January 2024

Global Equities Investment Outlook for 2024

2023 was a prime example of how difficult it is to forecast GDP growth and stock market direction, particularly in the short term. The recession that economists widely predicted failed to eventuate and whilst earnings growth was muted the US S&P 500 index returned over 25% for the year! Here we put 2023 into context and consider the risks to the upside or downside to GDP, corporate earnings, and stock market valuation levels for 2024.

This information has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Global Equities Fund.

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."
– Mark Twain

Whilst the macro-economic environment and outlook can significantly impact stock market sentiment and movements, it is difficult to predict particularly in the short to medium term. Despite this, it is certainly something we follow, and endeavour to factor into our stock valuation models and portfolio. Instead of trying to accurately predict GDP growth and stock market levels we try and consider a range of possible scenarios, their likelihood and how these may impact the companies in which we invest.

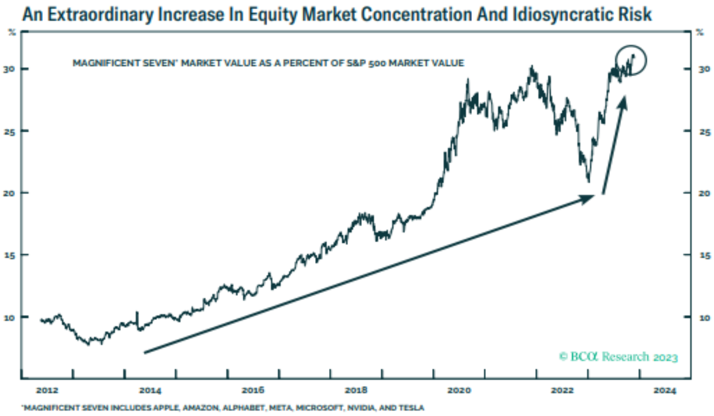
Based on this, we aim to hold stocks with a broad mix of underlying exposures to ensure we are not beholden to any particular macro outcome.

In this article we look into the key drivers of the economy and stock market and highlight the range of possible scenarios for 2024 in the context of recent and long-term history. Note for simplicity we will for the most part focus on the US market and economy, as it sets the tone globally and is ~2/3 of global developed market cap.

2023 Context

The difficulty of predicting the macro outlook proved particularly true in 2023. Most market economists (and we could see why) were forecasting European and US recessions that never eventuated: 2023 real US GDP growth will be over 2%. Whilst bottom-up analysts were slightly more accurate in forecasting flat 2023 S&P500 EPS of ~$223 (with Q4 reporting still to occur, the current estimate is ~$221), this was a result of stronger sales offsetting a weaker bottom line. According to Bloomberg, at the end of 2022, strategists on average predicted the US S&P 500 would end the year at 4,078, or +6.2%. This is in stark contrast to the ~28% total return to 4,837 that was experienced! Furthermore, no one was calling for the performance of the S&P 500 to be largely driven by 7 stocks. **The "Mega 7" (Apple, Microsoft, Amazon, Alphabet, Nvidia, Meta and Tesla) were up over 75% in 2023 vs. the remaining 493 stocks +10.5% (with almost all this ex-Mega 7 performance occurring in November/December).**

The Mega 7 now represent an extreme level of concentration at ~30% of the S&P500 Index and in our view gives high exposure to a limited set of thematics (e.g. cloud, consumer and AI) and were responsible for ~60% of the index's 2023 return. Whilst the Mega 7 performance as a whole faded toward year-end it did appreciate overall in response to both solid earnings growth as well as significant valuation multiples re-rating.



Source: BCA Research

GDP Building Blocks

Back to basics: what we can expect in terms of economic growth for 2024? With GDP growth forecasts being revised higher subsequent to the Federal Reserve (Fed) "pivot" from considering rate hikes to discussing rate cuts at its December meeting, US real GDP growth is now projected to be +1.3% year on year in 2024. In determining the likelihood of this scenario, we take a step back and consider that in simple terms economic growth or output is a function of:

- *The amount and quality of labour:* This is impacted by population growth, demographics and labour force participation.
- *The stock of capital per worker*: Savings and investment add to the stock of capital which leads to more economic growth.
- *The level of technology:* Improvements in technology increase productivity.

Government policies also play a big part in encouraging (or discouraging) economic growth via investment in infrastructure, policies and tax incentives that affect productivity and labour force participation and/or encourage capital accumulation and technological change.

This is a significant consideration for 2024, when the US holds its presidential election. Whilst election day is the 5th of November, there are also the various state primaries and presidential caucuses, not to mention the trials of the former president, and 2024 Republican nomination favourite, Donald Trump**! Note also that 2024 is a year of elections for countries representing 80% of world market capitalisation, 60% of GDP and 40% of the global population, including the UK and European parliament.**

The Amount and Quality of Labour

Taking the first factor, the amount and quality of labour, as its primary driver (i.e. population growth) we consider how it might contribute to GDP growth in 2024. United Nations forecasts the US population growth rate to be 0.53% in 2024, relatively unchanged from the 0.5% in 2023 which was a step up from the ~0.35% achieved through 2021 and 2022.

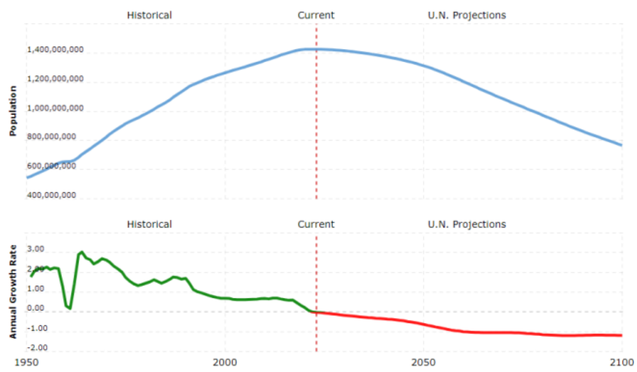
Longer term, the contribution from population growth is expected to decline. Note that for other major developed markets the population growth outlook is weaker. Population growth in 2024 for France and the UK is forecast to be 0.19% and 0.33% respectively, whilst it is expected to fall 0.05% and 0.54% for the larger countries of Germany and Japan respectively.

Europe's population as a whole is expected to steadily decline from 742.3m today to 703m by 2050! What's more, the median age in Europe and the US is also forecast to steadily increase by ~5+ years over the same period which could result in lower labour force participation and productivity.

The largest emerging markets also offer limited assistance. **China's population level peaked in 2021 and has just been overtaken by India. It is forecast to decline 0.03% in 2024 with the decline accelerating to more than -1% in the next 40 years.** Further China's median age is predicted to rise from 39.5 to 50.7 by 2050 (for context, the US median age is forecast to rise from 38.3 to 43.1 by 2050). Whilst India's population is forecast to grow by 0.92% in 2024 (and it doesn't have an ageing population problem) its growth rate is also expected to decline from 2024 to negative levels by 2065.

With this backdrop in mind, while US population growth is positive in 2024 and the coming decade, momentum is deteriorating. Combining this with negative growth in a number of other globally important countries it is difficult to see population as a tailwind to growth in 2024 for the countries in the MSCI World benchmark.

China Population Growth



Source: Macrotrends, United Nations – World Population Prospects

The Stock of Capital per Worker

For the stock of capital and level of technology the outlook is potentially more optimistic. As we have previously highlighted, the US government has passed a trifecta of spending Acts namely, the Infrastructure Investment and Jobs Act (IIJA); CHIPS & Science Act (CHIPs); and the Inflation Reduction Act (IRA). **The three Acts total US$1.85tn in Federal Government spending or over 7% of current US annual GDP. There will also be substantial additional private sector spend on top of this.** Whilst the spend will likely be spread over 5 to 10 years, it ramps significantly in 2024, peaking in 2026/7.

Wolfe Research however predict that total US government spend will be a drag for the overall economy in 2024. Whilst they agree the ramp up in fiscal outlays for the CHIPs and IRA hasn't happened yet, because 2023 was such a (surprisingly) strong year for fiscal stimulus, the overall impulse is likely to slow.

The employee retention credit alone added ~$150bn of stimulus in 2023, and private spending on manufacturing structures rose $80bn compared to 2022 (which dwarfs the anticipated $4bn increase in govt spending on CHIPs in 2024 and $50bn ramp up in IRA). For the CHIPs Act, a large majority of the spend is expected to be private sector investment, which very much ramped in 2023, and this is unlikely to repeat in 2024. Overall, whilst we still expect positive impacts from increased infrastructure investment, particularly from these government spending acts, there is a risk it is at least partly offset by reduced investment spend elsewhere.

In our portfolio we still like to hold names like United Rentals that are yet to see the full impact of this trifecta of spending acts in their earnings but are conscious that these businesses are cyclical and could thus start to price in a downturn ahead of time should the rest of the economy start deteriorating.

The Level of Technology

For improvements in technology, we need only look at the investment in AI (Artificial Intelligence), the source of much of the stock market strength and excitement in 2023. Technology research and advisory firm, IDC forecasts enterprise spending on generative AI services, software and infrastructure will soar over the next few years from $16bn in 2023 to $143bn in 2027, a CAGR of 73.3%.

Generative AI is predicted to account for 28.1% of overall AI spend by the end of 2027. Whilst AI spend is small in the context of overall IT spend it is helping drive IT spend growth. More broadly, Gartner project that Worldwide IT spending will grow by 8% in 2024 to $5.1tn. This is an increase from the 3.5% growth in IT spend in 2023, driven by continued growth in cloud and cybersecurity spend in particular combined with a return to growth in the devices market. In addition, we are still to appreciate just how much technology and particularly generative AI may be able to help improve productivity and save time.

The Financial Times highlighted a recent Harvard Business School study that monitored the impact of giving GPT-4, OpenAI's most recent and advanced offering, to employees at Boston Consulting Group. BCG staff randomly assigned to use GPT-4 when carrying out consulting tasks were far more productive than their colleagues who could not access the tool. Not only did AI-assisted consultants carry out tasks 25% faster and complete 12% more tasks, but their work was also assessed to be 40% higher in quality.

Overall, we conclude that productivity is an important area for upside surprise in GDP growth and hence we continue to like having some exposure to areas that assist in this such as AI investment. **Stocks with this exposure in our portfolio include Microsoft, Nvidia, Salesforce and Adobe.**

Nearer term approach and considerations

A more specific way of thinking about GDP growth is by calculating the change in expected spend by different groups in the economy. This approach can be calculated using the following formula:

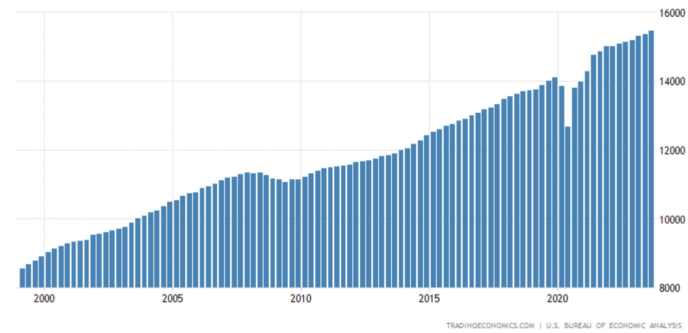
GDP=C+G+I+NX

where: C=Consumption, G=Government spend, I=Investment, and NX=Net exports

Consumer spend is the biggest component, accounting for more than two-thirds of US GDP. Shifts in consumer confidence and willingness to spend thus have an important bearing on economic growth.

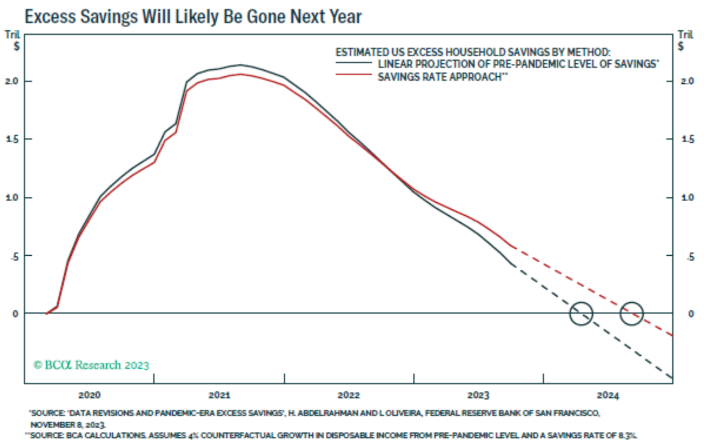
One thing economists miscalculated in 2023 was the overall strength in consumer's balance sheets post the pandemic and hence level of confidence and willingness to spend. For the year to September 2023, real US consumer spending grew by 2% after already solid growth of 2.5% for the 2022 calendar year. Post a very strong decade of growth, following the global financial crisis (GFC), quarterly US consumer spend now sits approximately 30% above its level 10 years ago and 10% above its pre-pandemic level.

US Consumer Spending (constant prices, 2017, SA)



Source: TradingEconomics.com, US Bureau of Economic Analysis

Whilst we believe the saying that one should never underestimate the US consumer, we do note that several signals suggest the consumer outlook is tougher. Firstly, the excess savings accumulated during Covid are widely expected to dry up in 2024. Secondly, for those with debt outside a mortgage (in the US most mortgages tend to be fixed for 15-30 years) or getting a new mortgage, their interest bill has increased significantly. What's more, tight lending standards make it difficult to access new credit. Thirdly, whilst inflation is increasing at a decreasing rate, it is still contributing to higher prices for goods and services.



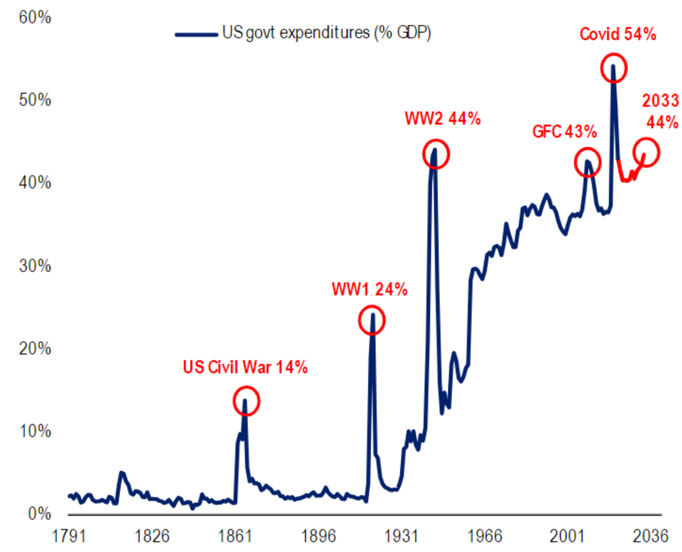
Source: BCA Research

The offset here is that the US is still seeing strong employment and after almost two years of inflation exceeding growth in wages, the opposite has been the case since early 2023. **If the low unemployment rate can be sustained, the tight labour market may mean solid wage growth can persist which would be supportive of consumer spending near term.**

For Government spending we have already highlighted the various infrastructure spend programs but putting these in context with historical levels versus GDP as shown in the chart below suggests we have been at extreme levels. What's more with high levels of public debt programs such as these it becomes even more difficult to fund.

US Government Expenditures

US government expenditures % GDP since 1791



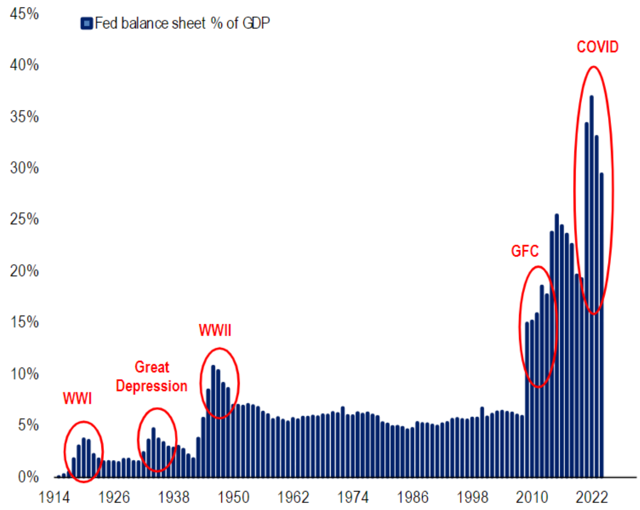
Source: BofA Global Investment Strategy, Bloomberg

It is also worth considering Fed liquidity or Quantitative Easing/Tightening and how this might influence GDP growth in the near term. In addition to the stark increase in liquidity from the GFC and then Covid, the chart below shows the impact of Quantitative Tightening (QT) in 2022.

Another surprise in 2023 was that instead of continuing with QT, the regional banking crisis in March led to an increase in liquidity injections or Quantitative Easing (QE). A number of macro economists have been highlighting that Fed liquidity is expected to turn down in 1Q 2024 as money is drained out of its Reverse Repo facility and bank reserves fall.

US Fed Reserve Balance Sheet

Fed balance sheet % of GDP since 1914

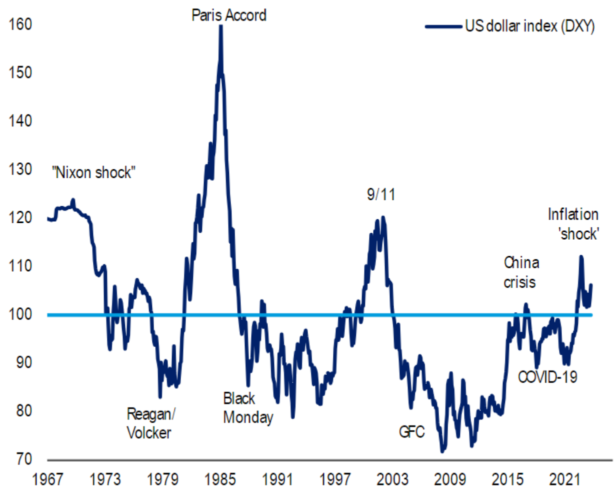


Source: BofA Global Investment Strategy, Bloomberg

Finally, Investment and Net Exports are the smallest components of GDP. They also tend to be more global and volatile, impacted by government tax and other policies, interest rates, business sentiment and currency movements. Investment similarly overlaps with capital stock and technology discussed earlier.

US Dollar

US dollar index (DXY)



Monthly data

Source: BofA Global Investment Strategy, Bloomberg

The US dollar has been strong in 2023 and at high levels on a Purchasing Power Parity basis but interestingly isn't far from its long run average on a long-term basis.

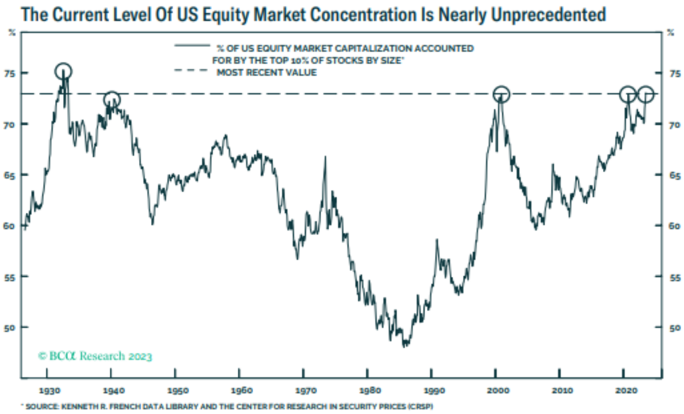
In conclusion, whilst a number of key inputs suggest downside to US GDP growth over the medium term it is possible that the US is able to deliver growth and avoid a recession near term.

Company Earnings

The next difficulty is that Wall Street and Main Street may not necessarily move in the same direction, or at the same rate. Ultimately, share prices are a function of earnings and the multiples that the market is willing to pay.

US GDP growth may however not translate directly into the growth of the stock market or companies that make up the S&P 500. This was indeed the case in 2023. It could also be the case again that earnings growth for the "Mega 7" varies not only from the rest of the market but the rest of the economy. That said, the bigger these companies get and more concentrated the market and economy become the harder it is to separate.

There is also a non-trivial risk that just as the strong share price performance of the Mega 7 led to increased passive buying and a circularity of stronger share price performance, we may see the reverse in the event of strong weakness in these names.



For the S&P 500, consensus bottom-up forecasts are for ~10% & 11% EPS growth in 2024 & 2025 respectively after being roughly flat in 2023. Underlying this is 5% and 5.5% sales growth respectively (in line with the 5% CAGR achieved over the past 20 years) and EBIT margins improving by 1.5% and 0.7% respectively in 2024 and 2025. Note the 2025 level of 17.4% represents a 20 year high!

Interestingly, but perhaps logically, the Mega 7 stocks have much higher near-term growth forecasts at 12.8% CAGR 2023-25 vs. the remaining 493 at 4.6%. For earnings the CAGR is 18.7% for the Mega 7 versus 10.6% for the remainder of the S&P 500.

Valuation and the Cost of Capital

The cost of capital and valuation multiple that investors are willing to pay are inter-related and key drivers of stock prices in addition to the company earnings. So next we need to consider potential upside or downside to the market that might arise from changes in these variables.

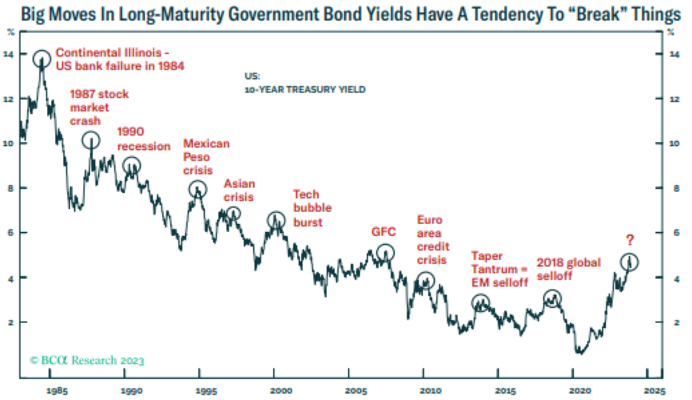
The S&P 500 currently trades on ~19.7x 1-yr forward P/E. This is a ~15% premium to its long run average (25-year average is ~16.3x). The P/E should also be considered in the context of interest rates or the cost of capital. This is because a P/E multiple is the inverse of an earnings yield, which can be thought of as the interest charge for an equity investment. Using this approach, today's P/E of 19.7x equates to an earnings yield of ~5.1%. This contrasts with the current US 10-year government bond rate at just under 4%. Today's bond rate is also above its 25-year average of ~3.3% and all else equal would justify lower valuations than the past as a higher cost of capital (as a result of higher rates) equates to a lower P/E multiple.

It is worth flagging that ex the Mega 7 stocks in the index, which trade on ~30x 1yr forward P/E, the remaining 493 stocks trade on ~17x P/E. which is closer to (but still above) the long run average.

Assuming that the long run multiple is most reflective of long-term valuation, all else equal we can infer there is some pricing in today of either lower policy rates versus those implied in the 10-year yield, or higher earnings growth. Given our discussion of long-term GDP growth suggests little upside here the implication is that listed market companies outgrow the broader economy or that much lower rates longer term are priced in.

In the context of the very long-term we can see that the Covid era low rates were extra-ordinary but long-term rates above 3% (or real rates of ~2% as seen in the chart on the following page) appear more normal. With the recent move in the US yield curve following the Fed's December pivot (resulting in the market pricing in seven rate cuts to 3.6% by January 2025 and a 10-year yield below 4%) it would suggest that a reversion to normal means higher rates from here and hence potential pressure on current valuation multiples.

As we have previously highlighted, history shows that on average recessions start 9 months after last rate hike (currently July 2023), and for the Fed to hike 500bps without causing a recession would be history in the making. Only 2 of last 9 hiking cycles did not lead to a recession and that was where rates were only hiked by 300bps and starting from a point of low inflation.

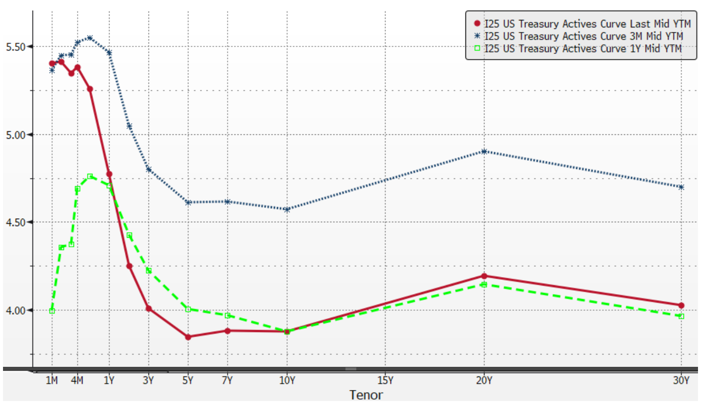


Source: BCA Research

Offsetting the rate hiking cycle and historical precedents is the US Federal Reserve's dovish pivot at its December policy meeting. At their last meeting of the year the committee held rates steady but signalled that inflation had improved more quickly than anticipated and suggested potential rate cuts for 2024.

The result was a significant reduction in mid to longer term US Government bond yields (with the US 10-year yield declining from 4.6% at the end of September 2023 to 3.9% at the end of December). **"Don't fight the Fed" is another well-known saying and in an election year it could become a guessing game of politics but just has the Fed pivoted in December it is possible for them to pivot again such as in a scenario where inflation remains stickier at higher levels.**

US Yield Curve today and throughout 2023



Source: Bloomberg

Conclusion

The building blocks for economic growth suggest that GDP growth should see downward pressure over the longer term due to lower population growth and reduced government spending. The offset may be from higher productivity driven in particular from generative AI.

Near term government policies and consumer sentiment are harder to predict but after a long period of monetary tightening and quantitative easing we appear to be at peak levels of liquidity and consumer spending with high levels of government and consumer debt.

Likewise, a reversion to long term levels for policy rates and the valuation multiple the market is willing to pay suggest risk is to the downside.

That said, in a US presidential election year we would not rule anything out. Given the range of possible outcomes, we believe it is ever more important to invest in a portfolio of diversified, high-quality companies that can grow across all market cycles and provide protection on the downside.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au