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Outlook 2024

ROYAL LONDON
ASSET MANAGEMENT

Introduction – Piers Hillier 3

Sustainable investing – Mike Fox 6

Multi asset – Trevor Greetham 8

Sterling credit – Paola Binns 12

High yield – Azhar Hussain 14

Gilts and cash – Craig Inches 16

Global equities – Peter Rutter 19

UK Equity – Richard Marwood 20

Property – Kevin McCauley 22

Investment markets: watching, and waiting

Piers Hillier
Chief Investment Officer

From an investment point of view, it could be argued that 2023 has been something of a damp squib. No pivotal change in central bank action, which has seen rate hikes continue remorselessly for most of the year. There has been no real change in bond market behaviour either, where yields have ground higher, although there have been signs of this turning as we come to the end of the year. Developed market equities have generally made reasonable gains but China and emerging markets have struggled.

I suppose this could be a case of be careful what you wish for. This time last year I wrote that we might see a degree of normalisation after a very volatile 2022, where my main fears were factors such as escalation in Ukraine or the Federal Reserve mis-handling the rate cycle would see things get worse before they got better. It feels like we've avoided that.

As always, there are no prizes for correctly making an annual forecast. So as the Chief Investment Officer of an asset manager with a long-term perspective, I am duty-bound to point out that every year we look back at some event or series of events that have caught everyone by surprise and that it is long-term investment decisions that ultimately matter. We aim to do this by using differentiated active approaches, underpinned by the belief that market inefficiencies provide investors with exploitable opportunities. We harness these opportunities in diversified portfolios, and retain a healthy scepticism of short-term market views and trends that can sometimes dominate sentiment.

All that said, there is value in questioning what we think about markets, what is priced into markets, and what could be the triggers – good or bad – that will affect market process going forward.

What are we looking for?

Since the end of 2021, we've seen interest rates rise dramatically – from near zero towards 4-5% depending on whether you look at the US, euro zone or UK. Sure enough, bond markets have sold off, but the effect on the real economy has been relatively muted. Yes, inflation has come down a lot, but as Craig Inches, our head of Rates & Cash is keen to tell me, getting inflation from over 10% to 4-5% is the easy bit. Getting it from 4-5% to 2% is much harder.

In a normal cycle – and obviously we have not seen anything that could be described as a normal cycle for more than a decade – such an increase in rates would see a material slowdown in consumer and corporate activity, with inflation slowing and unemployment increasing. Not this time – or at least not yet. The recent earning season has shown that the corporate sector has been very resilient and that the consumer is doing well too, no doubt helped by rising wages. But we have also seen an increase in bankruptcies such as WeWork.

So inflation is the key. It has proved persistent rather than transitory – as we suggested in this article at the end of 2021. Wage inflation is an obvious factor here. If we look back to the global financial crisis, everyone worried that slashed interest rates and quantitative easing would cause a sustained jump in inflation, only for that rise to actually be just a short-term spike. But the background to that time was different – we had falling economic activity reducing pressure on commodities and wage inflation that was near-zero as most people were just pleased to keep their jobs and hence unlikely to push for pay rises. Today, a cost-of-living crisis and tight labour market means employees are asking for and expecting pay rises to match the increase in their cost of living.

Ultimately, higher rates and financing costs (whether you are a corporate rolling debt or a consumer remortgaging) will feed into slower growth or recession, pushing companies to be more restrictive with pay rises – indeed, we are already seeing this in some parts of the economy.

All recessions are not equal

Recessions are not enjoyable and can cause considerable volatility and uncertainty in the real world as well as investment markets. Our Senior Economist, Melanie Baker, thinks that a recession or slowdown next year will be mild – a view I share. When I look at factors that can push a slowdown into a deep recession – over-excited property markets, high loan-to-value lending, expanded bank balance sheets – I think the global economy looks okay. Yes there will be pockets that are hit harder, but this does not feel like an early 90s, late 2000s scenario.

Impact on markets

This persistent inflation is not good news for very bullish bond investors – just as being near the peak in rates is not good news for ultra-bearish bond investors. But an environment of falling inflation, flat-ish rates and modest recession is not a bad place for credit investors. The increase in the risk-free rate (and as Figure 1 shows, sub-zero rates have disappeared), and reasonable spreads in investment grade and high yield markets, means that headline yields in these markets are pretty attractive.

> “The corporate sector has been very resilient.”

Figure 1: Sub-zero rates have disappeared

Source: Bloomberg. Global negative yielding debt is measured by the BNYDMVU Index (Bloomberg Barclays Global Agg Neg Yielding Debt Market Value USD).

Of course, a recession would push defaults and downgrades higher and demonstrate to many investors that credit risk is real. In my view, the major threat to harvesting that yield is therefore more idiosyncratic – weaker business models get found out in a slowing economy where financing costs have increased. And given that credit indices give the highest weightings to the most indebted companies, I would be cautious around passive credit exposure.

For equity markets, the fact that interest rates have peaked, or very nearly peaked in most major economies removes a headwind to performance, even if we are not yet at the point where the start of a rate cutting cycle presents a tailwind. Higher discount rates have been a factor but should now be reflected in market pricing. In my view, that makes valuations and earnings the main driver of returns and hence I would expect a wide dispersion of returns in 2024 – meaning that as in credit markets, knowing your companies is essential.

That same dispersion is something we see in property markets too – with Kevin McCauley, our Head of Strategy & Property Research, seeing obvious differences within sectors and in terms of prime versus secondary units, as outlined elsewhere in this Outlook document.

> “Knowing your companies is essential.”

Left field factors

Every year, something will pop up that catches people unawares or causes a change in market behaviours or thinking. An obvious candidate here is geopolitical risk: a decade ago, this was probably seen as a throwback or small probability factor. The scope for escalation around Ukraine and Gaza is obvious to all even before any new flashpoint emerges. In a macroeconomic sense, Chinese growth – or rather the lack of it – has been a feature of 2023: will this persist into 2024?

But smaller scale events can have more localised impacts. For instance, in 2024, Japanese law will change – giving domestic investors much more favourable tax-free investment allowances – moving these from small and restrictive vehicles to something more like Stocks & Shares ISAs in the UK. Previously, tax treatment means that the domestic Japanese investor has effectively been incentivised to invest in cash or Japanese Government Bonds. No longer. Will this lead to a wholesale dash into Japanese equities? Of course not – but I think it will create a greater appetite for risk assets which will include more equity exposure. Coupled with a decent economy and the Bank of Japan slowly returning to some sort of ‘normal’ interest rate model and there are some positive dynamics at play.

Objective-driven

This uncertain environment, with an apparent modest upside and downside, focuses the mind on overall investment objectives. Cash is now a viable short-term home – albeit inflation limits it as a long-term buy and hold investment (figure 2) – and for investors with a greater time horizon, a portfolio of hold-to-maturity credit could generate an attractive return, equity exposure will have to work harder to earn a return over the risk-free rate and property has definite pockets of value. All of which brings us to an investment truism: wherever you are considering investing, does the premium you expect to earn compensate you for the risk you are taking?

> “Equity exposure will have to work harder to earn a return over the risk-free rate.”

Figure 2: Cash is not a long-term holding

Where did it all go right?

Mike Fox
Head of Sustainable Investments

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.

> “Many companies will only deal with other companies that are in turn committed to their own decarbonisation.”

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.

Forecasting is hard

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!

Three big surprises and three big questions

Trevor Greetham
Head of Multi Asset

When thinking about the outlook for financial markets over the coming year it pays to start with a little humility. This time last year, economists had pencilled in recessions for 2023 on the back of swingeing rate hikes and extremely high energy prices. And yet, as is so often the case, things didn't turn out the way they were meant to.

A resilient world economy…

The first big surprise for 2023 was that the world economy was much more resilient to higher interest rates than anyone expected. The previous year had seen the most dramatic tightening in monetary policy in generations after inflation turned out not to be as 'transitory' as central banks had hoped. And yet the US economy trundled on as if nothing special was happening with growth more or less in line with its long run average. US home buyers are on 30-year fixed rate mortgages so, as long as they don't move house and refinance their loan, their payments don't increase. Most corporates are also benefitting from fixed rate borrowing. The Federal Reserve's underpinning of ultra-low rates in 2020/1 gave indebted companies something of a Get out of Jail Free card, allowing them to term out their debt at lower rates. Elsewhere in the world, a sharp decline in energy prices kept Europe and the UK bumping along the zero growth line and China's economy continued to expand, if not in spectacular fashion.

> “Inflation turned out not to be as 'transitory' as central banks had hoped.”

It's often said that central banks keep raising rates until something in the financial system breaks. So far signs of stress are not obvious. Silicon Valley Bank's problems early in 2023 were linked to losses on their holdings of government bonds rather than their loan book.

… with rising real yields…

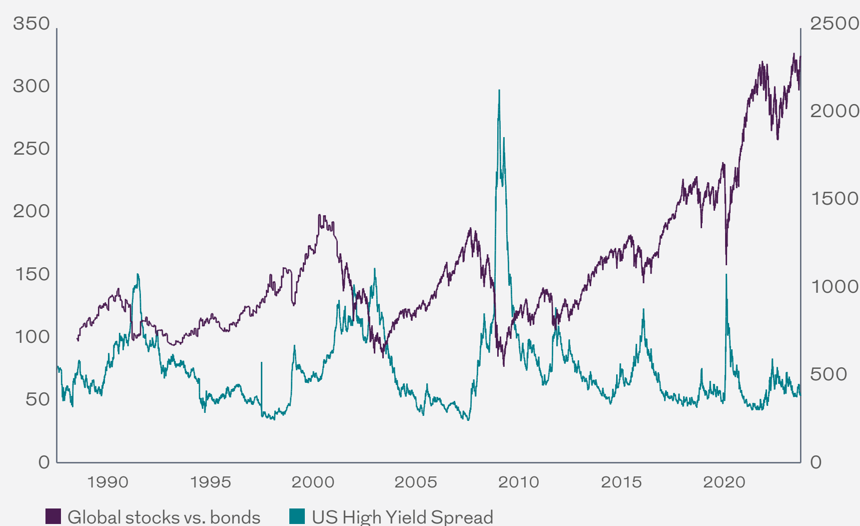
The second big surprise of 2023 has been the fact that government bond yields have continued to move higher despite a more-than-halving in the rate of inflation in major economies. Investors in US treasury bonds have suffered the largest peak-to-trough losses on record, with holders of 20-year bonds losing half of their money. Inflation expectations remained fairly steady at around 2.5% over this period, so the bulk of the move was in real yields, reflecting a belief in higher interest rates over the long run. Yields on 10-year US inflation-linked treasuries rose from -1.0% in late 2021 to more than 2.0% in 2023, a massive turnaround.

… and rich stock market valuations

This itself presents a puzzle and the third big surprise of the year. US real interest rates are the risk-free rate all other asset classes are priced off, and yet we haven't seen a blanket collapse in valuations. Property markets have seen yields rise, it is true, but stock market multiples remain rich. In our view, a major de-rating of stocks is most likely during a recession when earnings are also collapsing but earnings, like the world economy, have held up: in levels terms, S&P 500 earnings per share are 60% higher than in 2020. Much excitement for the future surrounds the prospects for artificial intelligence, with the tech sector outperforming once again in 2023 despite the additional rise in bond yields.

In sum, the world didn't plunge into recession and bond yields continued to rise. In financial markets, global stock performance remains at its cycle highs when compared to government bonds and credit spreads are tight (Figure 1).

Figure 1: Stocks versus bonds at cycle highs, credit spreads tight



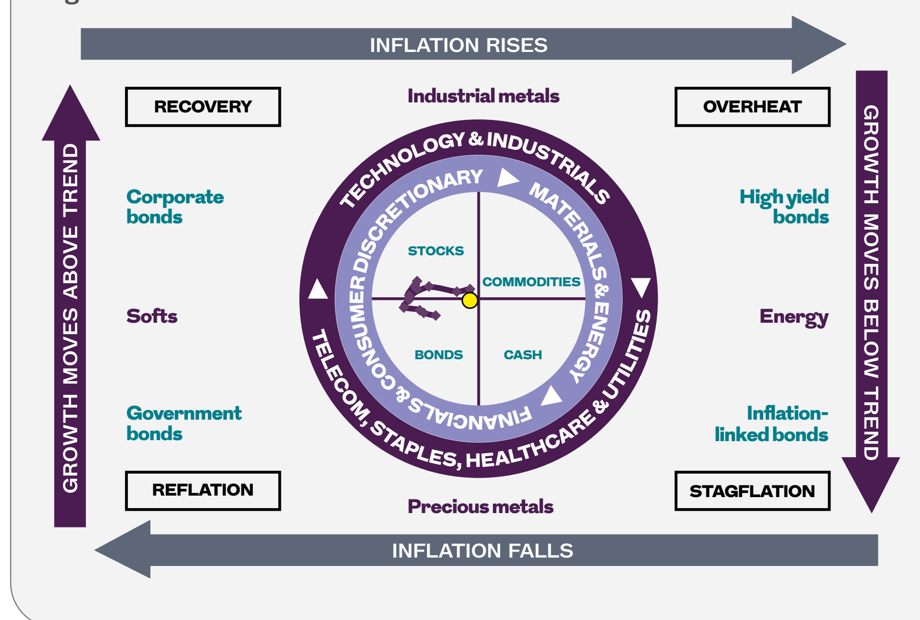
Past performance is not a reliable indicator of future results

We have three big questions for 2024 and beyond.

1) Where is the business cycle headed?

The first is where is the business cycle going? Is there even a global cycle anymore? We use an Investment Clock to relate the current stage of the cycle to asset allocation, telling the time using indicators for growth and inflation. As 2023 comes to an end our indicators are mixed, with the reading on our diagram close to the crosshairs (Figure 2). Global growth is holding up quite well, but business confidence has been declining. The surge in inflation has mostly reversed, but further progress depends on commodity price trends and the evolution of labour market slack.

Figure 2: Investment Clock in the crosshairs



Our base case sees economies continuing to weaken as consumers and businesses gradually refinance their debt at higher rates. Rising unemployment eventually bears down on wage inflation and bond yields drop. Stock and credit markets soften in the face of earnings downgrades and corporate defaults. This is a move into Investment Clock Reflation, with central banks beginning to cut interest rates. It sounds convincing enough, but we'd have said the same a year ago, before developments led us to take a more positive short-term view.

> "Our base case sees economies continuing to weaken."

So where are the risks to this base case? We might move back into equity-friendly recovery if the US can deliver a soft landing. With inflation coming back under control, it's plausible the Fed cuts rates before the full pain has been felt, turning what today looks like a looming wall of refinancing into a garden hedge the economy can simply step over. We suspect the same trick won't work as easily in the UK and Europe with wage inflation sticky and earnings prospects less rosy. If a US soft landing means the dollar stays strong, we could see another year of strong equity market performance in Japan though, with exporters benefiting from a weaker yen.

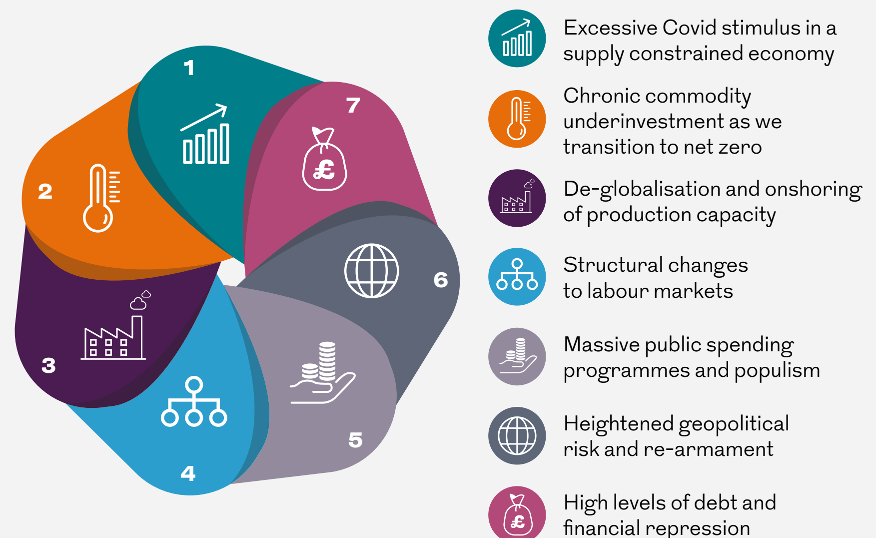
Downside scenarios come back to inflation and the lagged impact of interest rate rises. If core inflation stays high, or a deteriorating geopolitical situation leads to another surge in commodity prices, central banks could end up hiking rates still further, drawing obvious parallels with the stock and bond weakness of 2022. The sort of interest rates hikes we have seen over the last two years have almost always ended in recession after what monetarist economist Milton Friedman first called "long and variable lags".

2) Will inflation spike again?

Our second big question is longer term. Was the inflation surge of 2021-2 a one-off, related to excessive Covid stimulus left too long in a supply constrained world economy or is it a taste of things to come? In our view, we think it's likely that we have entered a new era of what we are calling 'Spikeflation'. This is a regime characterised by periodic upward shifts in prices on the back of structural drivers including the transition to net zero – which means reduced investment in fossil fuels, offset by a surge in the demand for metals that support renewable energy infrastructure – heightened geopolitical risk, demographics and deglobalisation (Figure 3) all against the backdrop of high debt levels which create the temptation to debase the value of money.

> "We think it's likely that we have entered a new era of what we are calling 'Spikeflation'."

Figure 3: Structural drivers of Spikeflation



Source: RLAM, for illustrative purposes

A period of spiky inflation would be very consistent with the historical record. Inflationary eras around the two World Wars and in the 1970s did not see high, stable inflation. They saw a series of individual price level shocks which in aggregate resulted in a twofold to more than fourfold rise in the cost of living. The measured annual rate of inflation over these periods fluctuated wildly, from close to zero to more than 20% (Figure 1).

Figure 1: Periods of high inflation since 1900

Inflation shock	Dates		Price level increase	Year-on-year RPI		
	Start	End		Low	Average	High
World War I	Jan 1915	July 1921	2.6x	0.0%	14.9%	25.4%
World War II	Oct 1939	Jan 1952	2.3x	0.0%	6.6%	20.2%
1970s	July 1967	Apr 1980	4.2x	1.4%	11.2%	26.9%
Post Covid*	Apr 2020	?	1.3x	0.5%	7.1%	14.2%

Source: ONS Retail Prices Index, long run series; * post Covid period to date as of October 2023

3) What does this mean for multi asset investing?

Our third and final question relates to investment strategy. What sort of approach does a highly uncertain economic outlook with the risk of further inflation shocks argue for? For us it means being as flexible as possible.

We believe investors should consider diversifying broadly, moving beyond stocks and bonds to include inflation-hedging assets like commodities or commercial property in their portfolios. They should also consider adopting a more active tactical approach to asset allocation suited to a period with more frequent recessions, as central banks repeatedly step in to bring inflation back under control. And they should look for strategies that can help them to manage downside risk.

The low inflation world from the 1980s onwards saw extremely long business cycles. We may be back to the five-year average that prevailed historically. More frequent recessions mean more frequent bear markets in equities. This matters especially to those drawing their retirement income from an investment portfolio. People are living longer but market cycles are getting shorter.

Sequencing risk is a growing issue for advisers to consider as more people use income drawdown - with market drawdowns potentially hurting future income potential. This was a factor in 2023, with many people forced to take large withdrawals after suffering large investment losses. With higher interest rates making annuities more attractive, decumulation investors will have to up their game.

Sterling credit: it's all about the yield

Paola Binns
Head of Sterling Credit

Sometimes, investing can be quite simple when it is stripped back to basics. When we look at the outlook for the next 12 months, we can see the prospects for issuance, the strength of corporate balance sheets and the potential for central bank action, but in my view, the starting point for next year is a very attractive 'all-in' yield.

It is very easy to focus more on credit spreads – after all, this is an essential premium we want to receive for the credit risk we take – but while these have not really moved a great deal over the past few years, the underlying gilt reference yield has increased dramatically. It is helpful to look at this in a historical context – Figure 1 shows that the yield on the iBoxx Sterling Non-Gilt index is back above 6% for the first time since the global financial crisis in 2008/9.

Market risks

Obviously, a higher headline index yield is not enough in itself: credit risk – which usually manifests through downgrades rather than defaults in the investment grade world – is real. At an aggregate level, we still believe that credit spreads more than compensate for that credit risk, but events in 2023, notably the collapse of Credit Suisse, reminded investors that this is not just a theoretical risk.

> "The starting point for next year is a very attractive 'all-in' yield."

We are expecting an economic slowdown in 2024. That may be a mild recession, or just flat-lining growth. The economy has been resilient to this point but I think that most investors expect the monetary policy tightening of the past two years to start to show up more in the real economy.

As a backdrop, that would normally be bad for corporates. But many have used the past few years sensibly, retiring higher paying debt, and taking advantage of ultra-low rates to issue debt at advantageous levels. That phase has now come to a close, but the extent of activity in recent years means that many companies have more breathing space when it comes to needing to go back to the market for financing.

Credit markets remain resilient

The collapse of Credit Suisse had a clear impact on the market, with the complete wipe-out of AT1 bond holders (while equity holders achieved some modest recovery), effectively stopping new AT1 issuance. But as we near the end of 2023, that pause has already come to an end. Banks issuing in this area are having to pay a high price to do so, but it was noteworthy that UBS, which of course took over Credit Suisse, was able to raise some $3.5 billion with the issue over-subscribed by around ten times.

Sterling credit remains a small component of global investment grade markets, with US and euro markets significantly bigger. As a result, it's easy to overlook the opportunities in the sterling market, especially with the drive to achieve higher global diversity in portfolios, but ignoring or removing exposure to this market means that an investor is missing out on a potentially attractive source of returns. For instance, at present our sterling credit all-maturities strategies typically yield around 1% more than the iBoxx index – meaning an all-in yield of around 7%.

> “Ignoring or removing exposure to this market means that an investor is missing out on a potentially attractive source of returns.”

There are always concerns…

For any fixed income manager, there are ever-present concerns, most of which stem from the inherent nature of fixed income, namely we want to ensure that the coupons and principal of the bonds we buy will be paid. And obviously changes in interest rates and expectations can lead to volatility in the current price of those bonds. If we look at central bank interest rates, we think that further material increases would only occur if inflation not only remains at current levels, but arguably spikes higher once more. That is not our core expectation.

On the health of the corporate sector and its ability to service existing debt, an economic slowdown obviously impacts corporate profitability. But as mentioned earlier, the corporate world has been pretty sensible in how it has managed balance sheets following the pandemic.

…and ways to mitigate them

Investors familiar with our sterling credit strategies will know that we like to mitigate risk by favouring diversification and security, the former because it reduces the impact of any negative event, and the latter because we continue to think that we are over-compensated for risk when compared with unsecured debt. In our view, the main attraction of this approach is that it has historically been less reliant on the economic cycle, which always feels a better place to be when forecasters are on the fence around growth and recession prospects in the year ahead.

So to bring this back to our starting point, although there are some potential pitfalls out there for sterling credit markets, for the first time in a decade we can go into a year looking at a headline yield that we think is attractive and sustainable, and some supportive underlying factors, including the fact that interest rates appear to have peaked and inflation is falling. For a fixed income investor, that is a decent starting point for any year.

Figure 1: Sterling credit yields have rebounded significantly

Sterling Credit Index duration and yield

Past performance is not a reliable indicator of future results.

High yield outlook for 2024: What's the carry-on in high yield markets?

Azhar Hussain
Head of Global Credit

Default climate remains benign

At the start of the year, we were forecasting a higher default rate than the trend we have ultimately seen play out, with defaults set to end the year around 3% to 4% – and we see 2024 playing out similarly. We see defaults sitting around 3% to 5%, with our most pessimistic case seeing 7%.

Even if defaults do end up breaching 5% and creeping towards 7%, we don't see this as particularly worrying as it won't change the fundamentals of the high yield market and will only come about from US Federal Reserve monetary policy, which has been priced into corporate valuations, instead of, as of yet, unknown increased economic hardship.

With this in mind, we believe 2024 should play out similarly to 2023: maturity wall concerns being overplayed; companies holding high liquidity; private debt markets eating the bottom cohort of public markets; public markets remaining open, with solid issuance levels. As long as public markets stay open, any maturity wall concerns will be swept away. And, as long as private markets are taking away the weakest parts of public markets, defaults will stay low.

Increasingly, private markets are slowly but surely reducing the CCC bucket of public markets – which improves the quality of names in which we choose to invest.

Economic trouble ahead not that concerning

In our view, the downward trending economic cycle is not much to fret about for the high yield market – with default rates coming between 3% to 5%, this isn't particularly worrying. The main difference, however, is how the 'higher-for-longer' environment will lead to a shift in the make-up of yields – which is currently about half spread and half underlying government bond yield.

Even in this higher-for-longer world, we still see the default cycle being extended into 2025, leading us to believe spreads will fall in a range of 340 to 450 for next year. So, if defaults and spreads are in a relatively benign state, the key for us then becomes income.

Finding yield in a high yield market

We are targeting a yield of 8% to 9% in this market, which, should, barring a material increase in interest rates, lead to a positive return in 2024. We are confident in finding insulation to protect ourselves from the structurally weakest parts of the market.

There is potential trouble, however, in the form of determining when the Fed begins cutting interest rates. This is not unique for us, though. The lagged impact of the sharp rise in rates over the past 12 months will eventually feed through the economic system. But this risk is not as bad as the downside risk of the Fed staying where it is. In trying to predict rate cuts, it is a case of positioning our portfolio appropriately but if the Fed doesn't bring rates down, we could see increased economic fallout and heightened defaults, as higher rates for longer begins to hurt when companies feel the increased cost of capital.

Higher for only-so-much-longer

Rate cuts from the Fed, and most other major central banks, are priced in for the next couple of years – which we have seen baked into corporate valuations. Again, this makes us think the biggest danger to the high yield market is the Fed staying where it is as corporate valuations are tied to interest rate expectations, so any change in rates will change valuations, which will then impact credit markets by reducing the margin of safety in terms of equity cushions and would mean higher spreads.

> "The lagged impact of the sharp rise in rates over the past 12 months will eventually feed through."

We think the tailwind risks of a much harsher recession than the shallow one currently predicted is hard to foresee as the credit market will be reacting to the recession, unlike its role in 2008 where it was a leading indicator as the root of the crisis.

While we are comfortable with what we feel is a benign economic environment, we do accept there is increased idiosyncratic risk now than there was 12 months ago. There is uncertainty around the Middle East and the upcoming US elections, while rising government deficits also offer a technical risk that is flying under the radar.

Where does that put our strategies?

With the main uncertainty next year coming from rates, we are high on short duration bonds and carry – income matters in this yield environment.

Although we have mentioned increased idiosyncratic credit risk, we do not see these risks sneaking up on investors. As a result, we will maintain our preference for liquid capital structures, staying away from smaller capital stacks, and a preference for larger names which have established routes to capital.

An ever-increasing important aspect of high yield markets is the role of private debt. We are seeing private debt markets grow in size, hoovering up lower rated companies. This focus on lower quality companies results in public markets being left in a structurally stronger place.

As the CCC portion of the market continues to diminish, taking out of public hands the most stressed part of our market, we can see clear signs of why default rates remain so low. If private markets dry up, will this then have a knock-on for us? It could, but we see no signs of private markets closing up: they have their dry powder, and we don't see where else they can use it.

With this lower than anticipated defaults, we believe you are not incurring the usual risks in the high yield markets – which is why we keep our focus on carry and income.

> "The credit risks are not going to sneak up on you."

Government bond outlook for 2024: Waiting on a recession, hunting for yield

Craig Inches
Head of Rates & Cash

Should you be dovish or bullish gilts?

Looking to next year, there are multiple events we need to consider when trying to predict how markets will react: there is a lot of supply coming; there is an expectation where the increased volatility (Figure 1) seen this past year may well continue. Given this, it is easy to present a case to be positive or negative on gilts. Government bond markets find themselves at a really interesting juncture following this summer's rally.

Figure 1: Gilt volatility has been high – over the year and intra-day

Gilt volatility has been high – over the year and intra-day

Source: Bloomberg. Chart shows UK gilt 10-year yields daily open, high, low and close during 2023 to 21/11/23

Generally, the Rates team is pretty downbeat on the UK economy's prospects for next year. Our Senior Economist Melanie Baker feels the outlook is lacklustre with a technical recession still assumed in the next 12 months, but a modest one.

We feel interest rates have peaked – with perhaps one more hike to come from the Bank of England (BoE) but ultimately if there is one more, or no more, the difference at this point will be negligible. We have seen stark rises in rates across major global economies, and these tighter lending conditions will eventually curtail economic growth as they work their way through the system and lead to downward economic trends.

What, if any, pain lies ahead?

While there are likely no more hikes on the agenda, what will cause problems is the increasing 'higher-for-longer' narrative that has emerged. Central banks look in no mood to start lowering rates as inflation is predicted to remain sticky: we have always maintained that the difficulty with the current higher inflation environment is getting back to central bank targets of 2%, not necessarily lowering it from its double-digit highs. Getting from 11%/12% to 4%/5% was the not difficult task, getting from 4%/5% to 2%/3% is where the pain will be felt. So, will central banks have the stomach to cause this hardship? Will the political will be there when jobs losses are mounting and a recession kicks in?

One thing to keep an eye on: the US Federal Reserve has a different mandate to the two major central banks here in Europe – the European Central Bank (ECB) and BoE. The Fed has to worry about both growth and price inflation, while the other two are tasked with keeping prices under control. With the BoE and ECB largely following the path of the Fed so far in this rate-hiking cycle, we are looking for clues that they may decide to forge their own way and when they feel confident enough to start cutting rates irrespective of whether the Fed has or hasn't.

Will the banks wait for a recession before starting to cut? Or will they feel the recent trend of no growth is good enough to start cutting?

Macro factors will continue to frighten central banks

Historically, central banks set monetary policy based on forward-looking inflation rather than being driven by spot inflation and the most recent economic indicators as we see today. When and if they return to looking at forward indicators, cuts should happen before inflation actually gets back to target. Bond markets have priced in cuts, we all know they're coming, but the only question that now matters is when they will happen.

In our view, at the beginning of this hiking cycle, central banks were behind the curve, then had to play catch up in an attempt to rein in rocketing prices, but now they are looking to gently corral the economy into a soft landing. This means the story of any impeding recession will be central bank-led based on how quickly their rate increases can work through the economy. If prices don't come down, rates will remain high. But, it is worth pointing out that bond markets have priced in rate cuts for 2024 – meaning any potential recession will need to happen soon.

With five-year gilt yields about 100 basis points below base rates as we come to the end of 2023, there is no surer sign that markets see rate cuts coming in the next few years – it is just about deciphering when, and how quickly, they come.

> "Bond markets have priced in cuts, we all know they're coming."

How will yields react when this recession comes?

If this predicted recession is a deep one, then yields will fall more than expected, but an intriguing issue to keep an eye on is the increased amount of gilt supply coming our way. Therefore, we expect to see yield curves steepening.

In a recession, investors seek out quality, which typically means we see buyers in the front-end of the curve, and with rate cuts typically being front-end led, we expect to see curves steepen. This is an environment that favours shorter maturities, making it hard to make a strong case to be in an all-maturities fund over a short duration equivalent. We see a rally more focused in the 10-year and shorter portion of the curve.

> "We expect to see yield curves steepening."

This makes it hard to find the sweet spot on where to invest, but never has the old adage of 'cash is king' rung more true than in the current environment. As a manager of money market and short term fixed income portfolios as well as gilts, we believe that investors are being paid reasonable rates to take on little risk, and it could be worthwhile parking assets while shorter-dated yields remain this high.

The real fun will begin when these yields begin to fall and investors begin hunting for yield elsewhere.

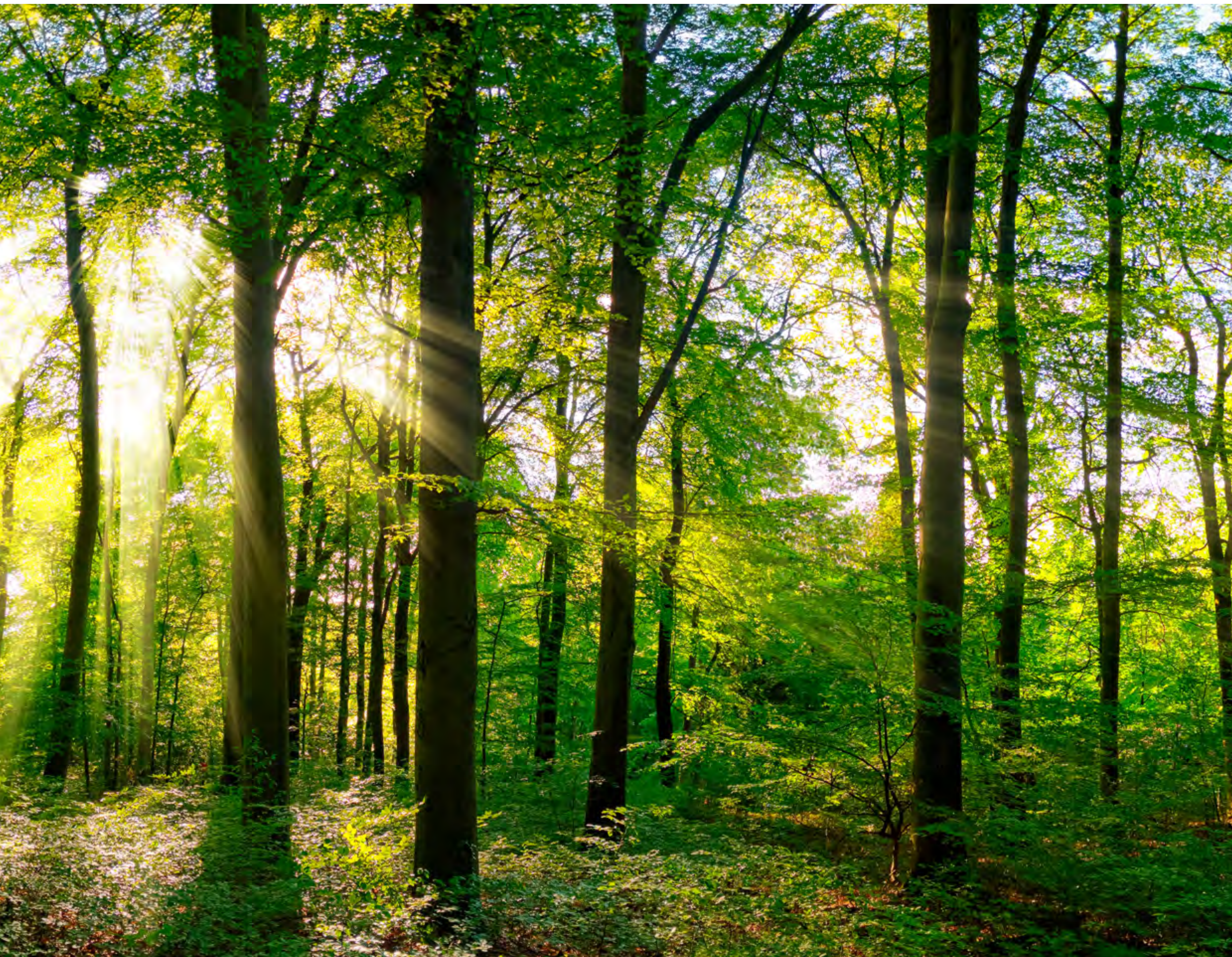
Where will this yield come from?

We see a lot of volatility ahead, which will be caused by investors looking to move assets back out of cash and into other vehicles in an attempt to maintain the current yields being offered. There is also a series of macro factors to consider: geopolitics in the Middle East, elections in the US, a continued heightened focus on monthly economic indicators, and increased supply.

As this volatility continues, we feel it has never been more important to be an active manager. While it is hard to be certain about an end point for gilt yields by the end of 2024, we do expect those macro factors and uncertainty around them to lead to some swings in yields which in turn provides opportunities to tactically trade around these events.

We are seeing markets becoming more and more concerned with fundamentals again – which is where we feel comfortable. Growth looks set to remain lower than long-term trend levels, and inflation needs to get back to 2%-2.5%, so yield curves will need to steepen from here. Therefore, we will look to be overweight the front end of the curve while holding an underweight position in the long end.

“We feel it has never been more important to be an active manager.”



Navigating the global equity landscape in 2024: A cautious year ahead, long-term equity market wealth creation intact

Peter Rutter
Head of Equities

As the world emerges from the shadows of a pandemic and navigates the complexities of geopolitical tensions and economic uncertainties, central bank policy is likely to continue to dominate near-term market headlines and drivers of indices. This presents a complex range of opportunities and challenges for investors in global equities in 2024.

After more than a decade of interest rates and bond yields globally at or near very long-term lows, the post-pandemic landscape has been characterised by a period of inflation in developed economies that turned out to be more than initial 'transient' expectations and has consequently caused major central banks to increase interest rates rapidly and substantially. Some of the impacts of these changes have already been reflected in economic activity and financial markets, but as we enter 2024 it is likely that the most meaningful impacts of higher rates and bond yields on consumers, businesses and the financial system are still to emerge. How these impacts unfold, and how indeed central banks react to them, will be a key driver of market and intra-market volatility and activity in 2024.

Outside of the envelope of interest rates and discount rates, we enter 2024 with the usual mixture of geopolitical, societal, and macroeconomic uncertainties. The specifics of the list change from year to year and in 2024 key items that will create volatility and change in markets likely include the US election cycle, China-US relationships, war in the Middle East and Ukraine, incremental activity in the fight against climate change and technological shifts with the impacts of AI likely increasing in society and the economy.

At an aggregate level we believe the long-term outlook for equities remains attractive with our global equity team estimate of the likely return from a diversified basket of global equities being Inflation + 4%. This is reasonable as a return in an absolute and historical sense, but it is noteworthy that for the first time in over a decade, cash and fixed income yields are much closer to the implied earnings yield of global equities. This could put some pressure on equity markets advancing well ahead of other asset classes in 2024, even if the long-term expected real return remains reasonable.

> “For the first time in over a decade, cash and fixed income yields are much closer to the implied earnings yield of global equities.”

UK equities: valuations and dividends are supportive

Richard Marwood
Head of UK Equity Income

What important lessons did you learn from 2023?

When I look back on 2023, one of the important features that sticks in my mind is the impact on businesses of destocking within supply chains. This happened across a wide range of industries and hit some manufacturers hard. The origins of the problem go back to Covid lockdowns when some goods were hard to source.

This prompted many consumers and the supply chains servicing them to over-order goods once they were available again, and to carry higher inventory levels. As supply chains normalised, that stock build has been unwound. Essentially, in many industries, end customers found their demand satisfied from their own existing stocks or from stock held by intermediaries in the supply chains, leading to sharp decreases in demand from manufacturers. As manufacturing volumes fell, operational gearing came into play, causing sharp falls in profitability for manufacturers. These impacts are transitory, but painful nonetheless.

In what way will 2024 be different from 2023?

Every year throws up new challenges and frequently ones that are very hard to foresee. I suspect 2024 will be a year when investors spend less time worrying about the path of inflation or pondering the implications of artificial intelligence, but other issues will no doubt take their place. I try to never get too fixated on the macroeconomic or political environment. While it is important to be very aware of the broader picture and how that impacts the companies held in a portfolio, it can be very dangerous to assume the world will be a particular way and to predicate the entire shape of your portfolio on that view. I believe it is better to drive performance by stock picking – understanding the businesses you invest in and how they might navigate the challenges of the macroeconomic environment.

> "It can be very dangerous to assume the world will be a particular way."

What is your view on UK equities?

The UK market had a rough year in 2023, if not in terms of returns, then certainly in terms of fund flows. As has been widely discussed, the UK market has been unpopular with investors for some time. Pension funds have generally been reducing exposure to equities, particularly UK equities, with many asset allocators moving more of their equity exposure into overseas markets.

The persistent selling has left the UK market valuations looking relatively low compared to other markets and this has attracted bid activity, with an increasingly long list of companies being taken over by overseas companies or taken off the public market in private equity backed bids. The other balancing factor, offsetting the persistent selling, has been share buybacks by companies themselves. UK companies have bought back their shares in unprecedented quantities over the last couple of years. Finally, I would say that I do not subscribe to the view that the UK market lacks interesting businesses. While we may not have an Apple or an Amazon, the UK market is home to many businesses that have world leading technologies or market positions in their particular fields.

> “Persistent selling has left the UK market valuations looking relatively low.”

What are your expectations for inflation and interest rates next year?

Inflation is clearly on a downward path from its 2023 highs, but personally I don't see it getting down to the low levels that some had assumed are the norm from the experience of recent years. From what we hear from the many companies we speak to, the costs of many things like materials and shipping are generally coming down, but wage inflation is still running at elevated levels.

Structurally, after Covid and with an element of deglobalisation, many supply chains have been changed to prioritise resilience over simply the lowest price, which has inflationary implications. Energy is also a major factor in inflation, and with elevated geopolitical risks, oil price volatility cannot be ruled out. As the world gradually transitions away from fossil fuels, as it must for the state of the climate, this linkage can be reduced. However, this will be a process of many years and the vast amount of infrastructure and materials that will be required to achieve that will need to be paid for, which could itself be an inflationary factor.

After their sharp rise in 2023, interest rates are now at what I would see as a normal rather than elevated level. In the long term I would expect UK interest rates to be around the level of nominal growth in the economy. If we assumed that long-term real growth were 1% p.a. and long run inflation were 3 to 4%, an interest rate of around 4 to 5% does not seem unreasonable.

What does the landscape for UK equity dividends look like?

Long-term dividend growth is obviously a key element of equity income investing. 2023 was a year that saw the dividend income into our fund outstrip the levels seen in 2019, that being a useful comparator as this was the year before the severe disruption to corporate pay outs seen in the Covid lockdown. This was pleasing, as the dividend growth was widespread across many sectors and offset the considerable headwinds to growth from the large mining companies like Rio Tinto not paying special dividends in the year.

> “Dividend growth was widespread across many sectors.”

My base expectations for 2024 would be for modest growth in dividends again this year. The UK market currently has a dividend yield that is not dissimilar to the interest yields available on cash, but dividends can grow, which can help investors offset the impact of inflation on their savings.

Are there any areas of UK equities that you would avoid or be cautious of investing in next year?

There are very few areas of the market that I routinely avoid, but there are themes that will need to be closely watched and considered for our investments. Debt is likely to be a key theme. Stocks exposed to consumer spending will need to be monitored carefully. Even though inflation appears to be on its way down to more moderate levels, many households will see their spending power impacted by the gradual ongoing repricing of fixed rate mortgage deals. The counter to this headwind is that wage growth seems to be growing at reasonable levels. Indebted companies will also have to be watched, as many companies will see their interest costs rise significantly either due to higher interest rates feeding through to bank facility costs or maturing corporate bonds needing to be refinanced at much higher rates.

Property outlook: Buyers' market?

Kevin McCauley
Head of Strategy
& Property Research

As 2023 draws to a close, the outlook for the property sector appears gloomy to many investment commentators. We acknowledge that there are several factors posing significant challenges to real estate investors, but we also believe that these generate attractive opportunities for the best to generate long-term value. Some of these factors – such as rising interest rates – are broad macroeconomic trends affecting multiple asset classes, but some are more specific to – and nuanced within – the property market.

Rising interest rates

Rising interest rates are a clear challenge for almost all asset classes. From a returns perspective, the higher risk-free rate will always make some investors move to less risky assets. Real estate markets are more sensitive to changes in the interest rate than other sectors. The fact that many buyers rely on debt financing is crucial when considering how interest rates affect capital values. As the cost of debt increases, the expected return for final investors also increases, which then pushes prices down. In this environment, being a 'fully funded' buyer can be a huge advantage – allowing a longer-term view rather than one driven by the cost of debt.

The drive to net zero

The shift to net zero carbon is a new challenge in this cycle. The last major rise in interest rates happened before the global financial crisis. Back then, understanding the carbon footprint of a building was a relatively minor concern.

Today, climate change is a key issue for tenants, investors, and policymakers. Consequently, it is a sizeable consideration in most property decisions: evaluating the lifecycle carbon footprint of a building – its embedded carbon, the energy and water efficiency, the potential for on-site renewable energy generation and end-of-life carbon implications – are now a standard part of the development, acquisition, and management process. Investors are placing as much emphasis on impact and sustainability as financial returns in their investment decisions.

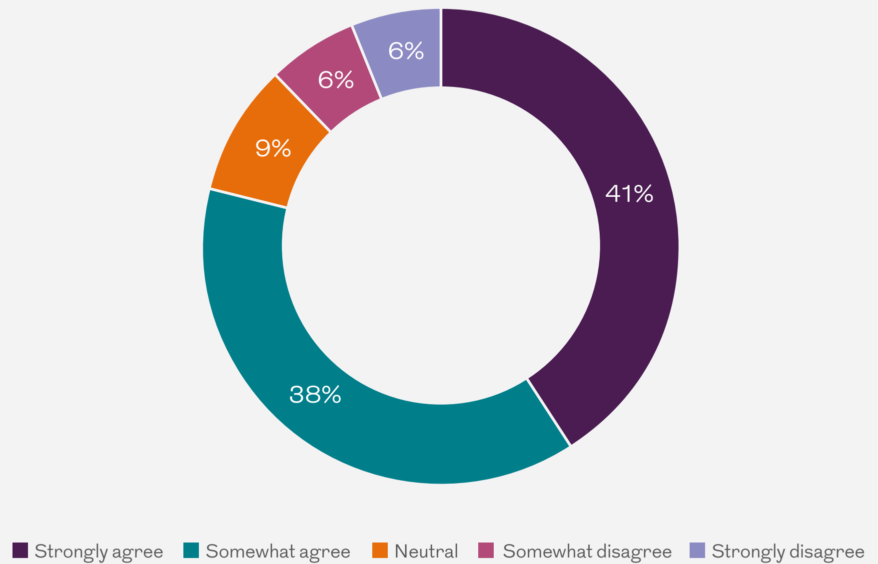
The office sector is a clear example of how this can affect value. The cost of (re)developing or retrofitting office stock for a net zero carbon world varies widely – generally speaking, the older the building, the higher the cost. By itself, uncertainty around the capex requirement would lower prices, but how companies use offices is evolving too. In a post-Covid world, most companies are not uniformly requiring employees to be back in the office five days a week. However, more are requiring more office attendance, whether that is three, four or five days a week. It's true of the public sector and the private sector too, with some of the very biggest businesses now linking promotions to attendance.

> "The cost of (re)developing or retrofitting office stock for a net zero carbon world varies widely."

As occupiers respond to this, office quality is now of paramount importance. High quality, amenity-rich space with strong green and wellness credentials are a major part of incentivising people to return to the office. Modern, well-located, prime office space continues to let well and is an investible proposition. However, demand in markets outside of large cities and dynamic innovation clusters has reduced sharply.

One bright spot is the curtailment in development due to the higher costs of debt and construction. This will lead to a supply crunch which should underpin rental growth for prime stock. We would expect lower quality space to struggle.

Our office strategy reflects these trends. We will continue to focus on creating and acquiring best-in-class stock in core markets such as London, Birmingham, Bristol, Manchester, Oxford and Cambridge.



Source: KPMG, survey of global real estate investors at the RE-Invest summit at MIPIM in March 2023

The need to diversify beyond traditional sectors

Historically, a property portfolio would have high weightings in offices, industrial (with logistics an increasing element in recent years), and retail. We expect to be able to find value in these sectors going forward, even with the cyclical headwinds and tailwinds that these sectors face.

However, economic, regulatory, and societal changes are also shifting trends in real estate that is reflected in greater investment into alternative sectors. Three areas that we think property investors should consider are life sciences, Build-to-Rent (BTR) and care homes.

The UK has a strong competitive edge in life sciences, a rapidly expanding field. The 'golden triangle' of London, Cambridge and Oxford is the hub of this sector, where life sciences firms benefit from the presence of highly skilled graduates and cutting-edge research. Compared with similar clusters in the US, which are supported by a significant stock of lab space, the UK still has plenty of room for growth.

Private rental residential is something many people are more aware of due to the popularity of buy-to-let over the past two decades. However, tax changes and rising interest rates mean it is no longer particularly advantageous for a private landlord. In both owner-occupier market and the private rented sector (PRS), there is a fundamental undersupply. If we look at the PRS sector, some stock is low quality: currently 23% of private rented homes do not meet the Decent Homes Standard, creating an opportunity for professional landlords to offer an improved product. We believe that BTR is a better option for both investors and tenants: we can create high quality homes at scale and cater to the demand of a growing rental population that is not well served by the current market. It is one with significant growth opportunities in the UK.

Finally, we would highlight care homes. We all know that the UK population is aging, but again, a high proportion of existing care home capacity is not really suited to how we age. Only 28% of homes have a wet room, while 81% of homes are older than 20 years and 40% of homes are converted from other uses and many will be outdated, according to research by Knight Frank. Preferences have changed, and residents expect more from a care home including high quality design environment and amenities.

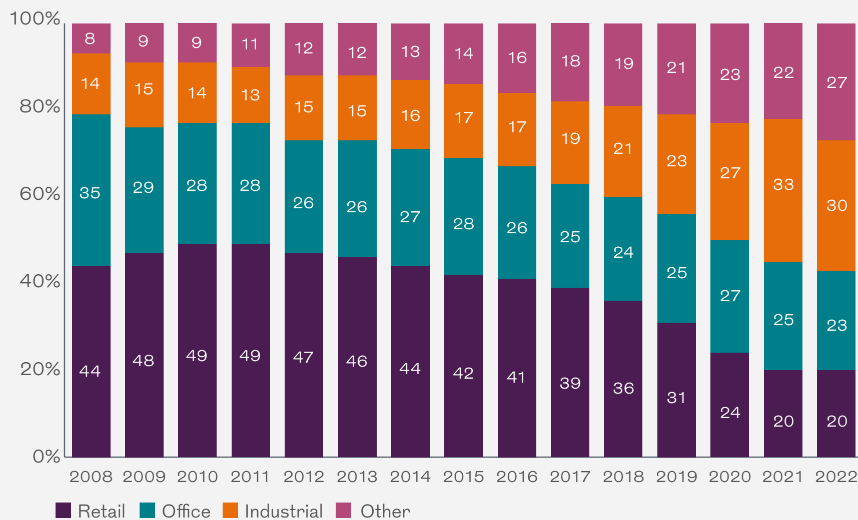
We prefer to partner with developers or operators who can build and run care homes that offer a longer and better quality of life for each tenant and align with our goals of net zero and environmental sustainability.

> “We can create high quality homes at scale.”

Positive sentiment

Property asset managers are often optimistic about their asset class. We have seen significant falls in value in 2022 and see a continuation of this trend for some sectors – especially offices – in 2023. That said, the capital value cycle is finely poised as we head into 2024. While there are plenty of areas where we would exercise caution – such as secondary stock in the office and industrials sectors – we are still in the early stages of seeing huge growth in new sectors that we feel could generate very attractive long-term returns for investors and help create solutions to some of the long-term issues facing us today.

Total capital value UK by broad sector, 2008-22



Source: MSCI UK Annual Property Index
Percentages subject to rounding.

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