Goodbody

Investment Outlook 2024

Going for (structural) growth

Contents

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Structural trends and higher yields to support portfolio returns

Joe Prendergast
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At the end of each year, we update our long-run expected returns for major asset markets. These numbers give an indication (not a forecast) of what an investor entering the market in late 2023 could reasonably expect to experience over the next five years, assuming no extreme shocks, bubbles, or calamitous events. These indications take into account many different variables, including the prevailing level of bond yields, the potential path of growth, inflation and interest rates, the outlook for corporate earnings growth and creditworthiness, dividend yields, and the current and prospective path of equity index valuations around the world.

The actual outcomes experienced by investors can be very different from these stylized indicative returns, but the overall numbers are calibrated to both reflect the macro fundamentals and be comparable to historical averages. Based on these assumptions, it is possible to build indicative expected returns for portfolios representing asset allocations for various investor risk profiles.

So how do long-term expected returns look in late 2023? Our CIO Bernard Swords notes that the outlook for global equity markets into 2024 is cautiously optimistic. The economic growth outlook is below trend but moderate world earnings growth of 6% or 7% still seems achievable. Given a world equity dividend yield of 2%, 6% earnings growth and allowing for some reversion to longer-term valuation averages, world equity returns of around 7.5% look reasonable – somewhat higher than projected at the end of last year.

Where will earnings growth come from? Economic growth may be sub-par, but earnings growth should still reflect some strong structural trends. Within Healthcare for example, Bernard expects the Med Tech industry to continue to benefit from aging populations.
The energy transition has had a few turbulent years, but it also remains a long-term structural trend in our view. We are increasing our exposure to decarbonisation through companies that facilitate electrification within our Industrials exposure and via Utilities. Artificial Intelligence may also have further impact, via a focus on the potential beneficiaries of implementation of this technology. See pages three and four for more on our equity allocations and indicative expected returns.

In fixed income, the key long-term expected return comes from the German five-year bond yield. At around 2.6% at the time of writing, this is up from 2.0% one year ago and -0.5% two years ago. Core fixed income is thus expected to contribute positively to portfolio performance. Our Head of Fixed Income Strategy Elizabeth Geoghegan notes the additional yield offered by corporate credit may be slightly dented by some pick-up in world default rates as higher interest rates bite, but even assuming a reversion to long-term average defaults there is a decent expected return on corporates over governments.

“Economic growth may be sub-par, but earnings growth should still reflect some strong structural trends.

As we look forward to 2024, expectations are for central banks to start cutting interest rates by the second half of the year, marking a shift in the return outlook for bond markets. We thus view longer duration assets as increasingly more attractive relative to shorter duration assets and maintain a preference for a portfolio well diversified across corporate as well as government assets. See page five for more detail on our favoured fixed income strategy.

Economic outlook: Policy development key in 2024

Dermot O'Leary
Chief Economist

Entering 2023, the "dismal science" of economics certainly lived up to its name. Predictions of "rolling recessions" in developed economies were commonplace, a position we too held a year ago. Thankfully, we were wrong. Instead, global growth, estimated at circa 3% was only modestly below its long-term average.

A better-than-expected performance from the United States is key in this outturn. In the third quarter, the US grew at a heady 5% annualised pace, and looks set to grow by over 2% for the full year. Two cyclical factors and one structural element have been important here. Most prominently, consumer spending, accounting for c.70% of US GDP, has continued to expand. A robust labour market has helped, but so has the rather unique feature of a drawdown of excess savings built up over the pandemic lockdowns. These savings peaked at over $2trn but have been consistently depleting. While estimates are uncertain, it is likely that these savings will soon be fully exhausted. With the household savings ratio at close to all-time lows at 3% and the Federal Reserve determined to reduce inflation through a softer labour market, a weaker outlook for the US consumer is in store for 2024. The second cyclical factor helping growth has been a bigger government contribution. This has been surprising considering the strong economy. Much could change depending on the make-up of next year's elections, but it is likely that fiscal policy will not be stimulatory in 2024. Throw in the lagged impact of tighter monetary policy and the ingredients are there for a US recession over the coming quarters, albeit a mild one.

Economic weakness in Europe

Outside of the US, there is already evidence of economic weakness in Europe. The manufacturing sector has been in contraction for all of 2023, while the services sector has recently joined it. Germany, the euro area's largest economy, is in the biggest bind due to its energy vulnerabilities and threats to its auto industry from the shift away from fossil fuels and competition from China. The French economy has already begun to contract recently, suggesting that the euro area may already be in recession. The UK economy is flatlining at best.

Opportunities and risks from structural factors

With central bankers keen to keep the foot on the monetary brakes until they have clear evidence that the inflation risk has passed, and governments under market pressure to get their fiscal house back in order, there are few cyclical growth drivers on the horizon in the short-term.

There are, however, important structural factors that bring both opportunities and risks for the economic outlook. Firstly, the energy transition is now in full flow, with all the global superpowers aiming to put their own mark on it. Secondly, the AI revolution took a giant leap forward this year. While the benefits, risks and direction of this revolution are unknown, it is clear it is not going away. Managed properly, it has the potential to reap huge productivity benefits. Due to the global import of these issues, a race has begun to finance and build the required infrastructure to enable these trends to take place.

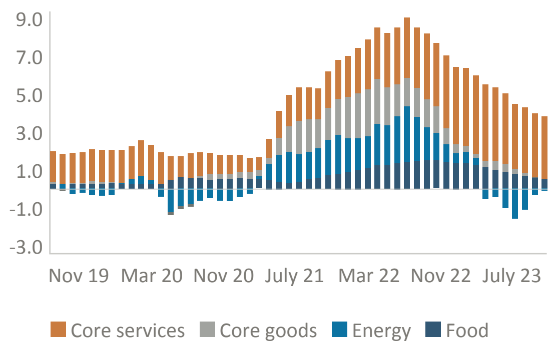
These issues go beyond economics and will have huge geopolitical implications. With about 50% of the world's population due to go to the polls in various elections in 2024, there is a lot at stake.

Figure 1.
US interest rate cutting cycles since 1955

Year	Median (%)	Current level (%)
Rate peak/ Current rate	6.1	5.3
Rate trough	3.5	TBC
Cumulative rate cuts	-2.9	TBC
Core inflation rate	3.6	4.0
Unemployment rate	5.9	3.9
Growth rate	-0.2	1.2

Source: Federal Reserve, FactSet, Goodbody

Figure 2.
Core inflation falling, but now driven by strong labour market



Source: Bloomberg, Goodbody

Unlocking structural growth opportunities in 2024

Bernard Swords
Chief Investment Officer

Our outlook for global equity markets into 2024 is cautious as earnings growth expectations are high, and the economic growth outlook is below trend. But the probability of a near-term recession appears to have declined, and earnings growth of 6%-7% seems achievable even with the normal level of forecast downgrades. Market valuations appear to discount some earnings risks. Interest rates are unlikely to present as material a challenge to valuations in 2024 as they did over the last two years.

Looking back, global equities have performed better than we anticipated in 2023, up almost 14% as we write. In our outlook last year, the consensus forecast for global earnings growth was 3% and there was an outsized probability of a recession in the developed world, which would typically drive negative earnings growth. Much better than anticipated economic growth supported earnings, which was a major prop for equity markets. But we must also bear in mind that performance has been quite narrow. Of the 11 sector groups, four are down year-to-date and only three sectors have outperformed.

Increasing our exposure to structural growth

Through much of 2023, our preference was for economically defensive sectors which typically have dependable earnings, in particular, Healthcare and Consumer Staples. With the earnings background looking better in 2024, it makes sense to try and capture more earnings growth than one would have aimed for in 2023. Nonetheless, there are still elevated risks around earnings forecasts and typical late-cycle growth scares should be expected. Consequently, we would have lower exposure to sectors with the most cyclical earnings (which are dependent on general economic activity), such as Materials, Energy or Banks. It is industries and companies that are economically defensive and with structural growth where we would increase our exposure. These do benefit from a better growth background and are also helped by stable bond yields as they tend to have higher valuations.

Structural growth themes for 2024

Where is the growth we are going for? We think the Medical Devices industry is one example of this. Volumes growth is recovering to pre-Covid levels, driven by ageing populations, low penetration in emerging markets and high barriers to entry. It also doesn't suffer from the same political scrutiny as other parts of healthcare. The energy transition has had a few turbulent years, but it remains a long-term trend. We are increasing our exposure to decarbonisation through companies that facilitate electrification within our Industrials exposure and via Utilities.

Artificial Intelligence (AI) had a breakthrough in 2023 with the release of GPT-4. But it's still too early to pick definitive winners and losers from AI. The valuations of many obvious participants have also moved higher, increasing risk. Hence, we have gone towards beneficiaries for the diffusion of AI rather than the product providers. So, within our Financials and Industrial exposure, we have companies which are good businesses at reasonable valuations, but which also have intellectual property which should become more valuable using AI tools.

> “Caution is still advisable at the asset level. But we would be more earnings growth orientated in 2024, looking for it from structural rather than cyclical drivers.

All considered, the background for equity markets in 2024 is looking better, with a good chance of single digit earnings growth and reasonable valuations to start. On the other side, the risk of recession is not gone; earnings growth expectations are high and at best a sub-trend growth rate in the global economy is expected. Caution is still advisable at the asset level. However, we would be more earnings growth orientated in 2024, looking for it from structural rather than cyclical drivers.

Indicative expected returns for global equity markets by sector

Bernard Swords
Chief Investment Officer

Our average annual expected return from equity markets over the next five years moves up 1% from last year primarily due to a less challenged earnings outlook. The risk of recession remains but if it occurs it is likely to be mild, and thus we have an upgrade to earnings growth over the five-year forecast horizon. For the next five years, we expect earnings to grow, on average, by 6% per annum (p.a.) – that compares to 5% projected last year.

Valuation is a drag overall but is concentrated in a couple of sectors, notably IT and Communication Services, post the concentrated moves we had in equity markets in 2023.

> For the next five years, we expect earnings to grow, on average, by 6% per annum.

Healthcare leads by sector as a strong earnings recovery is expected in 2024 (see Figure 3). Low returns are projected for IT and Communication Services as valuations have increased substantially in 2023. This could be offset should the emergence of AI and other structural changes lead to a step-up in earnings.

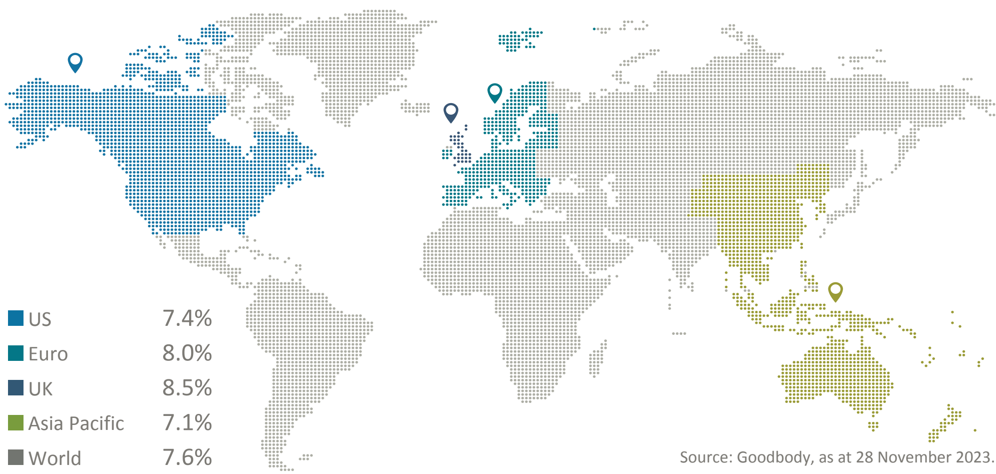
Regional disparity is low (see Figure 4). The UK and euro area score better as they have higher exposure to the lower valued sector and have a higher dividend yield. But this comes at the cost of lower earnings growth.

Figure 3.
Expected equity total returns p.a. by sector

Energy	Materials	Industrials	Consumer Discretionary	Healthcare
9.3%	5.4%	8.8%	8.2%	12.4%
Consumer Staples	**Communication Services**	**Utilities**	**Financials**	**IT**
7.7%	6.2%	8.9%	8.5%	4.6%

Source: Goodbody, as at 28 November 2023.

Figure 4.
Expected equity total returns p.a. by region



Source: Goodbody, as at 28 November 2023.

2024: A turning point for bond returns

Elizabeth Geoghegan
Head of Fixed Income Strategy

Last year, the theme across fixed income was that bonds are back. Fixed income finally offered significant and positive yields, which was a stark contrast to the negative-yielding environment which European investors had become accustomed to. As we look forward to 2024, the same thematic remains relevant, bonds offer positive yields and are an attractive consideration in any portfolio. What will matter most in 2024 however is the type of bonds which investors consider.

Over the last two years, central banks globally have embarked upon an incredible tightening path, hiking interest rates at a record pace to record levels to tackle record inflation figures. This significant move up in interest rates had a knock-on impact on bonds, whose price performance is inversely related to interest rate moves, leading to losses across the board for bond markets. Of course, the moves were not all equal with longer duration bonds, which are more sensitive to interest rate moves relative to shorter duration bonds, suffering larger declines. From an investment perspective, this backdrop meant that investing in short duration, low interest rate-sensitive investments has been the best strategy for investors looking for yield without unfavourable price performance.

> We think that 2024 onwards will mark a turning point for bond returns and the type of investments that one can consider.

A shift in the return outlook

As we look forward to 2024, expectations are for central banks to start cutting interest rates by the second half of the year, marking a shift in the return outlook for bond markets. Whereas the last few years have been about defensive yield opportunities, we think that 2024 onwards will mark a turning point for bond returns and the type of investments that one can consider.

So, what type of investments should one consider? The answer is based in our expected returns outlook. For simplicity, the decisions within fixed income can be framed as a choice between two factors: should one consider long or short duration bonds, and how should they allocate between corporate and government bonds? Based on our expected returns outlook, we view longer duration assets as more attractive relative to shorter duration assets, whilst high quality investment grade corporate bonds also remain attractive.

Longer duration in favour

Focusing on the choice between short duration and long duration bonds, our view is that inflation is falling successfully, and so the path for interest rates will be to move lower over time. Against this backdrop, the expected returns for longer duration assets are most favourable as these assets will experience higher positive returns following a fall in interest rates. Of course, interest rates will not fall in a vertical line, and so, it is important to increase any exposures in a gradual and risk managed manner over the short term.

Allocating between corporate and government bonds

When it comes to the second aspect, the deciding factor when choosing between corporate and government bonds will always be the growth outlook. Corporate bonds, issued by companies, are considered riskier than government bonds and as such will offer a higher yield to compensate investors for the additional risk. Our view that economic growth will be low but we will narrowly avoid a meaningful recession is positive for corporate bonds issued by high-quality companies. These high-quality companies can continue to service their debt and hence their bonds should perform well, providing additional yield and attractive returns for investors.

Structural themes in portfolios for 2024

Long-term expected returns for major asset classes are critical for setting strategic asset allocations.

Sarah Quirke
Head of Investment Solutions

How do we fit structural or other themes into portfolios?

There are many ways that structural themes can be introduced into portfolio construction. Traditionally, a structural theme could be reflected in a sector or industry tilt in a portfolio. For example, an innovation theme like AI could be expressed at a basic level via overweighting Technology or perhaps the semi-conductor sector specifically. Of course, single stocks could also be used to reflect a theme, but this would lack diversification and so be exposed to undue concentration risk. Increasingly, themes can be more precisely reflected in thematic collective investments (exchange traded funds or managed funds). For example, the structural trend to decarbonisation can be reflected more precisely, such as via exposure to a collective of companies focused on development and construction of alternative energy grid infrastructure.

There are other macro themes which can also play an important role in portfolio construction. For example, inflation or disinflation. These could be primarily reflected in fixed income exposure, where long maturity assets with fixed interest coupons would benefit more from disinflation, while shorter-duration assets with more flexible yields could suit more a structural shift towards inflation.

What are the other parameters that need to be considered and how do they affect portfolios?

Long-term expected returns for the major asset classes are critical for setting strategic asset allocations. These are used as a guide to risk and reward metrics for each risk profile. And they define the reasonable (but only indicative) objectives for the strategy embarked upon for each investor. Financial situation, attitude to risk, time horizon and objectives of the investor are very important in determining the right risk profile and this needs to match with the agreed objectives for the portfolio, as defined by the expected returns.

Many other key considerations come into play – any constraints or preferences, notably on Sustainability, or tax treatment preferences, or cost and complexity considerations. It's a bit of a puzzle, but the right solution will always relate back to the core views and strategic asset allocations.

What defines success in terms of portfolio construction and the investor experience, in your view?

For a wealth manager, the single most important metric has to be delivery of investor objectives in absolute terms over the investment time horizon. On the day that a prospective client sits down with a portfolio or relationship manager and defines their attitude to risk, their preferences and aspirations, a picture can be formed of what a suitable strategy might be, what investments would be appropriate, and what the prospective returns could be from taking an estimated amount of risk in financial markets. Whether these goals are ultimately achieved or not is the principal metric of success.

Secondly, how have our asset class selections performed relative to pre-selected benchmarks? For example, if the investment research team chooses a basket of stocks, has this under-performed or outperformed the total return of the world equity index, all in euro terms? The same for fixed income, relative to the broad euro fixed income index.

Third, how have our portfolios performed against peers – i.e., specifically, wealth managers attempting to achieve the same goals as we are. Capital preservation is an important objective in this industry. So, growth most often needs to be achieved conservatively. Portfolio construction is a significant contributor to finding the right investment solution.

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