Q1 Market Outlook 2024

December 2023

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Higher for Longer

Q3 2023 was defined by investors' expectations that the US Federal Reserve (Fed) was nearing the end of its rate hiking cycle. While the benchmark Federal Funds Target Rate (FFTR) was indeed left unchanged at the 5.25% to 5.50% range at the latest November Federal Open Market Committee (FOMC), the released Summary of Economic Projections indicated Fed officials still see the fed funds rate peaking at 5.6%, implying a potential last hike before the year close. This seems supported by the latest core personal consumption expenditures price index, the Fed's favored indicator of underlying inflation, which eased slightly to 3.7% but was still well above the Fed's target of 2%. However, investors remain confident of a pause in the hikes as the rise in long-term U.S. Treasury yields tightens financial conditions further and signals to the Fed that the impacts of their rapid hikes in short-term rates have finally landed.

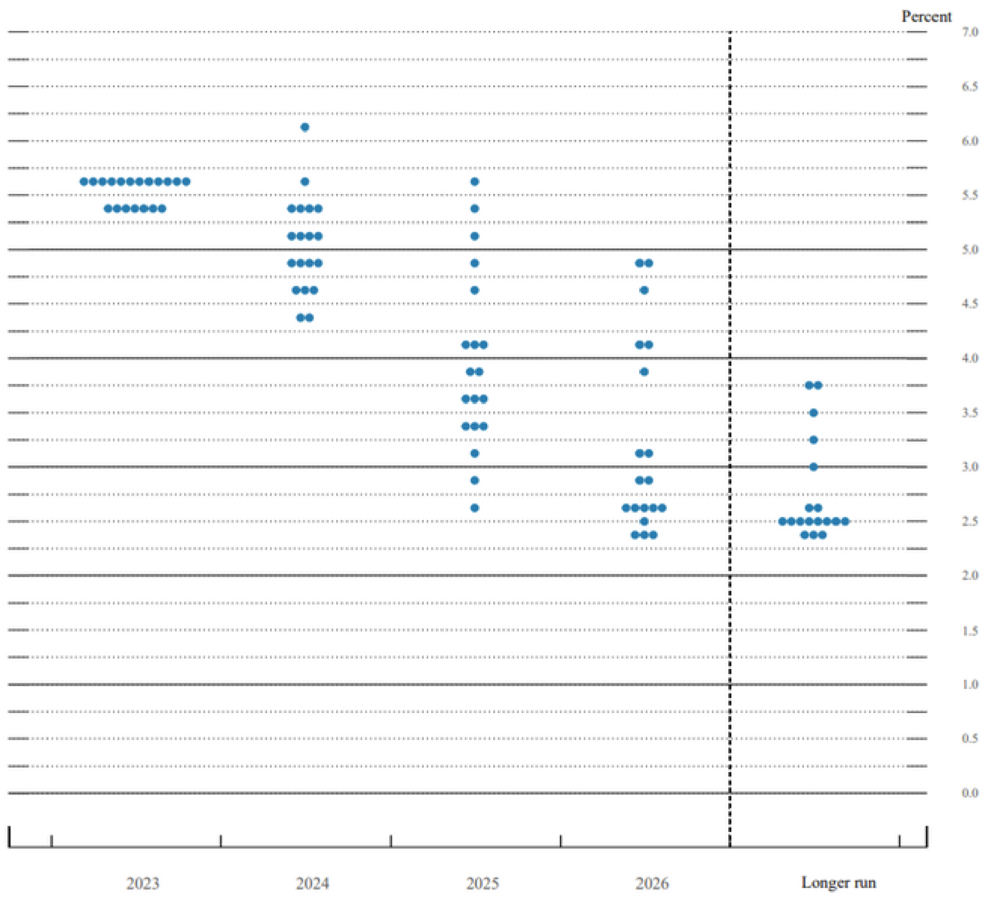

Figure 1: Interest Rates Projection | Federal Reserves

In Q3 2023, the S&P 500 index saw a modest performance, registering a near-flat return with a slight dip towards the end of the quarter, primarily due to concerns about inflation and the Federal Reserve's interest rate policy. Reuters forecasted the index to end the year at 4,496, marking a 17% increase from the end of 2022, despite a weak Q3 performance. Comparatively, the S&P 500 index had a stellar performance in the earlier part of 2023, rising over 14% after a 19% fall in 2022. The performance in Q3 2023 was less stellar due to concerns surrounding the U.S. central bank's higher interest rates, which were expected to continue due to persistent inflationary pressures. Despite these challenges, earnings growth for S&P 500 companies in 2023 was estimated at 1.8%, with a forward 12-month price-to-earnings ratio nearing 19, from 17 at the end of 2022.

The energy sector demonstrated remarkable resilience and adaptability in Q3 2023, even though plagued by geopolitical tensions and volatile investor sentiments. Crude oil prices have also experienced substantial volatility this quarter, influenced by geopolitical developments and supply chain disruptions. The Brent crude visited a low of $78 before climbing steadily to $93 in September. Despite these challenges, major oil companies posted reasonable profits, benefiting from rising costs of oil prices as well as a diversified portfolio that increasingly includes renewable energies. Natural gas also saw a surge in demand due to seasonal factors and supply limitations, driving prices to record levels on several occasions.

Yields across the U.S. Treasury curve rose against the persistent inflationary backdrop in Q3 2023, with the largest run-ups seen in the tail-end as the 10-year and 30-year rose 73bp and 84bp, respectively. The rout has led total returns to be negative for most fixed-income indexes in the investment-grade universe. Concerns over the US government's $1.7 trillion annual budget deficit, the historic $1.01 trillion in privately-held marketable debt that the U.S. Treasury borrowed in the quarter, and the Fed's shrinking of its balance sheet played a part in the sell-off, but the key driver of the bearish market is the term premium - the compensation demanded by investors for bearing the risk that short term interest rates diverge from current expectations during the bond's lifespan.

Over the quarter, the rise in yields could be entirely attributed to significant increases in the term premium, as calculated by the Adrian, Crump, and Moench (ACM) model. As the Fed continues with its 'Higher for Longer' rhetoric, increasing uncertainty in markets over where future yields are headed is likely to result in higher term premiums as investors demand more yield to compensate for the duration risk, at least in the near future.

In the face of mounting interest rate hikes and persistent inflationary pressures, the U.S. economy has demonstrated remarkable resilience. In the third quarter of 2023, the economy outpaced expectations, posting an impressive annualized growth rate of 4.9%, which exceeded consensus estimates that had pegged it at a more modest 4.3%. This performance marks a significant acceleration from the 2.1% expansion observed in the preceding quarter.

The rebound from previous quarters' downward trajectory can be attributed primarily to a resurgence in consumer spending, which saw a remarkable fivefold increase, escalating from a mere 0.8% in Q2 2023 to a substantial 4% in Q3 2023, reflecting on the boost in consumer confidence and spending.

Inflation metrics, however, offered a mixed picture. Headline PCE surprised on the upside at 3.5%, outstripping the anticipated 2.7%. This overshoot results from escalating food and energy costs, which appear to be exerting upward pressure on the broader inflationary environment on a month-over-month basis.

Despite inflation concerns, U.S. retail sales delivered a strong performance, registering a 0.7% rise in September 2023. This not only surpassed projections of a 0.3% uptick but also highlighted the resilience of consumer spending amid escalating prices and the tightening of credit conditions.

However, most economists anticipate that the current economic momentum may not be sustainable as we head into the final quarter of the year and beyond. This narrative is supported by financial conditions that are expected to become increasingly restrictive. Further adding to this cautious outlook is a tangible 1.0% contraction in real disposable personal income during Q3 2023, a stark contrast to the 3.5% increase seen in Q2 2023, which could potentially signal a forthcoming deceleration in consumer spending and overall economic activity.

Sources: Federal Reserves, SPDR

US Markets

The US Equity market has shown resilience in the face of global uncertainties. Markets remained under pressure over the past month but rebounded from their lows near the start of October. While specific sectoral performances varied, the broader indices reflected a cautiously optimistic sentiment among investors.

In the face of imminent interest rate cuts slated for Q2 2024, a tactical shift towards overweighting the technology sector presents a compelling opportunity. The FOMC has recently halted its interest rate hike in November, with CPI and headline inflation numbers suggesting that inflation is already cooling. This implies that the Fed may have already reached the peak of its hike and is looking to cut rates in the medium term.

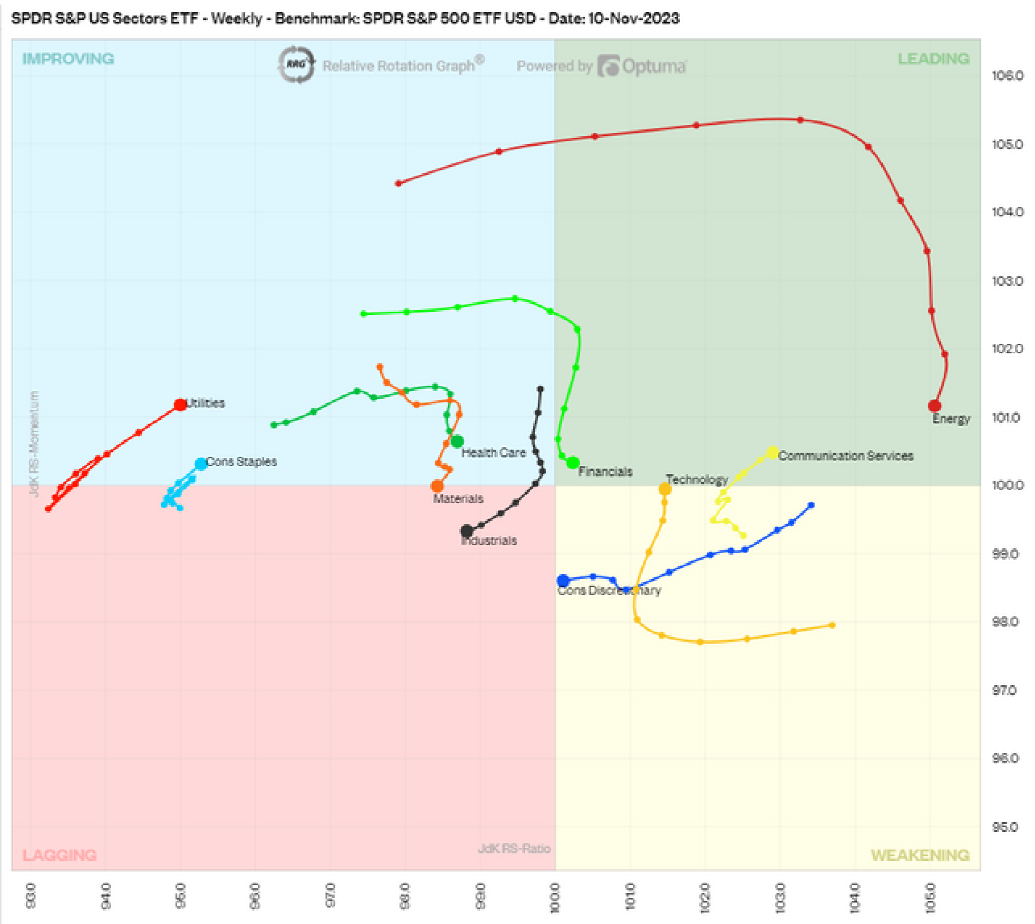

Figure 2: Sector ETF Momentum Map |SPDR

With lower cost of debt and increased risk appetite from investors on the horizon, the US Technology sector will be outperforming in the near term. Moreover, the tech sector has completed its cycle of sell-offs, with valuations now looking more attractive at 42.4x as compared to Q3 2022 at 29.5x. Additionally, there is a sense of growth momentum beginning to build within the sector, as per the SPDR Sector Momentum Map. Companies are reporting stronger forward guidance, and there is a notable uptick in innovation and product cycle refreshes.

Heading into the last quarter of 2023, the US Energy Sector is navigating a challenging environment that could signal potential underperformance for investors. The instability of oil and gas prices, with Brent crude around $87 per barrel and WTI crude at approximately $81 per barrel, reflects the industry's susceptibility to international political upheavals, especially those arising from persistent conflicts in Ukraine and the Middle East. Such geopolitical strains highlight the sector's exposure to sudden market fluctuations and may impact its performance in the near term.

Figure 3: Price Performance Energy Sector vs S&P500 | Tradingview

The robust growth in renewable energy, especially in solar PV and electric vehicles, is indicative of a transformative shift within the energy domain. Investment in clean energy technologies has significantly increased, demonstrating the strong economic case for these mature technologies. The rapid pace of solar generation, which has set new records in numerous countries, and the scale-up of electric vehicle infrastructure underscore the transition towards renewable energy. Additionally, the share of renewables in the global power generation mix is expected to rise as traditional fossil fuel-based generation falls. In the U.S., the increased capacity from renewables is projected to reduce the generation from coal and natural gas plants. The long-term growth outlook for electric vehicles is also strong, with substantial market share increases anticipated in major automotive markets. These investment surges and anticipated record capacity additions for renewables could put additional pressure on traditional energy companies, potentially making them targets for shorting as the market adapts to these changes.

Economic indicators show moderate US growth, with a 4.9% GDP increase in Q3 and stable inflation and employment rates. These figures suggest a resilient economy but also indicate potential headwinds for energy demand due to inflation's impact on consumer and producer costs. The oil sector's underperformance in 2023, with a modest gain compared to the S&P 500, presents conditions perfect for a reversal. The sector faces high volatility in the near term with high energy prices and supply disruptions arising from geopolitically sensitive regions. Upstream companies are generating significant cash flows, yet it is uncertain how these funds will be allocated. The clean energy transition is underway, supported by policy and investment, but the pace is variable. The downstream sector grapples with demand shifts and capacity increases, indicating potential vulnerabilities. OPEC's production cuts may stabilize the market, yet the ongoing instability due to geopolitical and market factors could affect individual companies differently, highlighting possible targets for short sellers.

Sources: Fidelity, Deloitte Global, IEA, KPMG Global, International Energy Agency (IEA), World Economic Forum, U.S. Energy Information Administration (EIA), S&P Global.

Emerging Markets

In recent months, emerging markets economies have held up better than most of their developed economy peers. The emerging markets composite purchasing managers' index reads 52.7, while the developed market composite index slipped below 50. The main drivers for the strong performance in emerging markets are shifts in the global supply chain, robust demand from the rest of the world, and relatively high commodity prices that support the demand. With the economic outlook for developed markets expected to slow down in the coming months, emerging markets may need to look for sources of demand to sustain economic growth domestically.

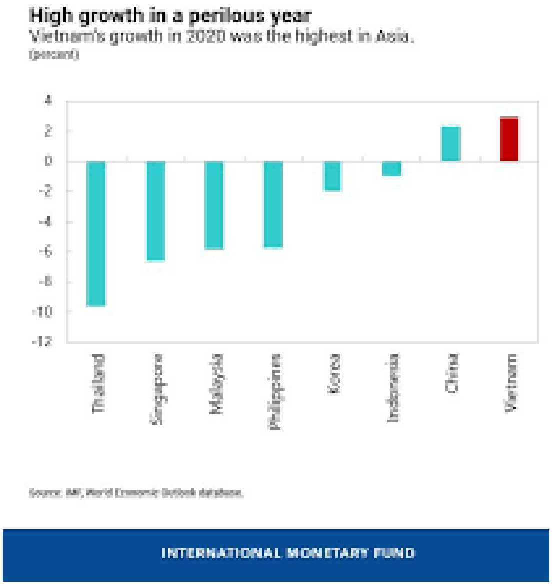

Figure 4: Vietnam's Economic Growth | IMF

Before the pandemic, the US imposed sizable tariffs on trades imported from China. During the pandemic, trade restrictions were accelerated between the two countries. In the first six months of 2023, US imports from China dipped 25% as companies started to look to de-risk and diversify supply chains amid the friction between the US and China. Countries in the best position to replace China in some manufacturing sectors, including Mexico, Vietnam, Taiwan, and India, have collectively added 5.1% to US goods since 2017. While it is essential to note the transition in imports of goods into the US from various emerging markets, companies cannot move out of China as shifting towards a third country may not be the safest bet since clothing made may contain cotton from the Uyghur region.

In comparison with developed markets, central banks from emerging markets have been more effective at keeping inflation under control. In the Eurozone as well as the American region, inflation has been strongest. Following that, there was a huge reaction by the central banks to reduce the huge inflation rates. In Latin America, many countries in the region have managed the inflation crisis with tight monetary policies and have already entered into disinflation mode. The disinflation has resulted in central banks cutting rates. For countries in Asia, only China and Vietnam have cut rates.

Countries in Latin America and Eastern Europe are positioned to bring in economic growth in consumer spending. For the past few months, these countries have been trapped in recession and are now set for a recovery stance. These economies have seen huge reductions in inflation, and with reduction in interest rates, purchasing power, and consumer spending should follow soon. Chile's central bank started cutting rates as inflation in the country started to head towards the target. Emerging markets in Asia have withstood the recent economic pressures much better than the regions in Latin America and Eastern Europe, hence, consumer spending will not be as impactful.

In 2020, Vietnam, part of the emerging markets, experienced economic growth of 2.9 percent, ranking among the highest globally and highest in Asia. This was driven mainly by the swift recovery of domestic activities and strong export performance, notably in higher-tech electronics sectors as remote working became increasingly popular. While some structural challenges remained unresolved, Vietnam is an economy with solid economic fundamentals. Vietnam emerged as a prime destination for high-quality FDI inflows due to its favorable environment, strategic location, and abundant resources. During the COVID-19 pandemic, companies looked to diversify their supply chains. Vietnam’s low labor costs, favourable tax policies, and abundant resources make it an attractive destination for manufacturing and other industries.

As a whole, emerging economies that have managed to control inflation well will be well-set to hedge themselves against a recession and keep economic activity moving in the right direction. However, with external factors in play (e.g. Israel-Hamas war & Fed raising interest rates), the outlook for emerging markets remains uncertain.

Source: Deloitte, CNBC, Goldman Sachs, IMF

ESG Opportunities - Realistic Investing

Global sustainable funds recorded a $13.7 billion inflow of new money in Q3 2023, a far cry from the $23.6 billion in the previous quarter. With slowing growth, high inflation, and recession fears, a challenging macroeconomic backdrop put pressure on most capital markets. Europe, which holds 85% of global sustainable fund assets, attracted inflows of $15.3 billion, down from the $25.4 billion inflow in Q2, amidst regulatory and economic concerns in the region. The U.S. experienced its 4th consecutive quarter of outflows, recording $2.7 billion in withdrawals over the quarter and a cumulative $14.2 billion of outflows over the past year, as political backlash against sustainable investing continues to drag on investor demand.

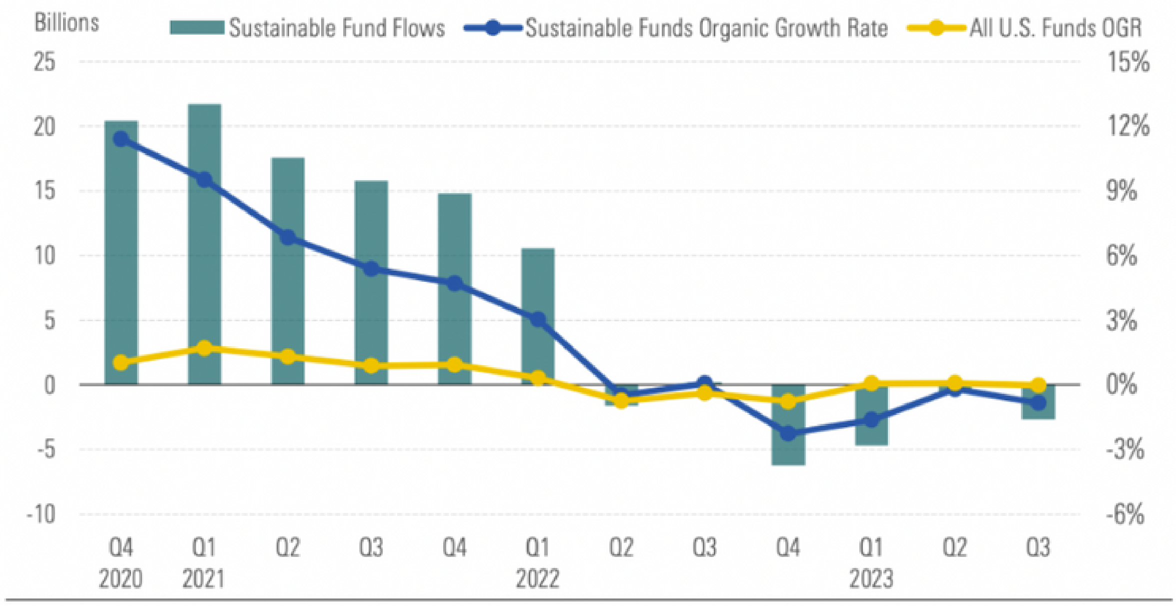

Figure 4: ESG Fund Flows | Morningstar

Proponents argue that the decline in investments could be attributed to global conflicts, which triggered investors to move from ESG-labelled funds to safe havens. The more plausible explanation is that investors demand performance above all else. Even though sustainable funds are unable to outperform their non-sustainable counterparts (which is to be expected) and have much higher expense ratios, investors believed the tradeoff for better ESG performance was worth these sacrifices. However, murky ESG standards and recent accusations of greenwashing have lent credibility to the argument that sustainable funds do not actually deliver better ESG performance. Even the most fundamental basis of ESG investing, the idea that ESG investing would raise the cost of capital for non-ESG companies, was debunked by strong evidence proving that the ability of said firms to source capital was not materially affected by the wave of ESG investing. The combination of higher premiums, low returns, dubious ESG performance, and limited impact will thus force investors to approach ESG with more caution and realism.

Despite the mounting evidence on the ineffectiveness of sustainable investing, climate risk still remains a critical investment risk. As the UN Climate Change Conference (COP28) approaches, the world awaits results from the first-ever Global Stocktake, which assesses the world's progress towards achieving goals outlined in the 2015 Paris Agreement. However, the likelihood of a positive result is slim as preliminary reports from the UN have stated that the world is still "not on track" to meet its goals.

Investors can consider supporting a realistic transition framework to have an actual impact. Natural gas, a fossil fuel that has long been considered non-environmentally friendly, has been utilized as a bridge fuel for several countries in their energy transitions. However, opportunities still remain in the sector as most emerging economies still remain highly dependent on dirtier fossil fuels such as coal and petroleum. With the world's 4th largest supply of natural gas reserves, the U.S. looks poised to ramp up natural gas production to meet the rising demand. Increased demand for U.S. natural gas by European countries looking to reduce dependencies on Russian natural gas has forced the Biden administration to reverse its policies restricting the sale of gas leases on federal lands. Hence, investment into natural gas infrastructure such as pipelines, process facilities and transport can be considered.

While equity investment to drive innovation in certain segments such as energy storage is still required, most sectors already have effective technologies developed, such as solar and wind. The bulk of funding requirements stem from the immense capital required for technology deployment, representing another attractive investment opportunity.

Source: Morningstar, Forbes, Financial Times, UN, EIA

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