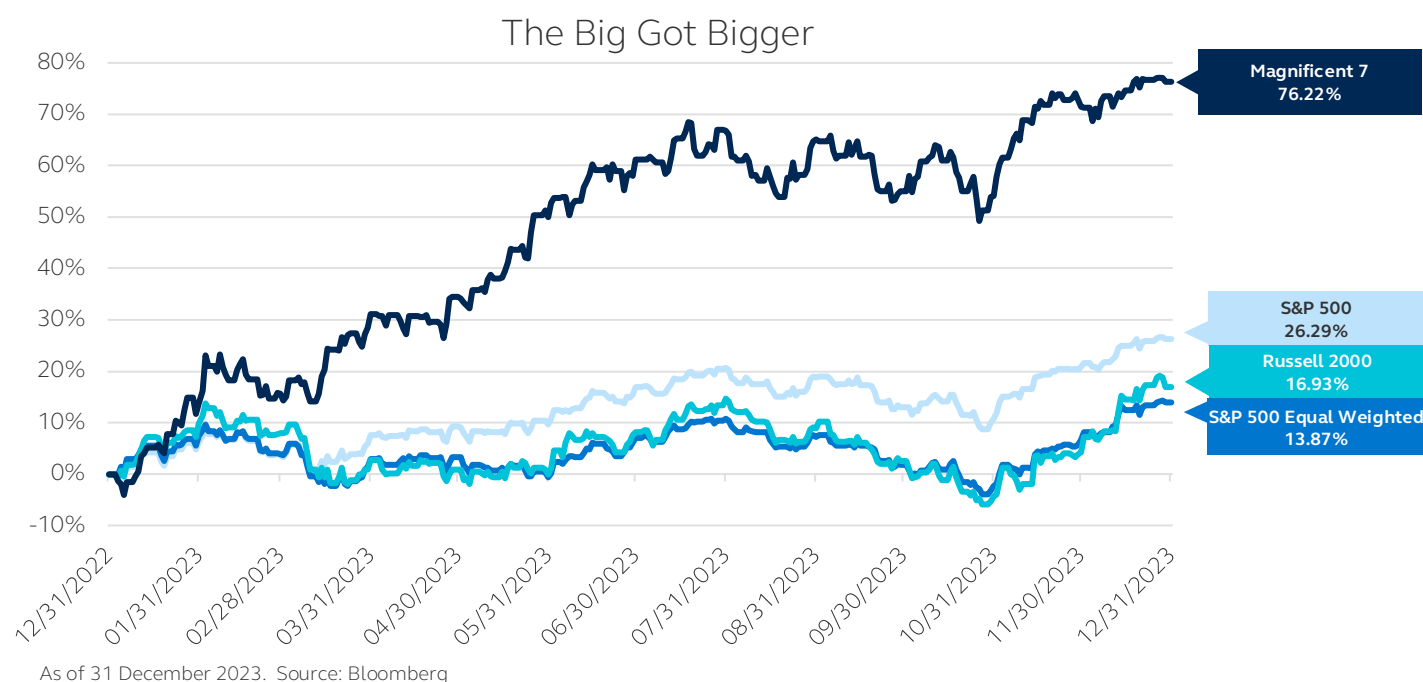
Notable themes

- **Policy pivot** – led by the Federal Reserve, Central Banks all but confirmed that the era of sharp monetary tightening is concluding with expectations for rate cuts in the year ahead.
- **Improved breadth** – previously narrow leadership by the “Magnificent 7” broadened to include smaller-caps and rate-sensitive segments of the market, driving healthy gains across most sectors and regions.
- **Emerging divergence** – reshoring and geopolitical trends drove return dispersion as investors favored beneficiaries in Mexico and India, while China saw declines for the third consecutive year.

The final quarter of 2023 marked a strong finish to a strong year, with equity returns surprising to the upside. Historically robust returns were seen across most market segments, despite a host of challenges, including averting the most widely anticipated recession in modern memory. The action in the equity markets, was accompanied by an especially wild ride for bond investors. Notably the yield on 10-year Treasury notes briefly touched 5.0% in mid-October, before embarking on an epic rally to finish the year at 3.9%, only slightly above its levels at the start of the year.

Investor optimism was building as the fourth quarter progressed, powered by further declines in inflation and slowing job growth, prompting signals from the Fed and other western Central Banks of the final innings of monetary policy tightening. As the year closed, the S&P 500, Dow and Nasdaq generated total returns of 26.3%, 16.2% and 44.6%, respectively, while the Bloomberg U.S. Aggregate Index gained 5.5%.

The quarter also delivered a significant improvement in market breadth, as smaller-company shares and interest-rate sensitive, lower quality cyclical stocks finally began to participate in the market advancement, after struggling for much of the year.



For the full year, the market was still dominated by a very narrow group of mega-cap technology stocks, particularly those with current involvement or future ambitions in next generation alternative intelligence. Realizing this group was no longer accurately described by prior derivations of the “FANG” acronym, the new catch phrase “Magnificent 7” made its debut. Another dominant, low breadth theme for the year was the phenomenon of “GLP-1” drug efficacy in fighting diabetes and curbing obesity. The sharply rising popularity of these new drugs powered huge gains for providers Novo Nordisk and Eli Lilly yet stymied many more health care and consumer staples shares based on anticipated reductions in demand for legacy health treatments, and food consumption, especially snacks.

Overall, the final quarter could be broadly characterized as a “relief rally” punctuated by short-covering among previously downtrodden, higher debt companies, and renewed optimism for interest-rate sensitive financial services shares, especially real estate investment trusts. Investors were comforted that the Fed left policy rates unchanged at 5.25%-5.50% for three consecutive meetings. More significantly, the latest dot plot projections by FOMC committee members revealed median expectations for 75 basis points of cuts next year—essentially endorsing the view that future direction of travel for rates is downwards.

Chair Powell emphasized the significant inflation progress to date, noting that rate cuts were a topic of discussion by the Federal Open Market Committee (FOMC), and the latest dot plot revealed a sharper pace of rate cuts than indicated in the September projections. Powell stopped short of declaring the tightening cycle over, making a cursory nod to the idea that the committee will consider the extent of “any” additional firming if needed. It seems relatively clear at this stage that the rate hiking cycle is over, and the next move will likely be downwards.

Across the pond, the European Central Bank (ECB) held steady like the Fed but maintained a more hawkish stance in its rhetoric. The policy statement delivered the key message that rate cuts are not yet on the agenda given two clear phrases: “Key ECB interest rates are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal” and “policy rates will be set at sufficiently restrictive levels for as long as necessary.”

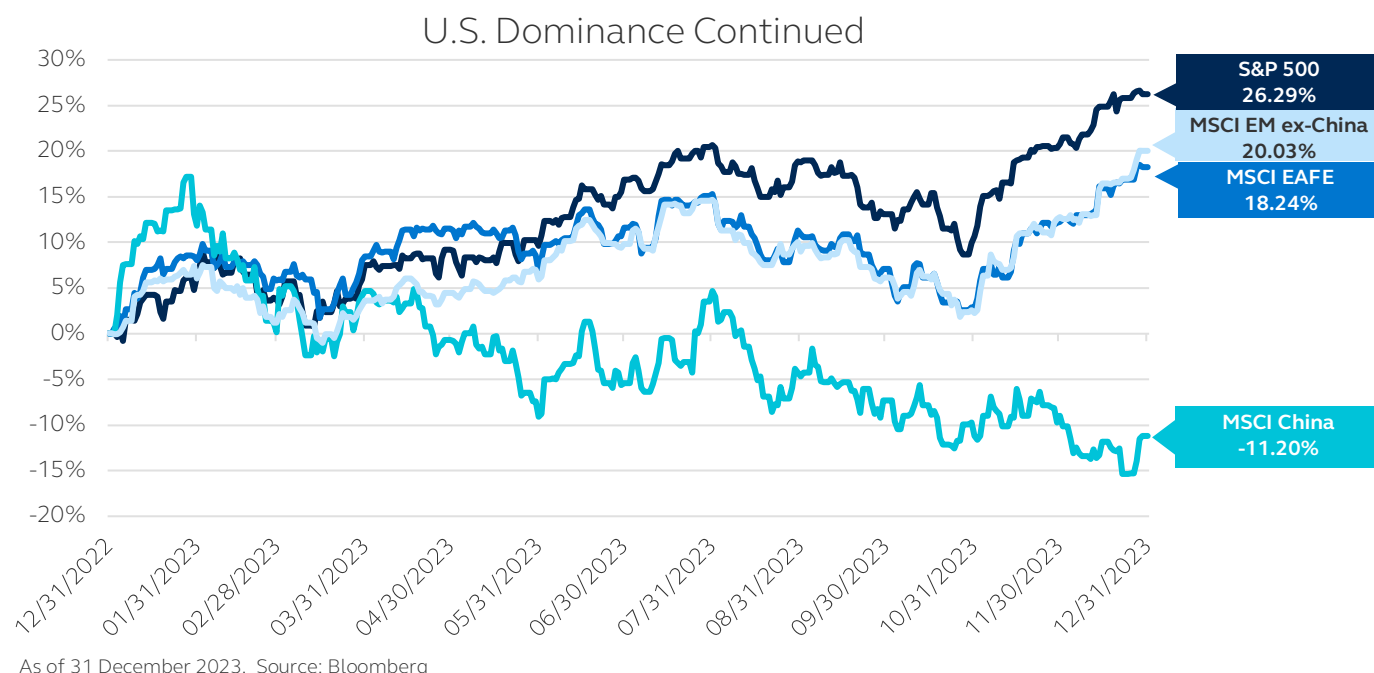
The ECB did not emulate the Fed and ECB President Lagarde did a forceful job in pushing back against expectations for imminent rate cuts. The ECB retains enough inflation caution to tread carefully around pivot expectations and will likely only signal rate cuts once it has sufficient confidence about the inflation outlook. Equity markets did not seem to fully accept the President’s remarks since yields dove lower and equities rallied. The MSCI Europe closed the year up over 20% with more than half the returns coming in the final quarter.

Economic conditions and outlook remained top of mind amongst market prognosticators as so many were calling for an inevitable recession that has yet to surface. Growth and job creation across the globe has been adequate enough to appease Central Bank members and their long-standing hawkish trajectory. While growth outpaced expectations in the quarter, the job market has begun to slow following significant strength in September.

In September, the economy added 336,000 nonfarm payroll jobs, above the average gain of 267,000 over the previous 12 months. These payroll gains were nearly double consensus expectations of 170,000 new jobs which abruptly spooked markets. However, this was followed by payroll gains nearly halving in October and then November’s reading of 199,000 nonfarm payroll jobs, just below the 3-month average of 204,000, providing evidence of a softening in the labor market.

Recent inflation reports have also delivered a welcome softening as the year-over-year numbers fell each month in the fourth quarter ending 2023 at 3.1%. Just a year ago, the reading was over 7%. Declining oil prices have been a welcome relief, as has the recent pull back in prices of new and used automobiles.

Early in the quarter the market had to digest a spike in oil prices, stemming from the horrific Hamas invasion and targeting of Israeli civilians and subsequent complete mobilization of the Israeli military and ground invasion within Gaza. The surge in prices proved short-lived due to changing supply/demand dynamics. After reaching levels in the \$120/bbl., both West Texas Intermediate (WTI) and Brent are now below \$80/bbl. driven by debates around production quotas and softening economies. The energy sector was the lone industry to post negative absolute returns in the quarter while also lagging for the full year.



Emerging markets saw a wide disparity of returns for both the quarter and the year. Mexico was a standout performer with a more than 40% gain for the full year, with almost half coming in the final quarter, helped by reshoring efforts. While not cheap, India fared well as multi-national companies including Apple announced intentions to begin manufacturing in the region. This led to a 12% gain in the quarter and more than 20% for 2023. On the other end of the spectrum was China, which stood apart as a significant laggard, posting double digit losses, and extending its bear market to three consecutive calendar years.

Foreign investors continued to be discouraged by unexpected policy announcements from China, despite Xi's recent efforts to improve sentiment. The People's Bank of China has been trying to restore and expand local consumption but has struggled to regain traction following the extended pandemic lockdowns, along with mounting debt pressures, and deepening real estate defaults led by private developer Country Garden. The latest thorn in the side was a proclamation of new rules to clamp down on online gaming. Despite the broad global stock market rally, the MSCI China Index declined by 4% in the fourth quarter and 11% for 2023.

The accompanying table summarizes regional and global sector aggregate performance on a USD basis, gross of cross-border tax withholding.

	3 months	12 months
MSCI World Index	11.53%	24.42%
North America	11.93%	26.59%
Europe	11.10%	20.66%
Pacific	9.28%	15.59%
MSCI Emerging Markets Index	7.93%	10.27%
China	-4.22%	-11.20%
Asia Ex China	13.43%	21.17%
Latin America	17.55%	32.71%
EEMEA	8.37%	8.19%
MSCI All Country World Index	11.15%	22.81%
Communication Services	9.39%	38.13%
Consumer Discretionary	9.88%	29.54%
Consumer Staples	5.57%	3.16%
Energy	-2.72%	5.94%
Financials	12.61%	16.34%
Health Care	6.02%	4.08%
Industrials	13.39%	22.53%
Materials	11.65%	12.66%
Real Estate	16.02%	9.44%
Technology	17.63%	51.45%
Utilities	10.97%	1.37%

Sources: MSCI, Standard and Poor's in USD. As of 31 December 2023.

Looking ahead

The strength of the broader economy is feeding into investor optimism heading into the new year.

Although rate cuts are indeed likely, and not just by the Federal Reserve, there's still reason for caution. A mild recession is still possible and may only justify a soft cutting cycle, especially if structural inflation is slow to improve. Indeed, at year end, market expectations measured by Fed Funds futures contracts are pricing in nearly 150 basis points of rate cuts, double what was implied by the Fed's "dot plot" projections.

As we head into 2024, it's a mixed backdrop with both upside and downside catalysts to consider.

The Federal Reserve has all but officially confirmed the tightening cycle has concluded, though it's clear that the rate hiking cycle is over, and the next move will be downwards. Market prognosticators now expect rate cuts to begin in early 2024, although the timing is murky at best with economic growth holding up well. On the other hand, the labor market is visibly slowing as job openings have fallen to the lowest levels since 2021 and the latest inflation gauges are closing in on the Central Bank targets. This sets the stage for a potential advantageous equity backdrop of a soft landing accompanied by a rate cut environment.

Conversely, others would profess that previous tightening policies have yet to fully make their way into economies and negative implications are set to be more pronounced in 2024. Furthermore,

inflation has the potential to be stickier at these levels given geopolitical tensions are driving more reshoring efforts, while recent droughts and Red Sea attacks are driving cargo logistical issues and sending freight rates higher.

Further risks are being conveyed via consumer pressures as savings are being depleted amid the elevated rate environment, while U.S. fiscal deficit issues could keep Treasury Yields higher for longer.

While both bulls and bears can make arguments for equity direction in the year ahead, it's clear that interest rate pressure is likely to be downward. There remains risk that the full impact from tighter monetary policy has not yet been experienced. In the end and following a period of valuation improvement, earnings remain a key catalyst to further upside. Stock selection will be key amidst uneven global economic recoveries and Central Bank policy adjustments.

We believe we are in the midst of a generational change in global trade flows, as the West reduces its reliance on China and Russia. The U.S., Japan, and Europe should all experience expanding manufacturing bases. As the re-shoring trend accelerates and duplication in global supply chains increases, it will be a net benefit to global companies with the expertise in the capital equipment that will be needed to drive a manufacturing renaissance outside China. Japan has become an early winner in the deglobalization of supply chains with further upside coming from the increased attention surrounding Artificial Intelligence.

Artificial Intelligence is here to stay but following a significant valuation re-rating for many known to be "intertwined" in the opportunity, earnings growth will remain the key over the long run. As the technology improves and additional features/functionalities are developed, generative A.I. will be embedded across wide swaths of the economy. The total addressable market remains very large domestically and internationally with sizable monetization potential. Generative AI is highly computer-intensive from both an algorithm training and content creation perspective. This level of data creation necessitates the need for significantly more GPUs relative to other compute/training workloads. The long-term structural change remains relevant, but key will be picking the winners from the losers as so many have significant aspirations.

Over the past decade, Japanese companies have made great strides in corporate governance and capital allocation. Former Prime Minister Shinzo Abe's push in 2012-13 to improve capital allocation in the corporate sector has had a lasting impact, driving more long-term, value-enhancing decisions by Japanese companies.

Continued progress on these fronts is primed to release shareholder value in the coming years. As companies focus on higher profitability and improve balance sheet efficiency, return on assets (ROA) will likely continue to improve given the tailwinds of reshoring and improving governance. Recent conversations with Japanese companies indicate a greater willingness to use strong balance sheets for modest share buybacks. In fact, they seem more attuned to the greater value accretion of counter-cyclical share buybacks (buying when shares are depressed) than U.S. companies—which tend to use traditional rolling buyback programs that don't emphasize buying for value. The early innings of this is coming to fruition in 2023 following years of engagement.

We're seeing progress, albeit slow, within Europe. Our improved sentiment is underpinned by three primary fundamental pillars:

- Structural renovation – we are finally seeing “green shoots” after many years of restructuring and tough policy actions.
- Innovation renaissance – Europe increasingly offers some interesting sources of innovation across sectors, providing valuable diversification.
- Global gateway, at a discount – Despite improvements, European companies continue to trade at historically low relative valuations compared to U.S. and global peers, providing an attractive and timely rebalancing opportunity.

Following a period of valuation improvement, earnings remain a key catalyst to further upside. Bottom-up stock selection will be key amidst uneven global economy recoveries and fluid Central Bank policies.

Risk Considerations

Investing involves risk, including possible loss of principal. Past Performance does not guarantee future return. Equity markets are subject to many factors, including economic conditions, government regulations, market sentiment, local and international political events, and environmental and technological issues that may impact return and volatility.

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