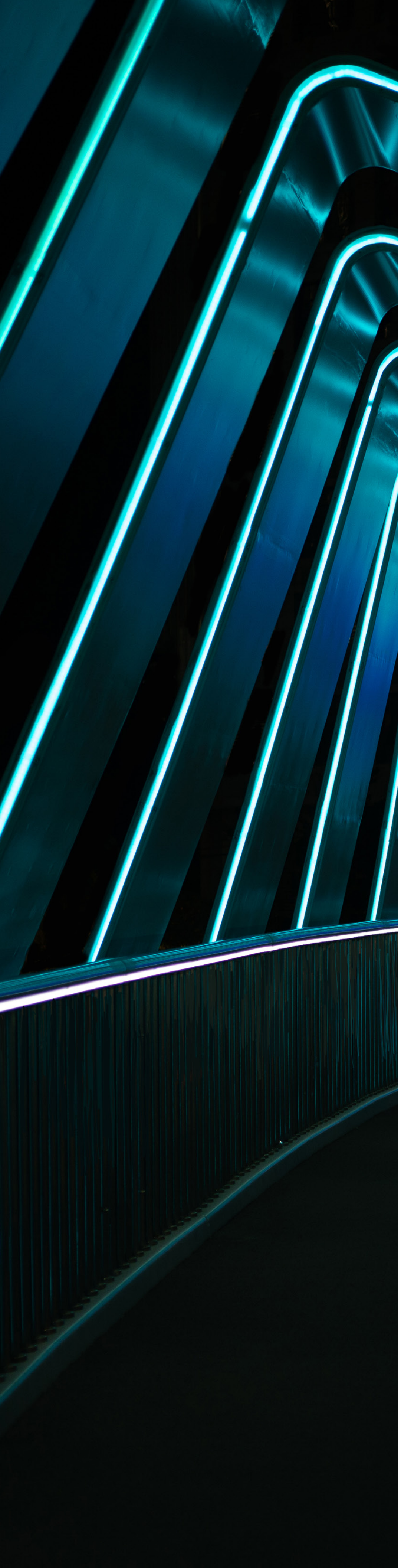
MACQUARIE

MACQUARIE ASSET MANAGEMENT

Actionable ideas for a world in transition

OUTLOOK 2024



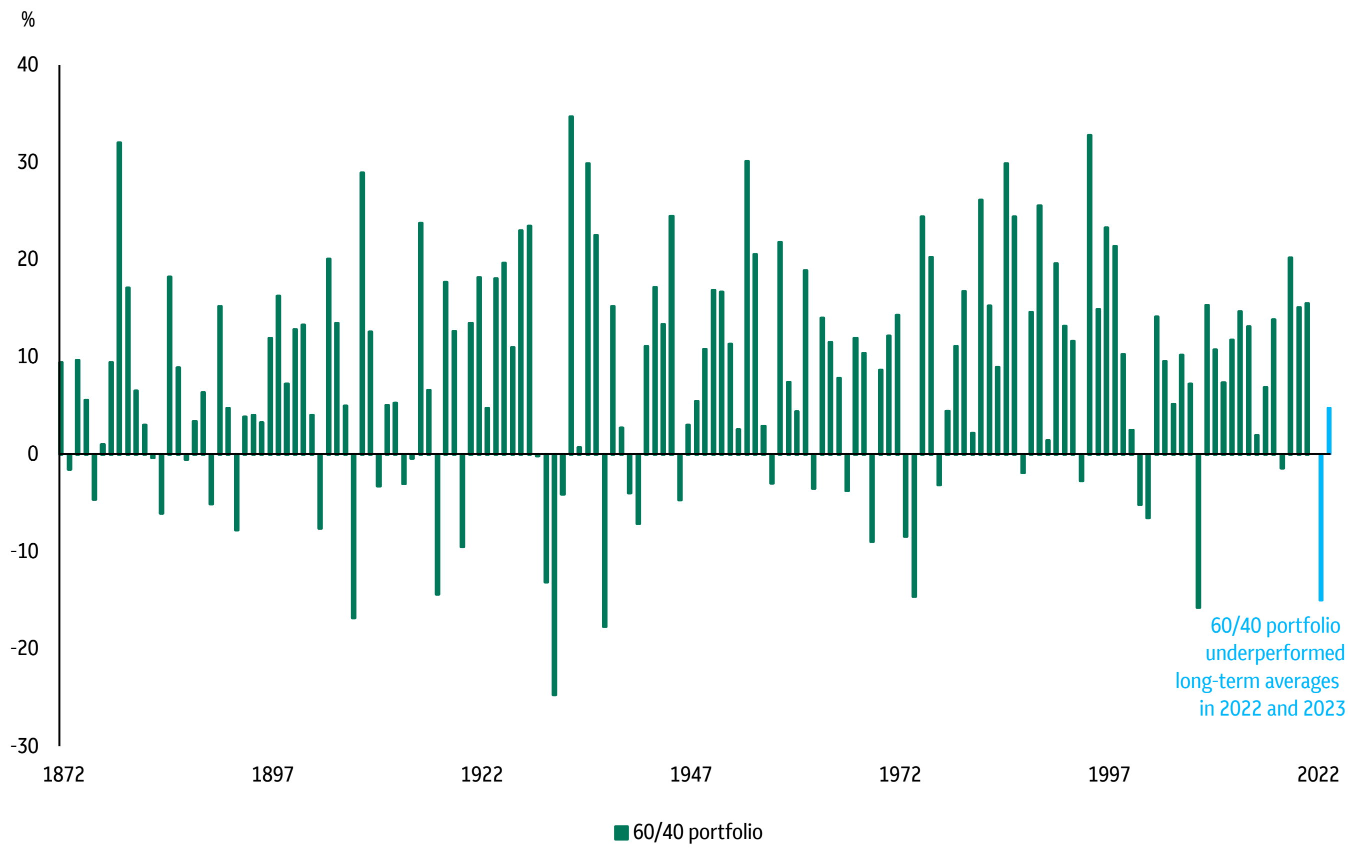
Although 2023 was a better year for investors than 2022, the macroeconomic outlook remains volatile and challenging. Inflation is still above central bank targets, developed world gross domestic product (GDP) growth is slowing, recession risks are high, and geopolitical risk is on the rise. Volatility creates opportunity for investors, however.

- Quality companies that have market power, can control their own margins, maintain prudent capital structures, and have strong and nimble management teams are likely to navigate the choppy waters ahead better than most.
- Companies benefiting from the revolution underway in artificial intelligence (AI) and large language models not only could see rapid growth in the years ahead but are likely to benefit from policy tailwinds globally as governments look to boost productivity.
- We believe bonds should perform relatively well in 2024. Yields are back to levels not seen since 2007, the cyclical outlook is challenging, inflation is falling, central banks are pausing, and markets are not pricing in much in the way of interest rate cuts.
- Municipal bonds in particular have reached yield levels not experienced in more than 10 years, while municipal credit is generally as strong as it has been in decades.
- Given the volatility and number of unknowns in the external environment, diversification will be vitally important, in our view. Private markets, including private equity, could play an important role here.

Macroeconomic outlook

It has been a tough couple of years for investors, with the 60/40 portfolio[1] underperforming its long-run average in both 2022 and 2023. In fact, 2022 was the fifth-worst year for this type of portfolio since 1872. While 2023 was better, driven by a rebound in equities on strong earnings, the portfolio's 4.7% return was still easily below its long-run average annual return of 8.3%.

Investors have been challenged the last few years



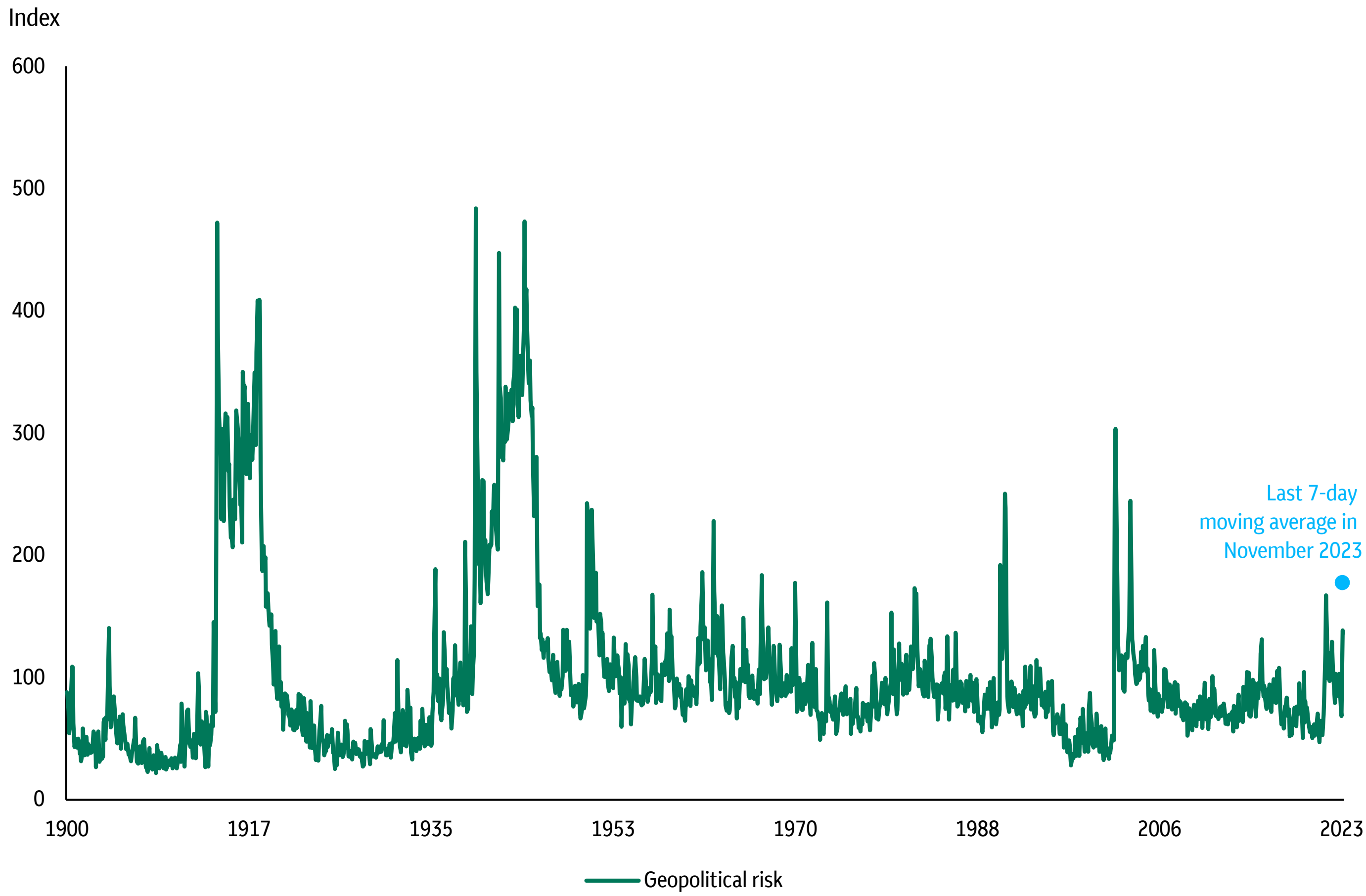
Sources: Robert Shiller online data, Yale Department of Economics, accessed November 15, 2023; Macrobond (November 2023).

As we look ahead in 2024, the macroeconomic backdrop remains volatile and challenging. In our last two Outlooks we talked about how the world has gone through "macroeconomic regime change," with the world of low and stable inflation, and ever lower interest rates, a thing of the past. Events over the last year have only added to our conviction that we are indeed in a new world, where the fundamental economic and political dynamics at work are different than they were in the three decades before COVID-19.

1. Portfolio consisting of 60% equities (represented by S&P 500 Index) and 40% bonds (represented by 10-year US Treasury bonds).

Geopolitical risk and global volatility have clearly been on the rise. The conflicts in Ukraine and the Middle East are the principal drivers at present, but these could ease in intensity going forward. We are more generally in a world of greater risk and uncertainty, in our view. Part of this is the fading of the post-1989 unipolar world. But the more significant point is that we have entered into a period of great-power rivalry between the US and China and this is likely to be long-lasting.

Geopolitical risk is back



Source: Data downloaded from Matteo Iacoviello Geopolitical Risk (GPR) Index on November 15, 2023.

This has many implications: trade frictions are on the rise; onshoring or friend-shoring is underway to increase the security of supply chains; and defense spending is increasing, eroding many governments' fiscal space and policy flexibility. But in terms of economic variables and policy it means:

- Developed world (DW) inflation will likely be more erratic, stickier at higher levels, and require higher interest rates to keep it at, or around, central bank targets. Target overshoots may become more common.
- Fiscal and monetary policy may be periodically constrained. Inflation may sometimes require central banks to tighten more, or ease less, than they would ideally like given the growth backdrop. Debt levels and interest costs will likely constrict governments' room to maneuver.
- GDP growth is likely to be more volatile and recessions more frequent, due both to more external shocks and less policy headroom. Downturns may be milder than in recent history, however. We aren't returning to the 1970s, in our view, but we could be reverting to a world of stop-go economics.[2]

This is a more challenging and volatile world, which will require skill to navigate. But volatility and change create opportunities.

One way investors may be able to protect themselves in this environment is by focusing on high-quality companies. Companies that have market power, can control their own margins (whether by offering critical services or having brand power), maintain prudent capital structures, and have strong and nimble management teams are likely to navigate the choppy waters ahead better than most.

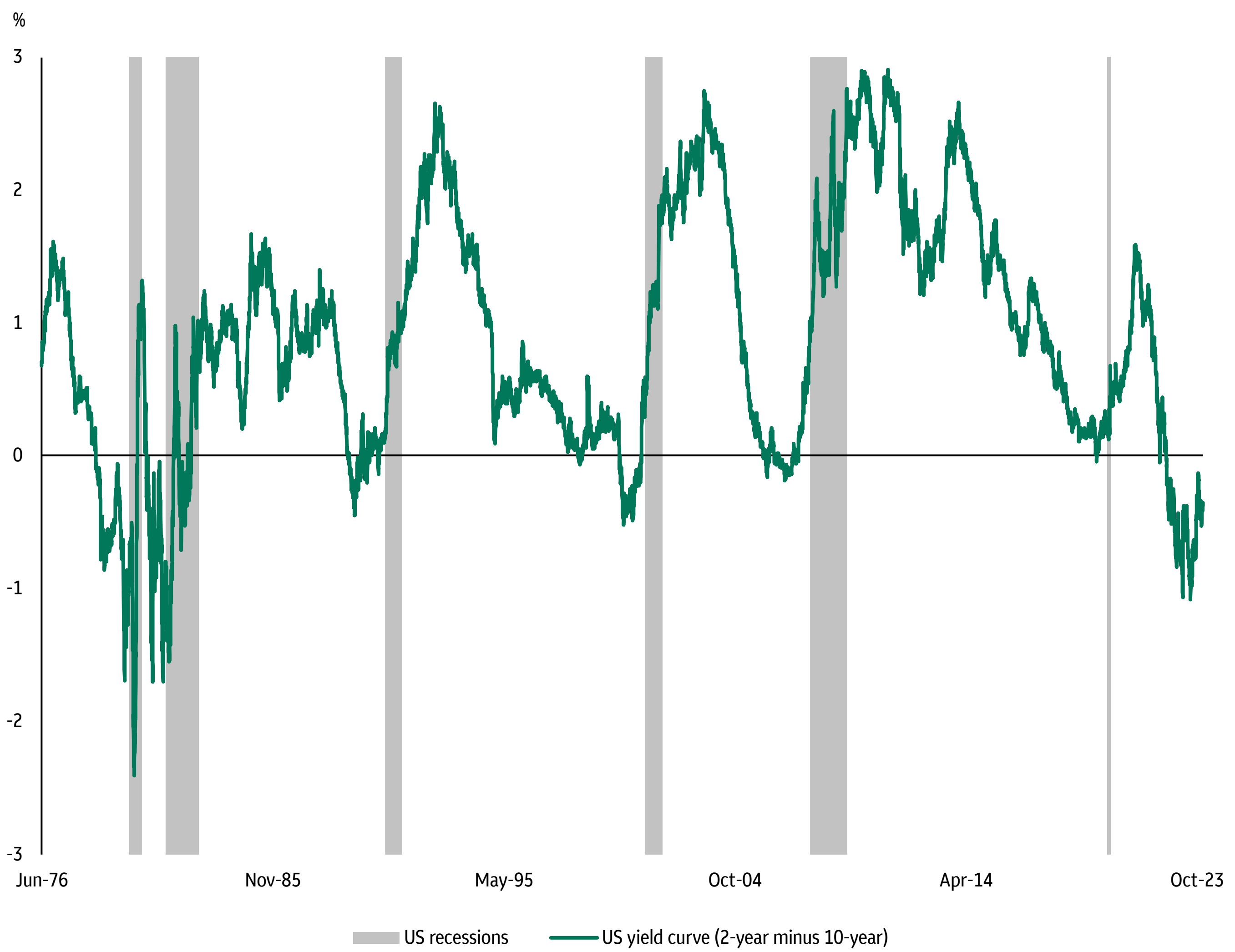
Another is by focusing on companies benefiting from the revolution underway in AI and large language models. All of the macroeconomic challenges we mentioned above are likely to weigh on productivity growth. AI, then, has come along at a particularly opportune time, as it may be able to counteract, or at least offset, some of the negative effects created by this new external environment. And because productivity growth appears likely to be key to long-run living standards, a lot of pressure should come to bear on governments and policymakers around the world to deliver productivity enhancements. Sustained policy support globally would be a big positive for investors in the sector and beyond due to its broad applicability and huge growth potential.

2. This was the phrase used to describe Britain's economy from 1955 to 1964 when inflation and concerns about the current account induced a lot of policy volatility that resulted in short bursts of growth, followed by periods of slow or no growth.

We also believe bonds should perform relatively well in 2024. The cyclical outlook remains challenging, in our view. The US economy, once again, proved remarkably resilient in 2023, underpinned by strong government spending and a consumer that has not wilted in the face of the headwinds of falling real incomes, higher interest rates, and tighter credit conditions.

But leading indicators are still signaling concern about the outlook for growth. The yield curve remains inverted, monetary aggregates have slowed sharply, and credit conditions have tightened. Yield curve inversions have often preceded recessions, and the US yield curve first inverted back in April 2022, which is 21 months ago now. While this is longer than the post-1980 median of the lag between inversion and recession commencement (of 15 months) it is within the range of historical outcomes over this period (the lag has ranged from five months to 23 months). In other words, if the US economy were to enter a recession anytime in the next four months it would be a historically normal outcome.

US yield curve inversions often precede recessions



Source: Macrobond (November 2023).

With the Euro area and UK economies either on the cusp of or already in recession and China sluggish under the weight of a struggling property market, global growth looks set to slow over the next six to nine months.

This is an environment that is ripe for bonds, in our view. Yields are back to levels not seen since 2007, the cyclical outlook is challenging, inflation is falling, central banks are pausing, and markets are not pricing in much in the way of interest rate cuts.

One area that really stands out to us is municipal bonds. High-risk credit could be challenged in 2024 as spreads on risker securities, which are generally below long-run averages at present, are not pricing in an economic downturn. But municipal bonds have reached yield levels not experienced in more than 10 years, while municipal credit is generally as strong as it has been in decades.

Low-risk bonds, such as national government bonds and high-quality corporates, also seem well placed. We are positive on owning duration given the high carry environment, potential for capital gains if a recession emerges, and as a protective lever within portfolios that contain riskier assets.

Lastly, given the volatility and number of unknowns in the external environment, diversification will be vitally important, in our view. Private markets, including private equity, could play an important role here. And we believe manager selection will be critical. Managers with deep sector expertise and a track record of delivering on earnings growth and adding real economic value have the potential to outperform in a world where the macroeconomic tailwinds of yesteryear are no longer present.

In summary, with inflation still high, GDP growth slowing, recession risks elevated, and geopolitical risk a growing consideration, we are in a period of heightened volatility for investors. But opportunity is volatility's long-time partner, and for experienced, judicious investors there is likely to be plenty of opportunity to deploy capital and earn attractive risk-adjusted returns in the year ahead.

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5 actionable ideas for 2024

Focus on quality in growth equities

By looking for durable characteristics, investors can find some predictability and earnings consistency, at a time when uncertainty and market volatility is high.

Capitalize on historic municipal bond yields

With tax-exempt yields already at levels not seen in more than a decade, there may be a significant investment opportunity for long-term investors.

Allocate with conviction across taxable fixed income

In our view, there is tremendous value in core bond sectors relative to other segments of the market. However, we believe it is important to maintain flexibility and allocate with conviction as opportunities arise.

Prepare for the growth of artificial intelligence

AI presents a myriad of opportunities, driven by its potential to revolutionize productivity and spur economic growth. Understanding its evolution, current state, and future prospects is crucial for making informed investment decisions in this rapidly advancing field.

Explore emerging opportunities in energy transition

We are seeing unprecedented interest in new technologies and approaches to the energy transition. This interest, in addition to tailwinds from regulation such as the Inflation Reduction Act, present investors with attractive investment opportunities.

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Macquarie Asset Management is part of Macquarie Group, a diversified financial group providing clients with asset management, finance, banking, advisory, and risk and capital solutions across debt, equity and commodities. Founded in 1969, Macquarie Group employs approximately 21,000+ in 34 markets and is listed on the Australian Securities Exchange.

All figures as of September 30, 2023.

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Past performance does not guarantee future results.

Diversification may not protect against market risk.

Fixed income securities and bond funds can lose value, and investors can lose principal, as interest rates rise. They also may be affected by economic conditions that hinder an issuer's ability to make interest and principal payments on its debt. This includes prepayment risk, the risk that the principal of a bond that is held by a portfolio will be prepaid prior to maturity at the time when interest rates are lower than what the bond was paying. A portfolio may then have to reinvest that money at a lower interest rate.

Market risk is the risk that all or a majority of the securities in a certain market – like the stock market or bond market – will decline in value because of factors such as adverse political or economic conditions, future expectations, investor confidence, or heavy institutional selling.

Currency risk is the risk that fluctuations in exchange rates between the US dollar and foreign currencies and between various foreign currencies may cause the value of an investment to decline. The market for some (or all) currencies may from time to time have low trading volume and become illiquid, which may prevent an investment from effecting positions or from promptly liquidating unfavorable positions in such markets, thus subjecting the investment to substantial losses.

Credit risk is the risk of loss of principal or loss of a financial reward stemming from a borrower's failure to repay a loan or otherwise meet a contractual obligation. Credit risk arises whenever a borrower expects to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Credit risk is closely tied to the potential return of an investment, the most notable being that the yields on bonds correlate strongly to their perceived credit risk.

Investors must have the financial ability, sophistication/experience, and willingness to bear the risks of an investment in private market securities. Such securities may be available only to qualified, sophisticated investors, may have liquidity constraints, and may bear the risk of investment in private markets securities.

Private market investments may entail a high degree of risk and investment results may vary substantially on a monthly, quarterly or annual basis. Among many risk factors, some are particularly notable. These include, without limitation, the general economic environment, the health of the housing market, employment levels, the availability of financing, the quality of servicing the assets backing the securities, the seniority and credit enhancement levels for structured securities, government actions or initiatives, and the impact of legal and regulatory developments. Additionally, private markets strategies may represent speculative investments and an investor could lose all or a substantial portion of their investment.

International investments entail risks including fluctuation in currency values, differences in accounting principles, or economic or political instability. Investing in emerging markets can be riskier than investing in established foreign markets due to increased volatility, lower trading volume, and higher risk of market closures. In many emerging markets, there is substantially less publicly available information and the available information may be incomplete or misleading. Legal claims are generally more difficult to pursue.

Investment strategies that hold securities issued by companies principally engaged in the infrastructure industry have greater exposure to the potential adverse economic, regulatory, political, and other changes affecting such entities.

Infrastructure companies are subject risks including increased costs associated with capital construction programs and environmental regulations, surplus capacity, increased competition, availability of fuel at reasonable prices, energy conservation policies, difficulty in raising capital, and increased susceptibility to terrorist acts or political actions.

Inflation is the rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.

Recession is a period of temporary economic decline during which trade and industrial activity are reduced, generally identified by a fall in GDP in two successive quarters.

A sector is a segment of the economy that includes companies providing the same types of products or services. Although companies within a sector tend to be reasonably consistent in their fundamentals, these fundamentals may differ substantially from one sector to another. For example, some sectors are cyclical, rising and falling with changes in the economy while others are defensive, maintaining their strength despite economic ups and downs.

A Treasury yield refers to the effective yearly interest rate the US government pays on money it borrows to raise capital through selling Treasury bonds, also referred to as Treasury notes or Treasury bills depending on maturity length.

The shape of the yield curve is closely scrutinized because it helps to give an idea of future interest rate change and economic activity. There are three main types of yield curve shapes: normal, inverted and flat (or humped). A normal yield curve is one in which longer maturity bonds have a higher yield compared to shorter-term bonds due to the risks associated with time. An inverted yield curve is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of upcoming recession. A flat (or humped) yield curve is one in which the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition. The slope of the yield curve is also seen as important: the greater the slope, the greater the gap between short- and long-term rates.

Yield curve inversion is when coupon payments on shorter-term Treasury bonds exceed the interest paid on longer-term bonds.

The **Caldara and Iacoviello Geopolitical Risk (GPR) Index** reflects automated text search results of the electronic archives of 10 newspapers: Chicago Tribune, the Daily Telegraph, Financial Times, The Globe and Mail, The Guardian, the Los Angeles Times, The New York Times, USA Today, The Wall Street Journal, and The Washington Post. Caldara and Iacoviello calculate the index by counting the number of articles related to adverse geopolitical events in each newspaper for each month (as a share of the total number of news articles).

The **S&P 500 Index** measures the performance of 500 mostly large-cap stocks weighted by market value, and is often used to represent performance of the US stock market.

Index performance returns do not reflect any management fees, transaction costs, or expenses. Indices are unmanaged and one cannot invest directly in an index.

Economic trend information is sourced from Bloomberg unless otherwise noted.

All charts are for illustrative purposes only. Charts have been prepared by Macquarie Asset Management unless otherwise noted.

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