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Watchword for Investors in 2024? Flexibility.

An economic soft landing could create buying opportunities during the volatile months ahead.

Insight from sub-adviser Schroders Investment Management

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Key Points

- Our base case is still for a soft landing in the US, but this is now very much reflected in the level of equities, credit spreads, and the extent of rate cuts priced into the bond market.
- With cash rates starting to fall, investors may want to consider being invested. But flexibility can help them take advantage of buying opportunities as they arise.
- Investors are itching to price in a Fed rate-cut pivot. But while inflation continues to move in the right direction, it feels premature for the Fed to implement aggressive cuts in the near term.

After the strong rally in markets into year end, valuations look a bit stretched across asset classes. Our base case is still for a soft landing in the US, but this is now very much reflected in the level of equities, credit spreads,[1] and the extent of rate cuts priced into the bond market.

The pack of cards needs to be reshuffled to provide fresh opportunities (as you can see, my memories of all the board games I played over Christmas are still dominating my thinking!).

The challenge, of course, is that markets can move quite quickly—we have elections in 40 countries this year, a tense geopolitical environment, and central banks in the middle of "landing the economy," which can always create volatility.

With cash rates starting to fall, investors may want to consider being invested. But investors will need flexible approaches to navigate these markets and potentially take advantage of buying opportunities as they arise. After all, the next card to be dealt can significantly change the hand you hold.

Pricing In a Fed Pivot

Last quarter, investors were concerned about further rate hikes from the Federal Reserve (Fed), while we were firmly of the opinion that rates had reached a plateau. Three months is a long time in the bond markets, as we now have a situation in which investors are itching to price in a Fed pivot.

We're not predicting significant rate cuts given the backdrop of high levels of employment. Although inflation continues to move in the right direction and wage growth has peaked, it feels premature for the Fed to cut so aggressively. As a result, we've closed our long-duration[2] positions and favor steepeners[3] to benefit from lower rates.

To the extent that the Fed may choose to emphasize falling inflation rather than tight employment conditions, we would view this as being more bullish for equities than for bonds because we still view the risk of an imminent recession in the US as being low.

The 3D Reset and its Implications

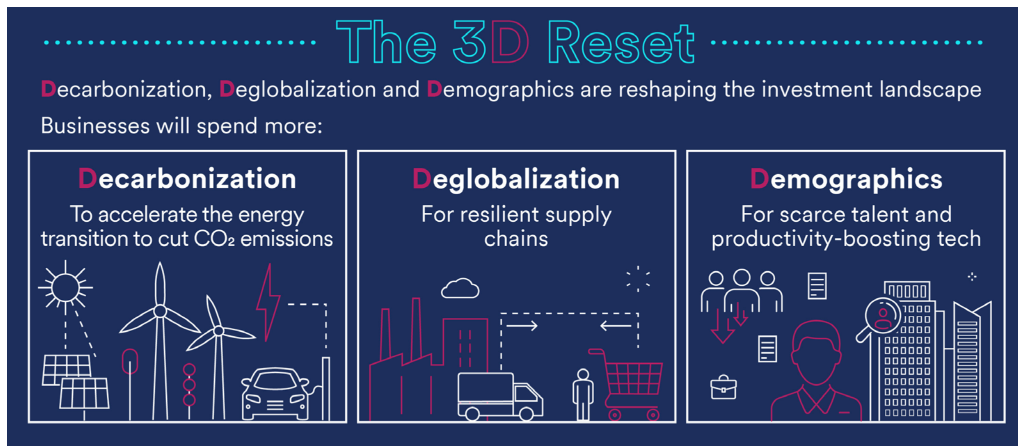
More broadly, and in the context of the 3D Reset (decarbonization, deglobalization, and demographics; **FIGURE 1**), the next phase is to really think about what policies may emerge from the reset. This is partly a function of the different conditions that each economy faces and the hand of cards that each policymaker has been dealt. This economic divergence is a source of investment opportunity:

- Many emerging-market (EM) countries have run more orthodox policies, which now leave their debt markets in a good place, with room to ease rates further, leaving us positive on local-currency EM debt.
- China faces a deflationary environment as it copes with the ramifications of its property crisis and, although we see some upside to the export cycle, it can't rely on mercantilism given the size of its economy and the protectionist backlash in the West.
- Japan is still running stimulative policies because of its deflationary history and its high level of government debt might be an obstacle to tightening.

- Europe has a growth problem given an aging demographic and higher energy costs than its competitors, but it also has a relatively stable political system, and its conservative fiscal policies are supportive of European bonds.
- The US has been able to run more stimulative policies because of the dollar's position as reserve currency of the world. As former President Ronald Reagan once said: "I'm not worried about the deficit. It's big enough to take care of itself". But Donald Trump's potential re-election to the presidency might push investors' patience too far if it results in the kind of fiscal extravagance that characterized his first term.

We continue to live in a world that's dealing with the aftermath of the pandemic and is facing unrelenting technological disruption.

FIGURE 1



Source: Schroders

Economics is an art, not a science, because of the role of human behavior. We continue to live in a world that's dealing with the aftermath of the pandemic and is facing unrelenting technological disruption. The 3Ds have also impacted the relationship between growth and inflation.

Taking all this together, the economic consensus forged over many years is being challenged. We need to fight the tendency to rely on the investment "maps" that served us well over the last decade. Instead, we need to focus on the divergences now occurring, and the fresh opportunities these are creating.

Talk to your financial professional to learn more about positioning your portfolio for a changing investment landscape.

[1] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[3] A steepener note (or steepener) is a complicated financial instrument that allows investors to speculate on the shape of the interest-rate curve and profit if it steepens rather than remaining flat.

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