ILIM

Investment Outlook

2024: THE YEAR OF THE BALLOT BOX?

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Foreword

2023 was a year when economic resilience blew through the pessimistic expectations of 12 months ago. Most asset classes gained amid falling inflation and robust economic growth. The theme of artificial intelligence (AI) helped propel earnings and equity returns, with a small number of mega-cap stocks – the "Magnificent Seven" as they have become known (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta) – riding to the rescue of the broader stock market. Meanwhile, interest rate volatility was high as rates rose to multi-decade highs before falling sharply into the end of the year as the Federal Reserve's (Fed's) dovish pivot suggested rate cuts in 2024. Indeed, the Fed remarkably managed to thread the needle of slowing inflation and the economy, without inducing a recession.

Looking forward, we expect a continued moderation in inflation and slowing growth, but no recession. This should allow central backs to loosen financial conditions through rate cuts during the course of 2024. If we track along this macro path, it should be broadly supportive for bond returns, while equities should also benefit from an expected rebound in earnings this year, albeit valuations may prove a headwind.

At the same time, we believe investors need to be mindful of the risks ahead in 2024. We see volatility remaining a notable feature of markets with investors focused on, and sensitive to, any disappointment in the economic data flow, particularly around inflation. Geopolitics is also top of mind as we look ahead to a significant election year set against the backdrop of rising conflict in the Middle East and ever greater polarisation of political views across the national and international arena.

The potential for heightened political tensions is starkly highlighted by elections in countries covering over half the world's population this year.

This has already begun with the presidential election in Taiwan on 13 January, which could have consequences for relations with China and the West, while the build-up to America's presidential election in November brings its own risks as the shadow of Trump looms large.

While our base case view supports a positive stance on risk, we believe a balanced and diversified portfolio remains the order of the day. Year-end valuations on equities and bonds reflected an optimistic outlook by markets, which in the near term may see some correction, but overall we see a positive environment for multi-asset investors in 2024.

Foreword continued

As we detail in the sections that follow, there are attractive opportunities within equities and fixed income, as well as compelling cases for diversified exposure in real assets where the turn in the interest rate cycle should support valuations in areas such as infrastructure; in addition, some green shoots may emerge after a challenging 2023 for real estate investors. We also delve into our views on sustainability and what we have seen on the ground in the defined benefit (DB) pensions space, so hopefully there's something for everyone!

I would like to thank all the team for their contributions to this year's investment outlook. Thank you for your continued support throughout 2023, and we wish you all well for 2024 – from all of us here at ILIM.

Anthony MacGuinness

Chief Investment Officer, ILIM

HIGHLIGHTS

> PAGE 5. **ECONOMICS:** Macro risks receding

> PAGE 5. **EQUITIES:** Improving fundamentals, with an AI kicker

> PAGE 7. **FIXED INCOME:** Monetary easing brightens the landscape

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Macro and Equities

ECONOMIC OUTLOOK

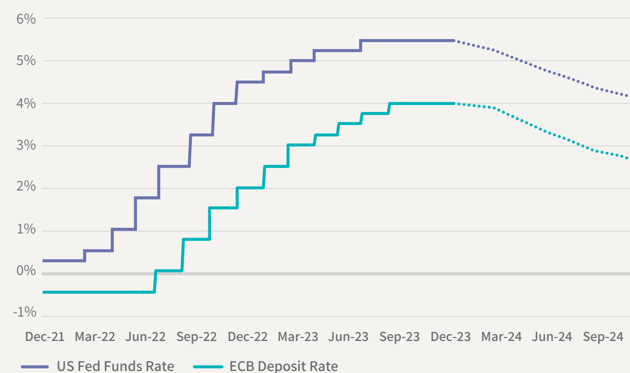
> Global growth is expected to slow but remain strong in 2024 with a soft landing increasingly likely.

Last year, growth surprised positively and the recession feared by many at the start of the year was avoided with the global economy estimated to have grown 2.7% in 2023. The US stood out, with initial growth forecasts of 0.3% being revised up to 2.5% by year end, while China and the Eurozone struggled to gain traction. The US economy was boosted by a strong labour market and the depletion of excess savings which supported consumption. Investment growth was firm as the Inflation Reduction and CHIPS Acts encouraged spending on green and semiconductor-related areas while fiscal spending was also higher than expected.

For 2024, it appears increasingly likely that a soft landing will be achieved as growth slows but remains firm at 2.3%. With headline inflation having fallen to 3.4% year-on-year (y/y) in the US and 2.9% y/y across the Eurozone, central banks appear to be winning the inflation battle and are expected to begin cutting interest rates from Q2, providing relief to interest rate sensitive sectors and supporting the overall economy.

In the US, growth is expected to slow to around 1.5%, close to the long-term trend, with consumption supported by positive real wage growth and the $30trn increase in household net worth since pre-Covid. Private investment should remain solid given spend associated with the green agenda and AI. While the Eurozone economy is likely to remain sluggish, a modest improvement in growth is expected, to approximately 0.6%, as consumers still retain a high level of excess savings and the lower interest rate backdrop should boost activity and sentiment. Despite difficulties in the property sector, the Chinese authorities look set to maintain sufficient stimulus to ensure growth remains in the 4.5-5.0% range.

CHART 1. Central bank rates and projections*



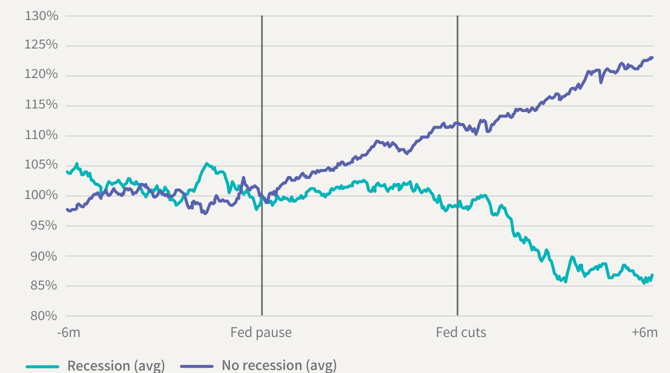
*Dotted lines are market-based projections. Source: Bloomberg

EQUITIES

> The fundamental backdrop for equities is positive with an expected soft landing, falling inflation, policy rate cuts, recovery in earnings and AI benefits all contributing to further upside in 2024.

Macro uncertainty is abating and growth looks set to remain firm. Inflation should continue to fall towards central bank targets, meaning the peak in policy rates has been seen and interest rate cuts are now expected, with investors discounting 125-150 basis points (bps) of cuts by both the Fed and European Central Bank (ECB) through the year (Chart 1). Since the 1970s, the S&P 500 on average has risen by approximately 13% in the 12 months after the peak in policy rates and has risen approximately 8% on average in the six months after rate cuts have begun, in a non-recessionary environment (Chart 2).

CHART 2. S&P 500 historical performance around Fed pauses and cuts



Source: CBRE/ILIM

Macro and Equities continued

Returns also tend to be favourable in a US presidential election year, which 2024 is. Typically, when a recession is avoided, the market does well during election years, rising on average by about 13%. Investor sentiment has improved and positioning increased during 2023, but investors still appear to be underweight equities relative to long-term positioning. As investors rebuild exposures, this could push equities higher in 2024.

Earnings have troughed, and the earnings recession in the US is now over with Q3 earnings up on a year-on-year basis for the first time since 2022. Consensus forecasts show global earnings growth improving from only 0.4% last year to almost 11.0% in 2024, driven by top line growth of low-to-mid single digits, while easing cost and wage pressures, operating leverage and AI-related efficiencies should all contribute to a rebound in margins. As is often the case, analysts' initial forecasts might prove to be too optimistic, with earnings growth of 7-8% probably more likely, but this is still a significant improvement compared to 2023.

The emergence of the AI theme was a key driver of equity performance last year, particularly in large-cap US stocks. AI provides a significant structural lift to economic and earnings growth and is expected to be a major support for equities and the economy over the medium to long term. The AI theme is likely to continue to be supportive of large-cap tech-related stocks and the overall market in 2024, although the scale of performance in AI-linked stocks is unlikely to be repeated in 2024; such stocks need to deliver on the raised expectations and grow into their higher valuation multiples.

While the positive fundamental backdrop suggests significant upside, equity valuations could put a cap on the returns achieved. Global equities are trading on a price-to-earnings (P/E) ratio of 16.8x, broadly in line with the long-term average of 16.0x, and appear expensive against bonds given the rise in yields over the last two years. However, if valuation multiples remain at current levels, equities would rise in line with earnings growth and, after including dividends, would generate returns of high single to double digits over the next 12 months.

Risks to the positive outlook for equities include the possibility of inflation being stickier than expected, resulting in fewer rate cuts or even further tightening, growth surprising to the downside and renewed fears of recession or unexpected geopolitical events.

Overall, we expect further gains in equity markets in 2024 and, while volatility linked to the above risks will remain a feature as various issues arise through the year, a return of high single to double digits seems to be a reasonable expectation when underlying fundamentals remain robust.

Lenny McLoughlin
Chief Investment Strategist

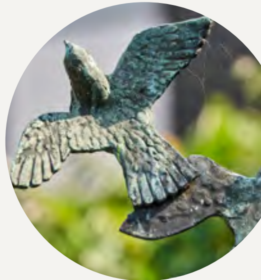
Fixed income

> Further falls in inflation are likely to lead to monetary easing and lower bond yields.

> Within fixed income, we see the best opportunities in sovereign debt, high yield bonds and emerging market dollar debt.

After a torrid two years for fixed income investors, 2023 promised to be the 'year of the bond' for many. This view was sorely tested for most of the year. High interest rates and wide spreads were meant to entice investment, but persistently high inflation and stronger growth meant it was tough for most of the year. For those investors that held their nerve, it all came good in the last quarter as softer inflation allowed key central banks to stop raising rates. Typically, when a central bank stops raising base interest rates, it has been a great time to own bonds. It was no different this time, with 10-year German yields dropping from a multi-year high of 3% back to a more modest 2%. Similar moves were seen in the larger US bond market. Perhaps it was the 'year of the bond' after all.

With yields lower than a year ago and credit spreads tighter, where does that leave investors in 2024? And more pertinently, have we learned anything from what happened in 2023? Worries about persistently high inflation becoming embedded in developed markets have subsided.



This has enabled the ECB to pause its rate hiking cycle at an all-time high of 4% for the key deposit rate. Markets expect that inflation will continue to fall towards the target rate of 2% over the coming 12 months. With weaker growth in Europe, we suspect bond yields can fall further and that the ECB will have to cut base rates in 2024, so, it should be another positive environment for returns for bond markets.

Once again, investors can have increased confidence that bonds will return to having that important role of outperforming when the economy slows. That's when equities can really struggle, so, if your bonds generate positive returns, it can support portfolios nicely.

Fixed income continued

Lower inflation will enable central banks to support the economy on any further growth setbacks. This simply hasn't been the case for the past two years as policymakers' focus remained on bringing down rampant inflation. It was hugely important for the key global central banks to regain credibility on inflation targeting. A failure of the ECB or the Fed to bring inflation significantly down would have damaged future prospects for the global economy. If investors cannot rely upon a stable inflation outlook, it can lead to higher interest rates and debt servicing costs.

With a wide range of fixed income asset classes to choose from, we see the best opportunities in sovereign debt, high yield bonds and emerging market dollar debt. Inflation-linked bonds are beginning to look more attractive as costs of hedging inflation have fallen recently. Within Europe, Italy should be well placed to outperform core bonds if we see the interest rate cuts come through from the ECB. Typical expected returns for most fixed income asset classes should be between 5% to 8%. If we get to over 10% for government bonds, it is likely due to an unanticipated recession.

TABLE 1 : **US 10-year yield post peak in federal funds rate**

	Aug-84	Sep-87	Feb-89	Feb-95	Mar-97	May-00	Jun-06	Dec-13	Average	Median
1m	-13	+29	+4	-44	+18	-45	-20	+3	-9	-5
2m	-66	-41	-23	-46	-2	-33	-42	-12	-33	-37
3m	-125	-33	-76	-60	-32	-59	-57	-14	-57	-58
4m	-127	-50	-114	-146	-58	-58	-52	-20	-78	-58
5m	-116	-102	-135	-146	-38	-69	-67	-36	-89	-86
6m	-100	-101	-120	-119	-64	-76	-49	-73	-88	-88
7m	-81	-63	-117	-143	-78	-124	-30	-70	-88	-80
8m	-144	-37	-151	-148	-91	-119	-63	-115	-109	-117
9m	-200	-22	-159	-168	-102	-132	-55	-97	-117	-117
10m	-224	-52	-156	-195	-108	-165	-50	-100	-131	-132
11m	-229	-31	-101	-209	-115	-117	-31	-97	-116	-108
12m	-246	-29	-84	-206	-112	-98	-17	-83	-109	-91

Source: JP Morgan, Bloomberg

John Thornton
Head of Fixed Income

Geopolitics

> **With countries covering over half the world's population going to the polls in 2024, and heighted global tensions, we expect to see global ramifications.**

They say hindsight is 20/20, but the 2020s have already thrown many norms out of the window and made for an unpredictable geopolitical backdrop. Indeed, last year had numerous surprises: Hamas' attack on Israel on 7 October, resulting in Israel's ongoing counteroffensive in Gaza; Russia's continued on-the-ground war in Ukraine; increasing trade tensions between the US and China (e.g. US CHIPS Act and alleged Chinese spy balloon); trade tensions between the US and Europe, and Finland joining NATO. Moreover, given these heightened global tensions, few would have predicted that global equity markets would be up by 18.7%[1] for the year.

In the post Covid era, we have seen a major shift in the global backdrop. We have seen not only the macroeconomic tides turn from supportive to restrictive monetary policy, but also a shift from peak globalisation to a thematic trend of deglobalisation.

The latter has been manifest as national interests have come to the fore, while international conflicts and supply-chain issues have led to increased focus on securing supply, leading to increased onshoring and nearshoring. This focus on security of supply over cost of key production inputs has also resulted in a rise in use of strategic industrial and protectionist policies around energy, semiconductors, data and defence. The backdrop is reflective of a new regime where we are seeing a more polarised and volatile world and greater occurrence of geopolitical events.

Should investors be worried? Historically, geopolitical events on their own tend to see an initial market reaction but then a swift recovery, i.e. they tend to have a short-term impact on markets (Table 2). However, a multitude of geopolitical events could sway sentiment and result in a sustained risk-off environment. Unexpected events can rapidly shift the state of the world, and such events are already increasing in frequency.

[1] Source: Factset, MSCI All Country World Index, in Euro terms, as at 31 December 2023.

TABLE 2: **S&P 500 returns (periods after the start of the event)**

Date	Event	1 week	1 month	3 months	6 months
May-48	Arab Israeli War	7.2%	10.9%	2.0%	-0.8%
Jun-50	Korean War	-7.6%	-10.0%	1.5%	4.9%
Nov-54	Algerian War	3.9%	6.9%	15.5%	19.4%
Nov-55	Vietnam War	4.4%	7.3%	4.1%	13.9%
Jun-67	6 Day War	4.1%	3.3%	6.5%	7.7%
Mar-69	War of Attrition	-0.7%	1.5%	3.5%	-6.0%
Oct-73	Yom Kippur War	1.4%	-4.5%	-10.0%	-15.3%
Mar-76	Dirty War	1.1%	-0.3%	1.4%	2.9%
Sep-80	Iran/Iraq War	-5.3%	1.2%	4.1%	2.8%
Apr-82	Falklands War	1.0%	1.1%	-6.5%	6.0%
Aug-90	Gulf War	-3.3%	-8.2%	-11.3%	-2.4%
Apr-92	Bosnian War	0.1%	2.8%	2.0%	0.4%
Mar-98	Kosovo War	3.4%	8.5%	7.6%	-5.9%
Oct-01	Afghan War	1.9%	4.1%	0.7%	4.8%
Mar-03	Iraq War	-0.8%	2.0%	13.7%	18.3%
Feb-11	Libya Civil War	-0.9%	-3.5%	0.7%	-9.3%
Mar-11	Syria Civil War	0.9%	2.9%	-1.3%	-5.7%
Feb-14	Crimea	1.3%	1.6%	3.5%	8.3%
Sep-14	Yemen Civil War	0.5%	-6.1%	0.3%	3.5%
Feb-22	Ukraine War	3.8%	5.5%	-6.0%	-2.3%
	Median	**1.1%**	**1.8%**	**1.8%**	**2.9%**
	Average	**0.8%**	**1.4%**	**1.6%**	**2.3%**

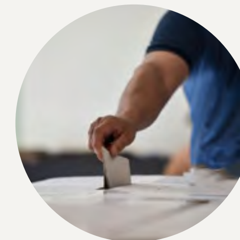
Source: Bloomberg

Geopolitics continued

WHAT TO LOOK OUT FOR IN 2024:

- The fallout from Taiwan's elections, and the potential for heightened tensions with China, which will continue to be a flashpoint for US-China relations
- Expected EU sanctions on China regarding EV vehicles
- 2024 will see more than 70 countries and regional countries experience major elections, the most important being the US election in November. This may see global democracy come under stress as populist movements look to increasingly challenge established institutions.
- Continued US-China trade tensions
- Potential for rising tensions in the Middle East
- Ongoing Russia-Ukraine conflict, with Russia's presidential election in March essentially a fait accompli to anoint Putin to another six-year term

While it is impossible to predict geopolitical events and their impact, we do anticipate heightened risks and a sustained trend of deglobalisation. Against this backdrop, we believe the 'set and forget' portfolio model is over. In this new regime, investors still need a disciplined and robust investment process that enables them to see through the market noise, while effectively risk-managing portfolios and staying anchored to their investment beliefs. At the same time, investors also need to be dynamic and flexible to take advantage of market dislocations that greater volatility can offer.



Leonie Mac Cann
Head of Client Investment Solutions

Alternatives

- **A falling interest-rate environment is likely to be supportive of infrastructure assets.**
- **Value equities remain close to historically cheap levels.**
- **Insurance-linked bonds remain attractively priced.**

This time last year in our 2023 outlook, we spoke about three key themes:

1. Insurance-linked securities looked attractive due to higher spreads and better terms.
2. Higher interest rates meant value stocks would likely outperform growth.
3. Those same interest rates might be a headwind for listed real estate and infrastructure.

How did we do? Well, as Meatloaf sang, "two out of three ain't bad"!

Insurance-linked bonds were one of the best performing asset classes in 2023. Our insurance-linked portfolio made over 16% in the year.

We increased our allocation to this asset class early in the year based on the increase in spreads as well as better risk terms embedded in the bonds. The bonds earned a strong, steady carry, and spreads narrowed as the hurricane season was more benign than in previous years.

Infrastructure assets struggled in 2023, especially those in listed structures where the price floats on an exchange. While their net asset values (NAVs) held up (and they generally have an element of inflation protection), the stock prices were hit as investors looked to switch their income portfolios to Treasuries. Our allocation to unlisted infrastructure is less sensitive to market sentiment, and held up better, returning 7%.

Our value/growth call didn't come to pass. Instead, the phrase 'The Magnificent Seven' became part of the investing lexicon, and mega-cap stocks dominated the market amid a tidal wave of AI-driven optimism. In the round, though, alternatives fared well, with our portfolio returning 6%.

Alternatives continued

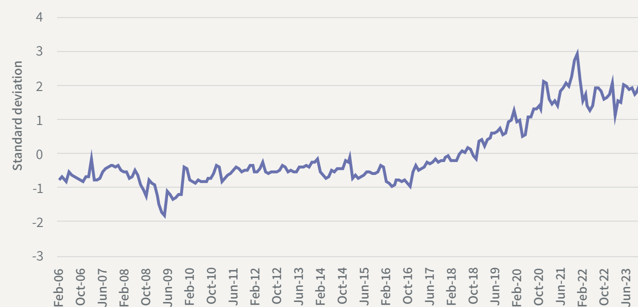
Moving on to what 2024 could have in store, the macroeconomic backdrop has changed, with the Fed signalling a loosening of monetary policy and rates set to fall from here.

So, while our listed infrastructure holdings endured a difficult 2023, they are likely to be supported in 2024, and we would expect to see the likes of Greencoat and INPP experience some convergence back towards their NAVs.

Falling rates are generally more supportive of growth stocks than value, but, while that remains a headwind, value stocks remain very cheap relative to growth stocks; indeed, they are around two standard deviations cheaper relative to their average spread, based on the MSCI Growth and Value indices' earnings yields (Chart 3).

CHART 3. **Growth-Value premium**

(0=historic average, +ve implies Growth expensive)



Source: Bloomberg

Insurance-linked bonds remain attractively priced, even accounting for the windfall gains in 2023. Demand for reinsurance remains high, and 2024 is expected to see record issuance. The insurance-linked bond market currently has $40bn in issuance; this could increase to $50bn this year. All those bonds have to find a home, and, while investors are likely to return to this market after the successes of 2023, they are unlikely to be sufficient to compress the spreads a huge amount from current levels.

Shane Murphy
Head of Manager Selection and Derivatives

Property

> **2024 is expected to emerge as an attractive buying opportunity for real estate**

The global interest rate reset of 2022, which saw debt funding rates for real estate elevated from historic lows, led to a dysfunctional and cautious property investment market in 2023. There has been little transactional activity and increased investor reticence. Valuations have incrementally decreased, reflecting weak investor sentiment, lender caution and an increased cost of capital. While the valuation adjustment still has further to go, and refinancing-led sales are still to emerge in the domestic market, the expected reduction in interest rates should relieve some pressure on the sector.

There are now signs of a narrowing of bid-ask spreads and indications of increased liquidity prospects in certain markets. Also, the recent recovery in the listed property sector, which has seen a significant reduction in the share price discount to underlying property values, can be seen as a reasonable lead indicator for stabilisation in the direct property market and a cause for optimism.

We anticipate that the final phase of impacts from the interest rate reset will unfold through the first half of 2024:

- Significant valuation adjustment has already been priced in, with valuations on average down 18% in Ireland over the last 18 months. We expect to see some further outward yield adjustment in 2024 before stabilising for most segments of the market later in the year, with valuations likely to overshoot 'fair value' assessments.
- Loan refinancing pressure resulting from the step change in debt costs should lead to more stock coming to the market for sale this year. More deals will transact as the bid-ask spread tightens as motivated vendors are required to accept available pricing and buyers benefit from the reduction in financing costs.

2024 is expected to be a very attractive buying opportunity for real estate.

Opportunistic investors, who have significant equity and debt available, will start to deploy capital, attracted to adjusted pricing levels. Property's risk premium over bonds in Ireland has increased to over 250bps, making the asset class attractive again to longer term core investors.

However, it will take time for them to commit new capital as they continue to manage fund liquidity challenges and deleverage in the higher debt-cost world.

Property continued

Finally, we believe the following key structural themes will drive property rental and capital growth prospects, as the property investment recovery emerges:

In the office sector, sustainability-led polarisation, based on asset quality, will see a divergence in valuation and pricing. Further depreciation in the value of older office stock will attract opportunistic capital to invest in brown to green refurbishments and potentially conversions, while selective pre-letting of super-prime, high-sustainability offices will emerge as large corporate occupiers see little new pipeline stock being delivered speculatively.

Remote and hybrid working models will continue to push office vacancy rates up, with many tenants reacting to lease events (expiry and breaks) by scaling back their size requirements or taking short-term lease extensions, giving them flexibility.

The residential sector remains the sector of choice for investors internationally. However, the structure of the rent cap in Ireland is deterring many investors from committing new capital. We expect to see consolidation emerging in the residential investment sector in Ireland as higher leveraged and subscale players exit the market.

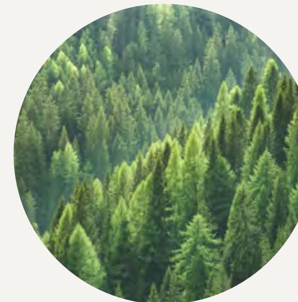
In the industrial/logistics sector, we anticipate record rents being achieved as tenants compete for limited new stock, with demand fuelled by persistency in online sales.

Deirdre Hayes
Head of Irish Commercial Property

Responsible Investment outlook

- **COP28 was a broadly positive bookend to 2023 amid record-high temperatures.**
- **Biodiversity is set come to the fore in 2024.**

We expect an ongoing narrative of a more fragmented world where national interests take priority and deglobalisation continues. This suggests less cooperation between countries, which could yet stymie progress on the green agenda. However, the United Nations Climate Change Conference (or COP28) concluded in mid-December and was a broadly positive bookend to a year in which the planet registered record-high temperatures. Notably, the majority of countries agreed to transition away from fossil fuels. Commitments included to triple renewable energy capacity and double energy efficiency by 2030, while oil and gas companies pledged to reduce methane emissions by 30% from 2020 levels by the end of this decade. The commitments also included the first global stocktake, which is intended to help countries collectively assess where they are, where they want to go and how to get there in terms of climate action, and to identify gaps to course correct.



The urgency of climate change requires a proactive stance and it remains at the centre of our approach to responsible investment and asset stewardship. We made a climate pledge in 2021 and joined the Net Zero Asset Managers initiative in 2022.

ILIM now has over 50% of assets under management in Article 8 funds, and our proprietary investment strategies specifically target a reduction in the carbon intensity of our investment portfolio by removing carbon laggards. We will be phasing out all of our coal investments as part of our commitment to Net Zero.

2023 provided further evidence that Environmental, Social and Governance (ESG) is now mainstream for investors, asset owners and, by association, investment managers. Once again, in 2023, flows into ESG-designated funds (Article 8 or 9 under SFDR) surpassed those into traditional funds, and this is true on a global basis into both equity and fixed income funds. This multi-year trend has seen sustainable assets rise to >6% of global assets under management and 20% of European AUM, based on Morningstar data.

Responsible Investment outlook continued

As we look to the future, and to 2024 in particular, ILIM will continue to focus its voting and engagement efforts on key priorities including climate change, corporate governance and human and natural capital. But, in a world where change is inevitable, it seems likely that biodiversity will come to the fore. The Taskforce on Nature-related Financial Disclosures (TNFD) has developed a set of disclosure recommendations and guidance for organisations to report and act on. It is widely accepted that biodiversity loss will negatively impact global growth; it is dangerous for human wellbeing, and, as noted by the European Central Bank, is "existential for the economy and the financial system, as our economy cannot survive without nature."

Finally, we believe that the regulatory landscape is likely to evolve further through 2024. Late in 2023, the UK's Financial Conduct Authority (FCA) announced changes to its Sustainable Disclosure Requirements (akin to the EU's Sustainable Finance Disclosure Requirements). Interestingly, the FCA introduced a fourth label for sustainable funds: a mixed-goals label. Is this a sign of things to come in the EU? We participated in a consultation process at the end of 2023, but findings are unlikely for a number of months and, we believe, no changes are likely before the start of 2025. Our sense is that there will be changes, but we are hopeful that any changes that come about as a result of this process will build on the existing approach (i.e. Article 8 and 9 funds). Investors have become familiar with these fund designations, and consistency of standards/regulations will ultimately be helpful for our clients.

Niall O'Leary
Chief Sustainability Officer

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