Where did it all go right?

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Forecasting is hard

As we come to the end of 2023, inevitably we start to look forward to what the next year will bring. Writing outlooks can be a thankless task. In 2020, any outlook for that year was void after the pandemic began, and 2022 outlooks were undermined by the invasion of Ukraine by Russia. Even last year outlooks which were concerned about an energy crisis were offset by an extremely mild winter. Forecasting is a difficult thing.

As we came into 2023 the consensus as we saw it was for a recession, caused by higher interest rates and energy costs, which would negatively impact equities but would benefit bonds, which had performed poorly in 2022. All of this was incorrect. There was no recession and as a results bonds have decreased in value whilst equities have performed generally well.

If we had to describe the consensus now, we would say it still disbelieves the strength of economies in the face of multiple challenges but has been persuaded by continued good corporate profitability that a soft landing rather than a recession is possible in 2024. Could this happen?

One of the more important points about investing is that it isn't what you believe which matters, it is what you believe relative to the consensus. There was no investment value in believing there would be a recession a year ago, as that is what markets had discounted. The value was in believing the outlook was not so bad, as when it turned out that way, markets repriced.

There will be many notes arguing a pessimistic outlook for 2024, so at least in the spirit of balance and debate, what could go right and what could go wrong next year?

The case for pessimism

Pessimism is one commodity the investment community has no shortage of. As we have previously written though, if you want to be a successful investor, be an optimist. If you want to be a successful journalist, be a pessimist. There is no shortage of people given airtime by the media who articulate how it will all end badly. What are they saying?

> "If you want to be a successful investor, be an optimist."

Most negative outlooks start with the same premise as last year, that there will be a recession in major economic regions such as the US and Europe. This recession, which itself is a function of the delayed impact of higher interests, will result in lower levels of corporate profitability than currently forecast.

In the US, where the government is already running large fiscal deficits (spending more than it raises in tax revenues) on upgrading the infrastructure of the country, a recession would result in a further weakening of its finances. This would require even more debt issuance, potentially forcing the yields on treasuries – the mechanism by which the government raises its debt – even higher, raising the costs of financing this debt even higher. This potential downward spiral, in both the amount and the cost of debt, in the US is a key part of the bear case for 2024.

There are other negatives to consider. Geopolitical tensions, whether they be in the Middle East (Israel), Europe (Russia) or Asia (China and Taiwan) are elevated. Inflation, which is currently falling, could begin to rise again reflecting tight labour markets and elevated wage increases.

In summary, the worst scenario we can think about for 2024 is one of declining economic activity, rising interest rates and rising inflation. Enough of the pessimism though, where could it all go right?

The case for optimism

One message we've been giving consistently through 2023 has been that whilst the macro-outlook for the economy and markets is unclear, the micro-outlook for industries and companies is much more certain. There are many definable societal and investment trends (the two often go hand in hand) which we believe will occur regardless of whatever path interest rates, inflation and the economic cycle take.

The first of these is digitisation. This is an area which was supercharged by the pandemic as working from home and hybrid working became more embedded in society. As this has lessened as a driver of future digitisation, generative artificial intelligence has come along to increase investor interest in this area again. Like all forms of new technology, hype and fact need to be carefully separated, but it seems to us that this form of AI will be transformative.

The first reason for this is the speed in which it has been released. It took seven years to reach 100 million internet users, while it has taken two months for generative AI to hit the same number. Never has such a powerful piece of technology been scaled so fast. Although there will inevitably be concerns about this, the productivity and skills improvement that will come along with it could solve many of the problems, including inflation and shortage of labour, that we see today.

The second area is decarbonisation. On some levels this has seen something of a setback as the war in Ukraine and subsequent withdrawal of Russian gas has meant more coal has had to be burnt to create the energy needed in Europe and elsewhere. The recent roll back of net zero initiatives by some governments has also increased the sense that decarbonisation is being put on hold. At the corporate level though, nothing could be further from the truth.

Carbon is an expensive commodity. Most corporates see this through the energy they use. Energy efficiency, and cheaper forms of energy such as solar, are effective cost-saving mechanisms regardless of the environmental implications of carbon burning. Also, many companies will only deal with other companies that are in turn committed to their own decarbonisation, because supply chain carbon emissions will impact calculations of the carbon intensity of their own businesses. These factors are creating a strong drive to decarbonisation whatever the political backdrop.

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Finally, healthcare outcomes are on a defined and improving trend. This is not new, but there are new disease categories, such as obesity and Alzheimer's, which are now becoming treatable. This adds to the increasing treatability of other areas such as cancer, which could lead to this disease becoming a chronic, rather than fatal one, within the next decade or so.

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Perhaps the only certainty for 2024 is it will turn out differently to how we expect. Our solution is to follow the greater certainty of industry and company trends, which should remain robust whatever happens to broader economic trends. One thing for sure though, it won't be dull!

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