INVESTMENT OUTLOOK 2024

MARKETING DOCUMENT

Back to the Future

Union Bancaire Privée

Michaël Lok
Group CIO
and Co-CEO
Asset Management

Back to the Future

After a global recession was avoided following the shocks of 2022–23, economic and geopolitical forces will continue to reshape the foundations of the world order in 2024.

The sharp rise in bond yields after a decade of manipulation by central banks has been the most visible sign of this new era. Indeed, our expectations of 4.5% US Treasury yields seemed fanciful only a year ago but growing fiscal deficits and rising inflation anxiety have created a new, higher floor under global bond markets.

However, this should not prevent bond investors from benefitting in 2024 as central banks suspend their tightening and bring an end to the three-year bond bear market. This pausing cycle will not be like those of the recent past, however, as central banks are set to see their dominance over the economy since the 1990s gradually give way to the growing influence of fiscal policy.

This 'fiscal dominance' will both drive economic growth and determine the new winners and losers in economies around the world focused on this major shift in the global order. Transformative technologies will continue to lead the way, with the global energy transition continuing apace.

Geopolitical realignment will continue to feature strongly again in 2024 as US policies drive a rapid diversification of supply chains away from China likely to create lasting investment opportunities for India and Latin America.

The new landscape also comes with new risks. Kinetic wars will continue alongside the reshuffling of regional power structures in the years ahead. However, the biggest unanticipated risks for 2024 are a return to 2016-style political disorder and stagflation.

With these convictions, explored in our 2024 Outlook, combined with UBP's active risk management approach, we look forward to working alongside you to preserve and grow your wealth amid this great transition.

The Rise of Fiscal Dominance

- The power over the economy is shifting from central banks to fiscal policymakers.
- Higher interest rates are driving widening budget deficits in the US and Europe.
- The Fed and the ECB will need to choose between amending their inflation-fighting rhetoric and accommodating large fiscal deficits in 2024 to avoid painful recessions.
- A pause in interest rate hikes would enable the US and Europe to accelerate the green transformations within their economies.

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A key benefit of the global order that has prevailed since early 1990 was the creation of low-cost global supplies which fuelled a structural decline in inflation.

The falling inflation, in turn, spurred a secular downtrend in long-term interest rates. This created a virtuous cycle for economies like China and post-Soviet Russia, whose growth required large amounts of increasingly cheap capital investment as it contributed to the accelerating pace of globalisation.

The steady drop in inflation empowered central banks, and the US Federal Reserve in particular, to use ever lower interest rates to soften the blow from recessionary surges and repair damaged financial systems.

INFLATION AND INTEREST RATE TREND REVERSAL

This trend was reversed after the Trump trade war of 2018–19, and with the 2020 global pandemic, followed by Russia's 2022 invasion of Ukraine, which have upended more than three decades of globalisation by stoking up inflation.

As importantly, high inflation and extreme income inequality have given rise to more vocal populist political factions. These have helped bring about larger structural budget deficits in the West as a result of unbridled fiscal spending to cushion, first, the pandemic-related market dislocations and, more recently, the inflationary pain experienced by both households and corporates.

This fiscal empowerment has impaired the almost unconstrained influence that central banks around the world have had since the 1990s and will likely force them to hand over the purse strings to their budget policy-making counterparts.

In the US, deficits have reached nearly USD 2 trillion in 2023 (7% of GDP) – the largest outside a recession since World War II – despite the economy being in its third year of expansion.

US deficits are the largest outside a recession since World War II

In the past, as long as interest rates were falling, the US was able to run large fiscal deficits, as the impact was offset by the low rates; in the early 1980s, when 10-year Treasury yields peaked at nearly 16%, net interest paid by the US Treasury reached an all-time high of 3% of GDP and 18% of tax receipts through the early 1990s. In contrast, when borrowing costs were at a low of less than 1% in 2020, the Treasury paid 1.3% of GDP and 7% of tax receipts. And this despite total public debt rising nearly tenfold from USD 2.7 trillion in 1990 to nearly USD 23 trillion by the end of 2019.

With accelerating deglobalisation, structurally larger deficits, and elevated inflation and interest rates, the Congressional Budget Office estimates those figures at 2.3% of GDP and 14% of tax receipts as of July 2023, and nearly 4% of GDP and 22% of tax receipts by 2028 – more than the US government paid when forced to issue Swiss franc and German Deutschmark debt ('Carter' bonds) in the late 1970s.

FROM MONETARY TO FISCAL DOMINANCE

Thus, with closely contested elections in the US and Europe in 2024, unless inflation falls back towards 2%, central banks including the Fed will need to make a difficult choice – continue their valiant inflation fight or accommodate fiscal largesse.

In the latter case, they will have to acknowledge the growing power of budgetary policy by ending their rate-hiking cycles in 2024 and leaving open the risk of elevated

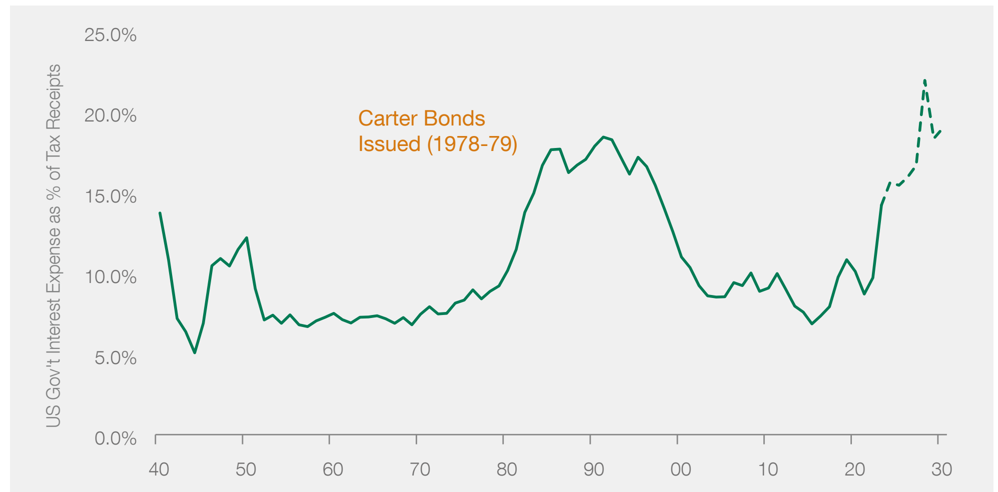
Central banks' pause gives way to rising influence of budgetary policy

inflation, or even of 1970s-style stagflation. Indeed, cyclically, we expect rate-hiking on both sides of the Atlantic to be suspended in late 2023, allowing the US and continental Europe as a whole to skirt widely anticipated recessions in 2024.

Indirectly, such a pause would also enable and accelerate the industrial transformation under way (see "The Two Faces of the Energy Transition", p. 9), a politically convenient outcome in an election year, as it would improve the US economy's medium-term growth potential.

Economically, while many may come to remember 2024 as a year in which inflation fears eased and recession was avoided, more subtly it may also represent the passing of the baton from monetary policy dominance since the 1980s to fiscal policy dominance looking ahead.

US GOVERNMENT DEBT SERVICE BURDEN SET TO ECLIPSE 20% OF TAX RECEIPTS



Sources: Federal Reserve Bank of St. Louis, US Treasury, US Congressional Budget Office (CBO), and UBP

Note: Dotted line represents CBO estimates assuming 4.3% nominal GDP growth and 2.8% average debt costs

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The Pause That Refreshes

- The global bond bear market should pause in early 2024.
- In equities, look to earnings recovery in technology, quality laggards, and Japan.
- The dichotomy between renewable energy company stocks' performance and the underlying fundamentals of the industry is typical of early booms in emerging sectors and, with time, should resolve into steady returns.

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The US and European rate-hiking cycles which spurred the three-year global bond bear market should come to an end in 2024, giving investors respite in the year ahead.

While inflationary pressures have been in retreat since mid- to late 2022 in the US and Europe, more importantly, global bond markets are once again rewarding investors for taking a risk on the trajectory of both interest rates and inflation.

The bond market normalisation means longer-term interest rate exposure can be reintroduced – near 5% in 5- and 10-year US Treasuries and 2.5–3% in comparable German bonds. As yields moderate, towards 4.5% for long-dated Treasuries and 2–2.5% for German Bunds, modest capital gains can be realised for the first time since 2020.

Investors who found shelter in credit in 2023 should be more wary and seek fuller compensation for credit risk in 2024. Refinancing cycles should pick up – first in Europe and then in the US – and drive the next leg of credit defaults as companies digest a new, higher interest rate regime. In the meantime, investment-grade bonds offer refuge.

For those seeking higher yields, our expectation of elevated equity volatility also means volatility carry strategies can complement short-duration high-yield bonds for higher income in 2024.

Though above-average valuations, near 16x global price/earnings multiples, are a concern for the start of the new year, they should ease as earnings recover, especially among the largest US technology names.

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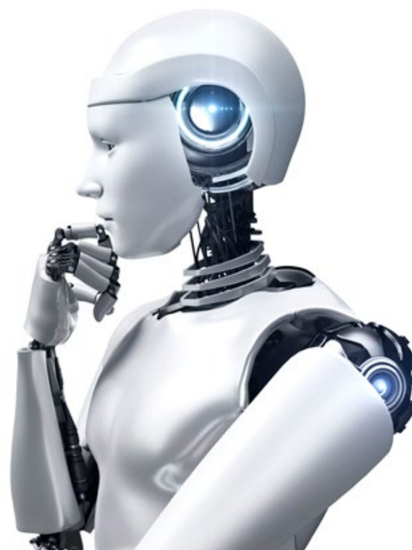

THE STRENGTH OF TECH AND INDUSTRY

With interest rate pressures abating, accelerating artificial intelligence spending should combine with cyclical recoveries in cloud, e-commerce, and digital advertising to drive double-digit revenue and earnings growth as the calendar turns, benefiting not only big tech but also the software sector.

Outside of technology, investors can look to quality laggards which offer an opportunity to access strong balance sheets and reliable earnings growth.

Credit investors will find refuge in investment-grade bonds

In addition, the weakening industrial cycle appears to be rebounding as 2023 draws to a close, driven by the new US industrial policy – focused on building 21st-century infrastructure, industries, and power generation.

Though equity markets have not rewarded investors in the new energy transition (see box "The Two Faces of the Energy Transition" for more details), American industrial construction spending had reached USD 1.9 trillion by the end of August 2023, rising nearly 65% year on year, the fastest pace this century, underpinning economic growth and employment.

Federal government funding for this policy agenda is expected to accelerate even more meaningfully in 2024–26, laying the foundations for earnings recovery. Meanwhile a stabilisation in bond yields should allow longer-term projects some financing visibility to accelerate through 2024 and beyond.

NON-US EARNINGS PROSPECTS IMPROVING

Looking outside of America, non-US equities are trading below 13x earnings, just above the levels seen during the 2008–09 Global Financial Crisis, the 2011 Eurozone Crisis and the 2020–21 pandemic.

Japan corporates have outpaced their US peers

With non-US equities near this historical valuation floor, earnings prospects can be the focus for investors to drive returns. Japan stands out, having hesitated for decades before pursuing comprehensive corporate and economic reform in 2012. Since then, Japan corporates have delivered 11% compound annual growth rate (CAGR) earnings growth, outpacing not only the 7.3% of the S&P 500 but matching the 11% of the higher-growth NASDAQ 100 index.

After the 22.3% rally in Japanese equities in 2023 (as at end October), Japan's decade-long earnings-driven bull market should carry on into 2024. Earnings

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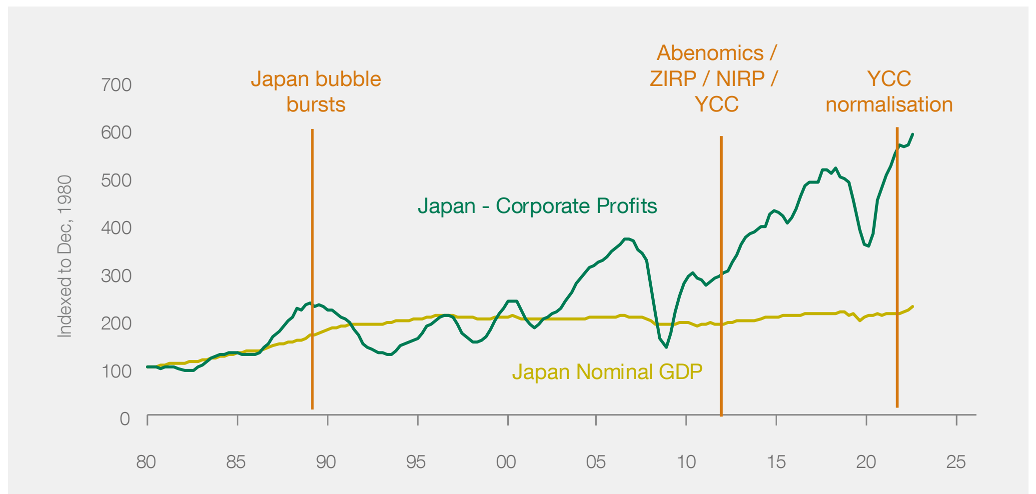
growth is expected to be driven to 7% by a global industrial recovery in the first quarter, with share buybacks and dividend growth continuing to support total returns.

RETURNS BEHIND THE VOLATILITY

Overall, while risks are elevated (see "The Return of Donald Trump", p. 12) during this transitional phase of the global economic order, opportunities are emerging as new equilibria are found, like in global government bond markets.

Moreover, just as they had to face a shifting geopolitical landscape in the 1970s, investors should look through near-term volatility and keep their eye on the returns from the long-term transformation of the global economy – in technology and new energy, as well as the changing global order (see "Looking Beyond China", p. 10).

DOMESTIC REFORM HAS CREATED SECULAR EARNINGS GROWTH IN JAPAN



Sources: Bank of Japan and UBP

Notes: 'Abenomics' refers to former Prime Minister Shinzo Abe's social and economic reform programs; ZIRP – Zero Interest Rate Policy, NIRP – Negative Interest Rate Policy, YCC – Yield Curve Control policies

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The Two Faces of the Energy Transition

Investors have been rightfully disappointed with the near 50% decline in MSCI's New Energy Index since 2020, which has occurred despite the near doubling of global solar and wind capacity, of electric vehicle sales, and of industrial construction and R&D spending in the US.

The dichotomy between the equity market's performance and the underlying fundamentals of such growth industries is not unusual, and is not surprising as capital has become scarce just as interest rates have risen.

Looking back, in its early days in 1992–95 the biotechnology sector faced a 65% drawdown before delivering 19% compound annual returns through 2019 as the enduring firms went on to drive drug development and growth globally.

More recently, the late-1990s rise of the internet took investors on a harrowing ride of +600% returns followed by a 90% decline by 2001 with rising capital costs culling the industry. Yet communications infrastructure carried on developing and internet innovation continued, allowing survivors to deliver nearly 17% compound annual returns in the years that followed.

Active risk management during these drawdowns in the early stages of nascent industries is key to maintaining long-term exposure to the transformation.

For investors, positioning across various segments of the energy transition value chain should help mitigate such early-stage risk. Traditional energy firms combined with more immediate beneficiaries, such as select utilities, can form an anchor for portfolios. Industrial construction companies can provide near-term growth as roll-out activity remains high while targeted component suppliers with pricing power can offer longer-term growth opportunities, especially if capital costs ease and implementation occurs faster than expected.

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Looking Beyond China

- Like post-1989 Japan, post-1998 Asia, post-2011 Europe, and the post-2008 US, China is in a post-bubble credit restructuring phase.
- Emerging market and global investors should look beyond China.
- India offers more attractive growth and corporate fundamentals.

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Though many are focusing on China's post-pandemic economic lethargy as the main obstacle to returns, the structural shifts under way within and around the Chinese economy present more persistent headwinds.

Long-term investors will recognise five distinct phases in the history of Chinese equity returns that have started with the following key events in China:

1. Reopening to the world in the late 1970s
2. Financial market liberalisation in the early 1990s
3. Formal ascension to the World Trade Organization in 2001
4. First attempt at restructuring its real estate sector in 2013
5. Ongoing real estate reforms amidst growing deglobalisation pressures

PHASES 1 AND 3 were most rewarding for China investors with foreign capital pouring in as China integrated into the global manufacturing chain.

PHASE 2 highlighted the challenges of pivoting from a command to a market economy as Chinese corporates struggled to generate earnings growth despite rapid revenue growth, leaving their equities broadly lagging behind those in both emerging and developed markets.

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Structural shifts within and around China present persistent headwinds

PHASE 4 demonstrated an adept transition as China developed its online economy while taking gradual steps to address the bubble in its real estate sector, much like the US economy at the same period. Unfortunately, China was unable to deleverage its private sector sufficiently during this phase.

And now PHASE 5 has been plagued by a series of shocks, both external and self-inflicted, including US-driven deglobalisation efforts (2018–present), the pandemic and extended local lockdowns (2020–2022), and China's tech crackdowns of 2021 highlighting the absence of an alternative growth driver.

During this phase, passive investing in Chinese equities should be avoided. Alternatively,

1. China-focused investors should concentrate on identifying new longer-term economic growth segments.
2. Emerging market investors should look to Indian equities, which have kept pace with or outpaced China's since the 1990s.
3. Global investors can also target Latin America to capitalise on the move away from a China-centric global value chain.

ALTERNATIVES TO PASSIVE CHINA EQUITY EXPOSURE

New longer-term economic growth segments

Indian equities in the emerging market allocation

Latin America for the value chain shift

The Return of Donald Trump

- The uncertainty caused by the possibility of another Trump presidency could raise demand for gold.
- His administration would likely give the traditional energy sector a boost, increase scrutiny on big tech and tighten containment measures against China.
- It would also affect US–Europe relations, the Ukraine front, and trade terms with China.

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A second Trump administration's policies would carry both economic and geopolitical costs

The possibility of the 45th US President, Donald J. Trump, returning to office presents the greatest uncertainty for the investment landscape in the year ahead.

Like in 2017, he would use fiscal policy to reward supporters and punish the opposition, but this time with deficits increasing from an already historically high level. Tax and regulatory burdens would likely shift as well: the traditional energy sector would get a boost, just as when he was last in charge, while big tech may see increased scrutiny in retaliation for perceived opposition since his first term. Another likely action would be expanding on the capital and intellectual property restrictions on China and on containment measures enacted since 2021.

Such policies would carry both economic and geopolitical costs. Economically, unconstrained fiscal spending could cause a resurgence of US and global inflation and rob the Fed of its power over the economy and over inflation (see "The Rise of Fiscal Dominance", p. 3). Geopolitically, strains between the US and Europe as seen during the first Trump administration would likely return, with implications for the Russia–Ukraine war. Across the Pacific, any rapidly tightening restrictions on trade, capital, and intellectual property would invite direct retaliation from China and rekindle the simmering conflict of the trade wars of 2018–19.

Among the risks for investors of another Trump presidency, it would expose the frailties of the global economy, including catalysing nascent inflationary tendencies and burgeoning fiscal deficits. On the political front, it could accelerate the realignment of the global geopolitical order with the rise of the 'Global South' and a shift of power from the historical leaders to emerging countries in Europe and the Middle East.

Overall, such destabilising policies may create an opportunity for gold to return as a long-term anchor of wealth preservation in investor portfolios.

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Michaël Lok

Group CIO and Co-CEO
Asset Management

Michaël Lok, who has over twenty years of experience in wealth and asset management, joined UBP in 2015 as Head of Investment Management. Previously, he was Global Head of Asset Management with Indosuez Wealth Management (Crédit Agricole Group), where he developed a range of UCITS funds for Private Banking and a set of UHNWI mandates and dedicated investment solutions with a focus on Asia and Latin America. This followed his roles as Head of Investment and Head of Risk and Quantitative Portfolio Management. Before that, he was Portfolio Manager at Banque Martin Maurel and HSBC France (ex-CCF). Michaël Lok holds two master's degrees, one in Finance (DESS) and one in Banking and Finance (DEA), from the University of Aix-en-Provence.

Norman Villamin

Group Chief Strategist

Norman Villamin joined UBP in 2015 and is now Group Chief Strategist responsible for developing the Bank's long-term investment strategy and investment convictions for the Bank's Global Investment Committee. Norman has over 20 years of experience managing wealth both on an advisory and a discretionary basis. He was previously Chief Investment Officer for Coutts International, Head of Investment Analysis & Advice for Citi Private Bank in the Asia-Pacific, Head of Asia-Pacific Research for HSBC as well as Head of Asia-Pacific Strategy for Morgan Stanley based in Hong Kong and Singapore. Norman holds a bachelor's degree from the University of Michigan and a master's from the University of Chicago both in Business Administration.

Nicolas Laroche

Global Head of Advisory
& Asset Allocation

Nicolas Laroche, who has over 18 years of experience in wealth management and financial markets, joined UBP in June 2016 as Global Head of Advisory Services managing a team of fixed income and equity investment specialists. In May 2023 he was appointed to the additional role of Global Head of Asset Allocation, joining UBP's Global Investment Committee. Prior to UBP, Nicolas spent 10 years with Crédit Agricole Indosuez Wealth Management as an advisor managing a book of UHNW advisory mandates. He started his career within the advisory team in the private banking division of BNP Paribas in Paris where he started building up his passion and skills for global equity markets, thematic research and stock-picking. Nicolas holds a master's in finance from the French business school Skema.

Patrice Gautry

Chief Economist

Patrice Gautry joined UBP in Geneva in February 2000 and heads the Bank's Economic and Thematic Research department. Prior to that, from 1991 to 1999, he worked in the Institutional Asset Management department of HSBC Group in Paris as Head of Economics and Investment Strategy. From 1988 to 1991, he was a manager of European diversified SICAV and mutual fund portfolios for the Ecofi-Finance Group. Patrice Gautry holds a research master's degree (*Diplôme d'Etudes Approfondies*) in Economics from the HEC-CESA Paris and the University of Orléans, with specialisations in currency, finance and banking.

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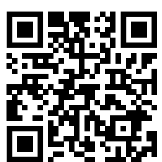

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