



■ Premier

Investment Outlook 2024

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Investment Outlook 2024

Global markets recovered well towards the end of 2023. And with some central banks pausing interest rate hikes towards the end of last year, there are signs that they may have reached their peak. So, what does 2024 hold for financial markets? And where should investors look for opportunities?

Our Investment Outlook 2024 sums up the issues that affected the global economy in 2023 and looks ahead to where the best prospects of 2024 might lie.



Section one: Interest rates

Interest rates settle and US economy stays resilient

For investors, last year was all about central banks battling to bring rising inflation back down by hiking interest rates. This created a challenging macroeconomic environment for investors at the start of 2023. Company profits are hit by higher borrowing costs when interest rates rise, as well as people being encouraged to save rather than spend. And existing bonds become worth less as new bonds come with higher yields. So higher interest rates can be bad for both stock and bond markets.



The (re)balance of growth and inflation

But generally, central banks made good progress rebalancing the global economy as the year went on, and financial markets were more positive by the year's end as inflation continued trending lower to much more benign levels.

The US economy – the most important for global investors – proved incredibly resilient during the year – surprisingly so – despite the US Federal Reserve (the Fed) raising interest rates by 5.25% between March 2022 and July 2023. The UK, on the other hand, saw much more sluggish economic growth.

The reason for the difference? Mortgages played a big role.

Interest rate sensitivity of the mortgage market

Generally, mortgages are a key route for higher interest rates to help control inflation. Central banks raise rates, mortgages cost more, people have less money to spend and inflation drops – as does the pace of economic growth. This chain of events was more noticeable in the UK as the mortgage market structure is more sensitive to interest rates. There's a prevalence of two and five-year fixed rate mortgages in Britain, so lots of people needed to renew and therefore felt the effect of higher rates.

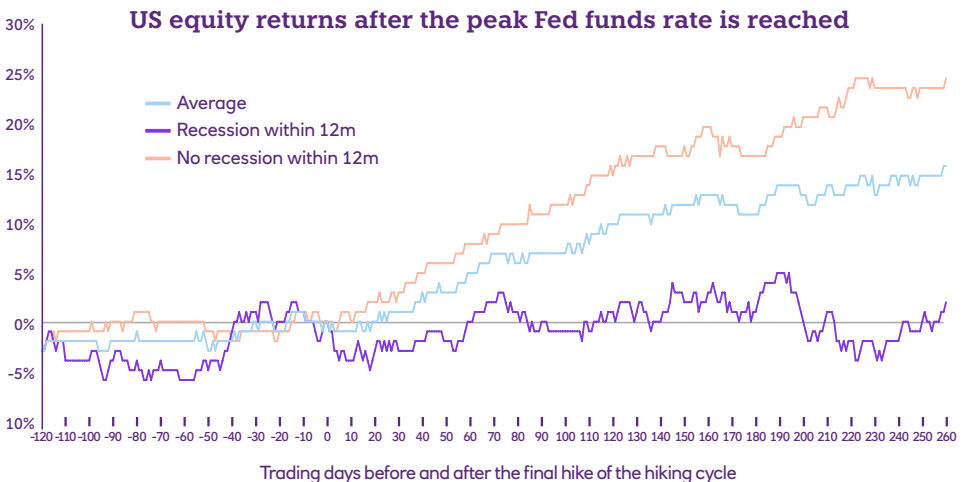
But in the US, it's common for mortgages to be locked in for 30 years, so the interest rate changes mostly impacted new buyers. Many people who fixed their mortgages while rates were low still had money to spend.



Central banks hit pause

In the summer of 2023, central banks finally took a break from raising interest rates, although reassurance on this front came towards year-end as inflation declined. US inflation fell from 9.1% in the summer of 2022 to 3.2% in November 2023, some of which reflected the Fed's intervention taking effect.

This heartened investors, partly because history shows that market conditions can improve significantly once interest rates stop rising. The graph below shows how US stocks have performed around the final rate hike by the Fed in previous rate-hiking periods. Performance is usually flat in the build-up to that last hike but, if the US economy avoids falling into a recession afterwards, stocks perform pretty well the following year.



Source: Bloomberg, S&P 500.

Past performance should not be taken as a guide to future performance.

Could US avoid recession?

It is worth stressing, though, that returns are much more muted when the US has gone into recession afterwards. As for what's going to happen this time around, we believe the US could avoid a recession or have one that's only relatively mild.

Bonds look more attractive

The greater certainty we're seeing on inflation and interest rates means bonds are looking increasingly attractive as well, after two challenging years.

It's first worth noting that bond yields (the fixed income you get from a bond) and their price (how much you can buy and sell them for in markets) have an inverse relationship. If yields go up, prices go down.

Attractive bond yields

At the time of writing, US government bond yields are around 5%. This means if yields don't change, an investor will get a return of 5% over the next 12 months. But this would change if the yield moves in either direction.

The table below shows what could happen to bond prices if yields were to change. If yields were to go up by 1% over the course of a year, which we think is unlikely, the 12-month return on the bond (including coupons) would be expected to be -2%. However, if yields fall by 1%, the 12-month return would be expected to be a considerable 12%.

10-year bond returns over the following 12 months

Starting yield	Change in government bond yields				
	-2%	-1%	0%	1%	2%
3%	17.0%	10.0%	3.0%	-4.0%	-11.0%
4%	18.0%	11.0%	4.0%	-3.0%	-10.0%
5%	19.0%	12.0%	5.0%	-2.0%	-9.0%
6%	20.0%	13.0%	6.0%	-1.0%	-8.0%
7%	21.0%	14.0%	7.0%	0.0%	-7.0%

Source: Bloomberg, Coutts.

Note: this assumes there would be a parallel move in bond yields and ignores second order effects.

Currently, with interest rates near, or even at, their peak, we expect bond yields to fall further this year and therefore, prices to rise. And if yields were to fall by 1%, an expected return of around 12% would be greater than what cash rates are currently offering.

Section two: Corporate earnings

Brighter times ahead for the US

Despite the US economy showing resilience in 2023, corporate earnings announcements (where companies release their quarterly performance figures) haven't been as positive. While companies have mostly managed to remain profitable, growth has been stagnant, which was to be expected against a backdrop of rising interest rates.

Higher profits on the horizon?

As a result, US earnings faced a 'recession' last year, when corporate profits fell for three straight quarters. But the outlook is starting to improve. Typically, when earnings experience a downturn, profits eventually rebound. This is because of companies cutting costs, and therefore benefitting even more than they would have when the economy improves.

US consumers still feeling the squeeze

This will depend on consumer spending this year, though. Despite most mortgages being locked in for 30 years before interest rates went up, consumer sentiment remains fragile. A survey by the University of Michigan last November found that nearly half of respondents were worse off financially than a year ago – mostly because of higher prices.



What to watch – US.

After a year of recovery, there are high expectations for some sectors in the US.

Mega-cap tech

The boom of artificial intelligence (AI) last year saw a lot of well-known technology firms spend big to keep up. The so-called Magnificent Seven – Apple, Microsoft, Amazon, Nvidia, Meta and Tesla – did very well as a result of the excitement. These seven stocks accounted for most of the positive returns from the S&P 500 in 2023.



Healthcare

With the sector beginning to normalise after the disruption caused by the Covid-19 pandemic, it's expected to be a key driver in US earnings growth this year.



Financials

At the other end of the table is the financial sector, where expectations are low. Having seen severe challenges in 2023, such as the collapse of Silicon Valley Bank, the sector now faces further issues such as slowing loan growth, rising credit concerns and increased competition.



UK playing catch-up

The UK's stock market is trailing behind its global peers. One reason for this is how prominently certain sectors feature in the market. For example, while technology firms had a stellar 2023, particularly in the US, the information technology sector holds a significantly lower weighting this side of the Atlantic.

On the other side of the coin, financials, which as we've said had a challenging year, take up a larger chunk of the UK stock market compared with the US, as seen in the data below.

Sector	MSCI UK Index (%)	MSCI US Index (%)
Energy	14.36	4.28
Materials	10.60	2.40
Industrials	11.48	8.69
Consumer staples	18.24	6.19
Healthcare	12.59	12.55
Consumer discretionary	5.81	10.67
Communications services	2.73	8.77
Utilities	4.27	2.27
Financials	18.22	12.37
Real estate	0.74	2.35
Information technology	0.97	29.45
Totals	100.00	100.00

Source: MSCI.

Because the UK is dragging its feet a little in terms of economic growth and market performance, the forward-looking investor may well be drawn more to the US instead for the time being. But once confidence in the Bank of England's policies and overall economic direction improves, the UK market should become more appealing again. In the meantime, the most popular strategy for UK investors will be to pick cheap stocks with worthwhile dividend yields.

Section three: Our asset allocation

With everything mentioned so far taken into consideration, our funds are positioned to lean into the positives while also earning the bond yields that come in a higher interest rate environment.

Within bonds, we're earning 4-6% yields from the global government and corporate bond markets at the time of writing. We're also benefiting from higher sterling corporate bond yields, which we bought into opportunistically in 2023.

Fund positioning

Our funds are positioned to lean into the positive outcomes seen in the business cycle while earning the bond yields of a higher interest rate environment.

As such, our investments lean towards risky assets, more specifically global equities which are heavy in US stocks. In addition, we retain a preference for high-quality, multi-national companies that can best manoeuvre the current environment.



2024 opportunities

Here are key areas where we see potential opportunities this year:

European bonds

Europe is much closer to a recession than the US, which should support European bonds as bond yields are more likely to fall.

Small caps

Smaller companies were on our watch list last year, but we didn't include them in our client portfolios and funds as rising interest rates created headwind challenges. But with those interest rate hikes ending, the outlook has improved for such firms. And smaller company valuations are at historically cheap levels, creating the chance to get good deals.

Responsible investing

We take a responsible investing approach within our NatWest Invest funds. This means we consider environmental, social and governance (ESG) factors when making investment decisions.

While we believe responsible investing remains a priority, there were media reports last year suggesting it was going out of fashion and being replaced with newer trends. There are, however, credible grounds for continuing to believe in the importance of sustainable investing.

Examples include:

- the Intergovernmental Panel on Climate Change documenting how global temperatures continue to rise
- unacceptably high rates of biodiversity loss, according to the United Nations Environment Programme
- increased levels of extreme poverty found in research by the International Monetary Fund.

Because these aren't going to be resolved overnight, there's still a need for investing in change. This is why we're exploring how we can continue to capture these issues within our responsible investing approach.

Managing risk

Asset managers have a fiduciary duty to clients to ensure that all investment decisions are made with their best interests in mind. A survey by The World Economic Forum found the leading risks for private-sector risk managers in their two and 10-year horizons are all ESG-related. Therefore, factoring ESG into investment decisions plays an important role when reducing downside risks within varying time frames.

Rebuilding trust

Many in the financial services industry have fallen foul of greenwashing – the overstating of ESG efforts within marketing. This has resulted in a loss of trust from investors in recent years and a demand in improved classification and transparency within sustainable investing.

Regulators are now working on creating standardisation, greater transparency and parameters around greenwashing, particularly regarding investment advice.

The UK's regulator, the Financial Conduct Authority, released its Sustainability Disclosure Requirements in November last year. One significant change will be to determine if ESG-related labels, if any, are relevant to investment products.

Investors will benefit from this as they can make more informed investment decisions, cutting through the noise, and will hopefully result in the rebuilding of trust in responsible investing.

With these moves to help rebuild trust in mind, we believe sustainable investing is very much alive and remains an important way to mitigate risk and seize new opportunities when investing.





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IMPORTANT INFORMATION

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