State of the Markets

Top five risks & opportunities

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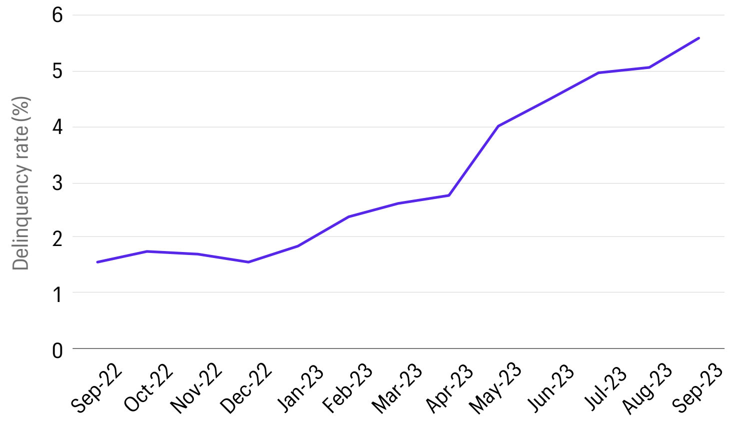
If ever there were a time to bring multiple views together to assess the markets, now would be it. We've asked two senior leaders from our Investment Analytics **(John Hockers, CFA, PRM)** and Systematic Edge **(Matthias Scheiber, Ph.D., CFA)** teams to share their predictions for the top five economic risks and opportunities in 2024.

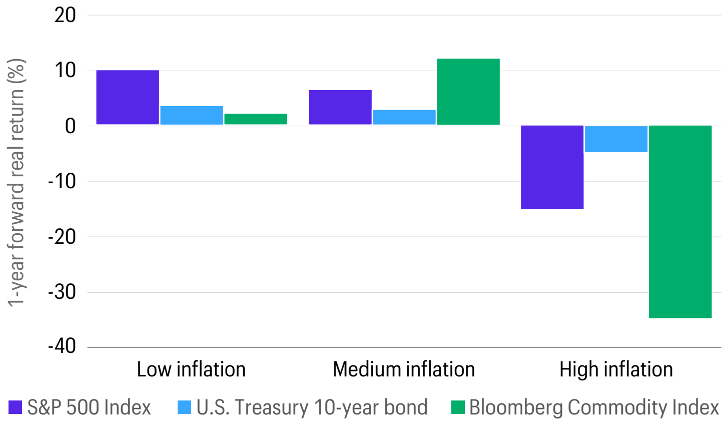
CHART 1: DELINQUENCY RATE FOR OFFICE PROPERTY LOANS MORE THAN TRIPLED OVER 12 MONTHS



Sources: Allspring and Trepp, as of September 2023

Loan delinquency rates are represented by delinquency rates for office property commercial mortgage-backed securities.

CHART 2: EXPECTED RETURNS ONE YEAR AHEAD BASED ON THE PREVIOUS YEAR'S INFLATION RATE



Sources: Allspring and FactSet

One-year-ahead calculations are from 31-Dec-71 through 31-Dec-22 for the years 1972 through 2023.

TOP FIVE RISKS

01 A global recession can't be ruled out.

The odds for a global recession are rising. Growth in international markets has already slowed, and U.S. growth will likely slow in 2024. While bad news economically, it could be good for asset prices if the slowdown is shallow. Europe is unlikely to add stimulus to revive economic growth as long as inflation stays high, and China is grappling with a slowing housing market and potential deflation of an asset bubble. In the U.S., interest rates are the highest in a decade, COVID stimulus is sunsetting, and student loan payments have resumed. **Consumers could tighten their spending, which could push the U.S. and Europe toward recession.**

02 Elevated interest rates are likely for at least the first part of 2024.

Consumer demand will likely decline, pressured by lower real wages and personal savings. Part of central banks' job in 2023 was to tighten financial conditions from very loose levels. Nominal rates had to rise while inflation fell, pushing real yields higher. **In 2024, real yields could fall back as the economy slows, and the U.S. dollar may weaken.**

03 Conflicts worldwide could escalate.

There are currently two main hot spots, and either one **could trigger a global equity sell-off:**

- Russia may conclude it's losing in Ukraine and pivot its strategy to include expanded environmental or nuclear terrorism to halt Ukrainian advances.
- A direct conflict between Iran and Israel or Iran and the U.S. could put Persian Gulf energy supplies at risk.

04 Commercial real estate (CRE) defaults could accelerate.

With employees working remotely more often, companies continue reducing office space. For CRE owners, fewer tenants mean less income. Today's higher rates complicate CRE debtors' ability to meet interest payments, driving higher delinquency rates. **Increased CRE defaults (Chart 1) could challenge investments tracking bond indexes**.

05 Sticky inflation will likely continue.

While inflation has fallen globally in 2023, more progress is needed—inflation in the U.S. and Europe is still nearly double the 2.0% target. Our research indicates progress will be hard unless demand slows. But there's good news: **Market expectations for inflation by year-end 2024 are 2.5%.**

TOP FIVE OPPORTUNITIES

01 Fixed income is likely to provide compelling investment opportunities.

- **Money market** yields are likely to remain robust. For investors worried about recession or geopolitical events, temporarily parking cash in money markets while their yields remain above the inflation rate could be lucrative.
- If there's a recession, **high-quality, long-duration bonds could rally**. When the Federal Reserve (Fed) cuts rates, longer-duration securities generally tend to rally. **U.S. municipal bonds may be among top performers globally in 2024,** especially for investors who can benefit from preferential U.S. tax treatment.

02 Alpha-generation potential should increase.

High short-term interest rates should lead to wider dispersion in 2024. Our analysis of historical trends (**Chart 2**) indicates an optimistic outlook for major asset classes given inflation's retreat into a "medium" 2%–4% range. The initial impact may be mixed, but alpha opportunities should increase.

- **U.S. small-cap stocks** hugely underperformed in 2023 but **could stage a 2024 comeback.**
- We see **value in U.S. bonds** for 2024 given higher real yields.

03 Emerging market (EM) equities (excluding China) may perform well.

If there's a recession in early 2024 and the U.S. dollar declines relative to other currencies, **EM equities could be poised to benefit** when recovery begins. Here's why:

- EM securities trade in local currencies. If those currencies increase versus the dollar, U.S. investors make money on exchange-rate changes.
- EM debts are partially in U.S. dollars, so when the dollar declines, EM debt costs do, too.
- Many EM countries (excluding China) sell commodities, which often rally when the dollar declines.

04 Real returns should be a key focus.

Focusing on real income and real capital growth will likely be essential to preserve purchasing power in 2024. With sticky inflation, real cash yields likely won't generate investors' desired investment outcomes. This environment **could favor real-return strategies focused on equities and higher-income bonds.**

05 Diversification using liquid alternatives could be beneficial.

Higher interest rates should make liquid strategies more attractive than illiquid strategies. **Focusing on liquid alternative investments** could be crucial as growth uncertainty persists. High asset class correlations can compromise diversification. **Market-neutral and alternative real-return strategies** offer uncorrelated returns to traditional assets.

To learn more

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Diversification does not ensure or guarantee better performance and cannot eliminate the risk of investment losses.

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock's weight in the index proportionate to its market value. You cannot invest directly in an index.

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