ODDO BHF
ASSET MANAGEMENT

2024 CAPITAL MARKET *outlook*

BY PROF. DR. JAN VIEBIG, CHIEF INVESTMENT OFFICER AT ODDO BHF SE – DECEMBER 2023

The price-driven supply-side shock is fading. It is still a little too early to declare victory on the price front, but inflation is indeed receding. When the interest-rate cuts priced in by market participants will indeed occur should depend above all on further economic developments. And economic indicators are not especially encouraging at the moment. Manufacturing and construction in particular are going through a slump, and the service sector has slackened considerably. On the other hand, job markets remain strong, and unemployment is moderate. Moreover, the financial standing of companies and households is, on the whole, quite robust, despite a heavier burden from higher interest rates. That's why we don't expect a severe recession, but the overall economic outlook does look tentative. As in 2023, economic growth is likely to be somewhat stronger in the US than in the euro zone. In the OECD's latest forecasts, which it released in late November, it projects growth to slow to about 1.5% in the US and to strengthen slightly to about 0.9% in the euro zone.

If these forecasts do pan out, there could be some room later in 2024 for initial rate cuts, in both Europe and the US. Market participants, who are prone to extreme mood swings, are currently pricing in cuts of 1.25 percentage points in the US and 1.5 percentage points in the euro zone. We think this is a little too aggressive, for two reasons: 1/ core inflation is still quite high, at 4.0% in the US (as of October 2023) and 3.6% in the euro zone (as of November 2023); and 2/ significantly rising labour costs (4.3% in the US in Q3/23) and 4.6% in the EMU in Q2/23). Monetary policy is nonetheless likely to shift course in the coming year.

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Even after pulling back recently, current bond yields are still at levels unseen for many years in Europe and the US. We are confident that anyone who invests at these levels for the long term will lock in attractive yields. With that in mind, we are generally overweighting longer-dated bonds, i.e., in terms of portfolio allocations, a slightly above-average duration. What's more, interest-rate cuts could offer opportunities for capital gains.

Higher yields also mean that mixed portfolios are attractive once again. The era of zero and negative interest rates is over. In reaction to higher yields, we are once again investing more in longer-dated bonds. The shifting yield landscape should mean that they will once again play a larger role in investors' portfolio strategies. This is even truer, as correlation between stocks and bonds is likely to normalise. We expect the correlation to decrease again after having been driven up by the supply-side shock. This will re-enhance the diversifying, i.e., risk-mitigating, effect of adding fixed-income allocations to mixed portfolios. This could make 2024 a big year for multi-asset solutions.

In early November we had raised our equity market exposure from slightly underweight to neutral, i.e., by increasing our equity allocations. This paid off during the November rally. Our neutral stance reflects our view that equity market risks and opportunities are now relatively well balanced. On the one hand, the growth outlook is tentative, companies are being hit by tighter financing conditions, and weaker demand is making it more difficult for them to pass on rising interest and labour costs. All this could squeeze their margins. On the other hand, equity markets are likely to get a boost in the new year from higher bond yields and, possibly, falling interest rates. Moreover, analysts believe that earnings growth (i.e., earnings per share) will accelerate in the new year. And, lastly, valuations are not very high on the whole. Price-earnings ratios on the S&P 500 and Euro Stoxx, for example, are now close to their long-term averages and are even quite attractive in some corners of the market.

But it's best to stay selective in choosing stocks for next year. Avoid cyclicals, for example, as they are particularly vulnerable to economic risks. The focus should be on defensives and, in our view, quality and growth stocks. We prefer companies that, among other things, feature high capital efficiency and moderate leverage, and that tap into long-term growth trends. We are thinking here primarily of tech stocks, artificial intelligence in particular, but also healthcare, which should be able to exploit demographic trends, and luxury goods, which are being driven by rising incomes in emerging market economies.

On top of the uncertainties surrounding economic development, there are some exogenous factors to keep in mind for 2024. The war in Ukraine and fighting in Gaza remain key risk factors. The January elections in 2024 in Taiwan could generate renewed tensions with China. Moreover, an eventful election year is looming in the US. On the Democratic side, everything is pointing towards incumbent President Joe Biden's running for re-election. On the Republican side, polls currently show Donald Trump with a big lead, but he is still facing several court cases. A Trump victory in November 2024 could lead to further polarisation in the US and to an end to US support for Ukraine. Ever closer integration within Europe would be the correct response to the rising geopolitical risks that will steer market volatility in 2024.