OUTLOOK 2024: BE WARY OF THE TENSION BETWEEN EQUITIES AND BONDS

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It is impossible to consider the outlook for 2024 without putting it into context of the year that has just passed. This time last year recession was widely predicted as central banks were ratcheting up interest rates in response to extremely high inflation. It turned out that economies were much more resilient than expected and 2023 turned into a very strong year for developed market equities, and a late flourish meant even the UK looks set to end the year firmly in positive territory.

Fixed income markets have had another challenging year, but investors are now firmly of the view that the Federal Reserve, Bank of England and European Central Bank have reached the end of their rate hikes. Inflation in the US and Europe slowed more than expected in the final months of 2023 and bonds staged a late rally as rate cuts in 2024 are factored into bond prices.

Volatility has continued to dog financial markets and progress in 2023 has not been smooth as investors were caught between hopes that inflation was being brought under control and fears that rates were rising ever higher. This was most noticeable in the spring when markets briefly conceded that central banks were willing to accept a recession as the price for taming stubbornly high inflation.

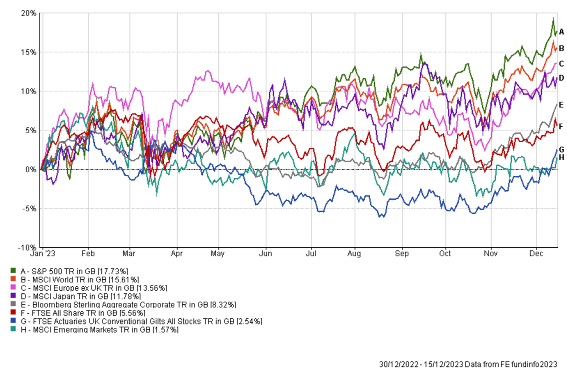
Outlook for inflation

Inflation was the major factor to watch at the start of 2023 and as we approach 2024 it remains the main driver of markets. This time last year headline inflation in the UK was 10.7%, in the Eurozone it was 10.1% and it was 7.1% in the US. Since then it has declined to 4.6% in the UK, 2.4% in the Eurozone and 3.2% in the US.

However, the target of 2% is likely to prove difficult to reach. Inflation in the services sectors of many economies remains elevated and wages are still rising fast. In addition, the drop in energy prices that helped bring down inflation in 2023 will not be repeated in 2024. Most forecasts see inflation continuing to decline in 2023 but at a much slower rate and it is expected to remain above target in most developed economies next year.

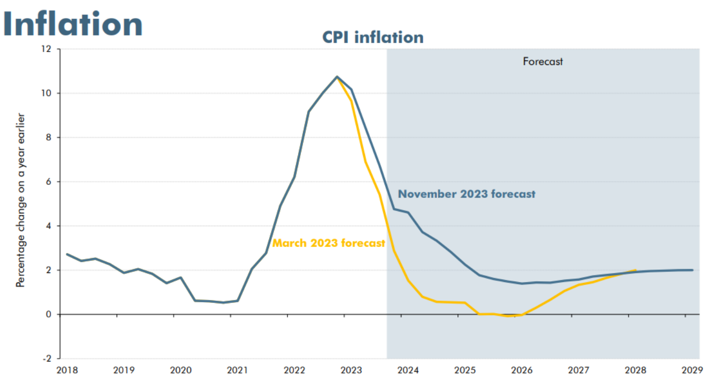
Central bankers continue to insist that rates will need to remain higher for longer than markets expect to get inflation firmly under control, so any signs that inflation is higher than forecast or may accelerate again would raise the possibility of further tightening.

Chart 1 - Equities and Bonds Gained in 2023



Source: FE Analytics, December 2023. Total Returns in GBP for year to 15 Dec 2023

Chart 2 - Outlook for UK Consumer Price Inflation



Source: Office for National Statistics, Office for Budget Responsibility, November 2023

Geopolitical uncertainty

The last two years have seen considerable volatility in commodity markets due to Russia's invasion of Ukraine. The high prices caused by this conflict have mostly unwound and the war appears to be settling into stalemate as neither side is able to gain a decisive advantage and there is little appetite on either side for a ceasefire. Meanwhile, the outbreak of war in Gaza has mostly left commodity markets untroubled.

However, there is always the potential for events to spiral quickly. A significant escalation in Ukraine has the potential to spook markets. Similarly, any broadening of the conflict in the Middle East to involve other countries and the potential for key oil shipping routes to be disrupted means oil and gas prices could be driven higher. For now, the resilience of the global economy and the availability of US shale oil production are more significant factors for global energy markets.

The tension between equities and bonds

The last 12 months have witnessed very different performances from bond and equity markets. Despite fears of recession, equity markets have powered ahead as higher rates failed to noticeably slow the US economy or have a lasting effect on equity valuations. The most dramatic performance came from US large-cap technology firms which dragged the rest of the S&P 500 higher as earnings kept pace with fairly ambitious targets.

Bond markets have been more mixed. Fixed income assets in general, and government bonds in particular, sagged under the weight of ever higher interest rates early in the year as fixed income investors gave up their expectation of rapid rate cuts as inflation proved to be stickier than forecast. However, the latter part of the year witnessed a broad rally as the decline of inflation accelerated and brought the end of interest rate hikes and the potential for rate cuts.

The two markets are now drawing very different conclusions from the same sets of data. Government bond markets still see the potential for a hard landing and have reset their expectations for rate cuts in the first half of 2024. Bond markets expect growth to decline far enough that central banks are forced to abandon their focus on inflation and reverse recent rate hikes in order to stimulate economic activity.

In contrast, equity markets are positioned for the Goldilocks scenario where inflation falls swiftly back to target with little or no decline in growth to provide the softest of soft landings. In fact, equity markets' optimism extends to seeing conditions turning out to be so benign that central banks are able to cut interest rates purely because inflation is returning to target.

These two outlooks are inherently contradictory and the tension between the two views is responsible for a lot of short-term volatility as markets consider each fresh piece of data for evidence that a particular view is correct. We expect short-term volatility to continue and consider there to be a reasonable chance of a significant correction in a major asset class over the next 12 months.

Economic data is unusually mixed. On one hand, hiring and wage inflation is still strong in the US and UK, and consumer demand has held up well in the face of very high inflation. On the other, growth in the UK and Europe has ground to a halt, activity in the housing sectors in the UK and US is much lower than usual and indicators of manufacturing output are showing decline.

It is worth keeping in mind that the Federal Reserve will be very keen not to repeat the mistakes of the late 1970s. After struggling to control inflation for much of that decade, the central bank was forced to raise the Fed Funds Rate from 11% in 1979 to 20% in 1981 after premature rate cuts helped inflation to spiral to 14% a year.

As 2024 unfolds central banks and markets are likely to be driven by new data as it emerges and begins the clarify which view is correct. In 2023 we successfully repositioned the portfolios as data and market sentiment changed and being able to be adapt to changes will be the key challenge in 2024.

Summary

Bond and equity markets are being priced for different outcomes and they cannot both be correct. If the brighter outlook for equity markets is right then the recession currently predicted by bond markets is just a phantom and the rate cuts currently anticipated will not be delivered.

On the other hand, if the recession expected by bond markets does show up then equity markets may see a substantial correction as current equity market strength suggests the softest of possible landings. Either way, expect to see more volatility in 2024 as at least one major asset class may be forced to adjust to reality.