ROBECO
The Investment Engineers

Global markets outlook

December 2023

For professional investors

Sustainable Investing Expertise by ROBECOSAM

General overview

Geopolitical safe havens are not rewarding investors

MULTI ASSET	1mo	3mo	YTD	1YR	3YR	5YR
MSCI World local currency	8,3%	1,6%	18,2%	12,2%	8,4%	10,4%
MSCI World (H, EUR)	8,0%	1,0%	16,3%	10,2%	6,8%	8,6%
Global real estate (UH, EUR)	6,4%	-1,2%	1,7%	-5,3%	3,9%	1,5%
Emerging Markets (LC)	6,2%	0,5%	6,5%	4,4%	-1,6%	4,2%
MSCI World (UH, EUR)	6,0%	1,1%	15,4%	6,6%	10,4%	10,8%
Emerging Markets (UH, EUR)	4,6%	0,6%	3,4%	-1,7%	-1,1%	3,1%
Global high yield (H, EUR)	4,5%	2,1%	7,1%	6,9%	-1,3%	1,3%
Global investment grade bonds (H, EUR)	4,4%	1,1%	2,8%	1,9%	-5,3%	-0,1%
Global Gov Bonds (H, EUR)	3,0%	0,1%	0,6%	-1,4%	-5,7%	-1,4%
Global inflation-linked bonds (H, EUR)	2,8%	-0,7%	-1,4%	-4,4%	-5,7%	-0,9%
EMD local currency (UH, EUR)	2,7%	0,8%	5,0%	3,6%	0,1%	2,0%
Gold (USD)	2,6%	5,0%	11,6%	16,2%	4,1%	9,6%
EMD hard currency (UH, EUR)	2,1%	1,0%	2,8%	0,3%	-1,6%	1,5%
Cash (EUR)	0,3%	1,0%	3,0%	3,2%	0,8%	0,3%
Oil Index (USD)	-5,8%	-5,5%	1,9%	1,7%	31,0%	0,0%
GSCI Commodities (USD)	-6,7%	-4,4%	-3,2%	-7,9%	26,7%	8,5%

Source: Robeco, Bloomberg

November was a history-making month across liquid assets. Equities and bond prices leapt higher as investors bet on peak rates and peak inflation. Equities rallied over 7%, which is a first when the VIX volatility measure index has fallen below 15; usually you would see these sharp rallies in bear markets for equities, when volatility is much higher.

In bond markets, US 10-year Treasury bond yields dropped 60 bps, their biggest monthly decline since December 2008 during the global financial crisis. Credit spreads tightened by the most in a month in the last five years as investors priced in rate cuts next year while also expecting a soft landing, so default expectations remained benign.

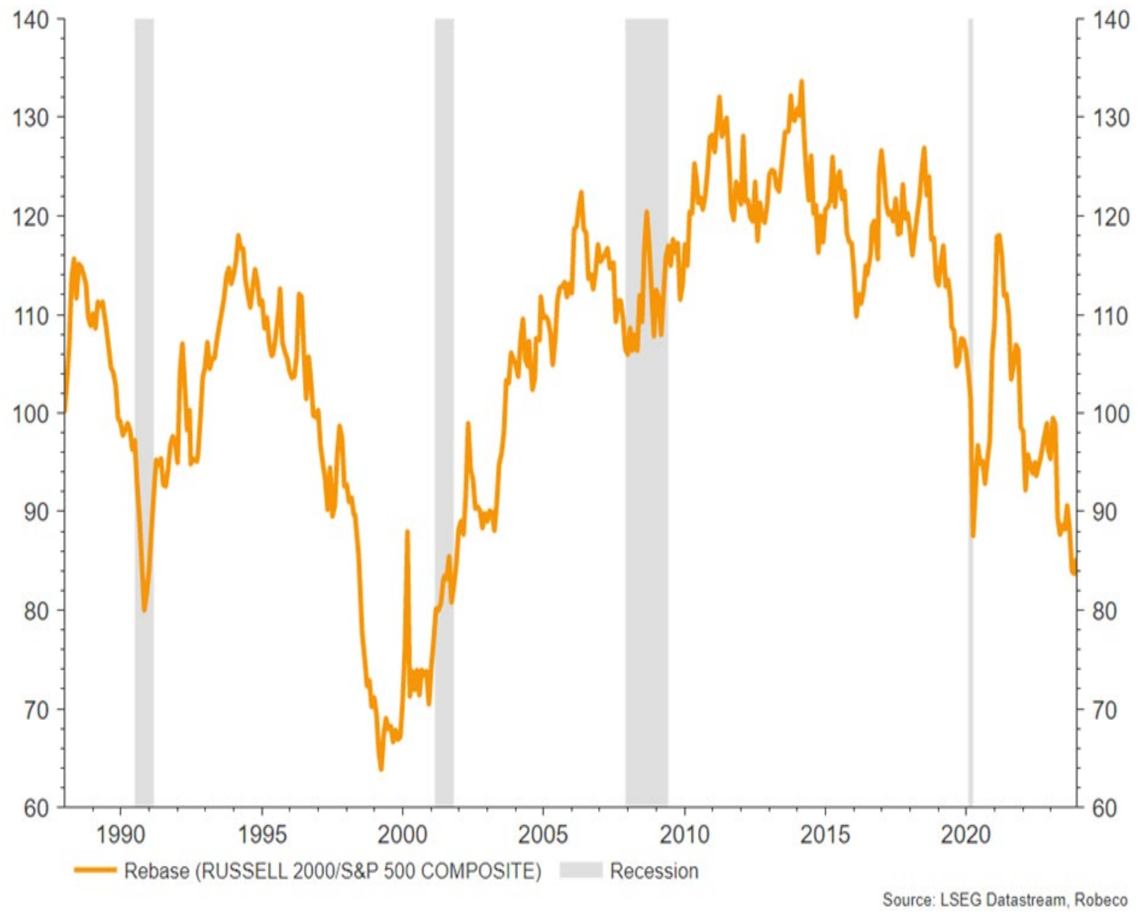
Surprisingly, gold held up well in this risk-on environment, as the lower real yield expectations and ballooning fiscal deficits worried investors. Bitcoin also benefited following strong gains in October.

If you look at the world through a commodities lens, prices fall sharply as Chinese policy makers failed to meet investor expectations for economic stimulus. This in turn led to a gloomier outlook and hence lower commodity demand. The postponement of the OPEC+ meeting saw a delay in further supply cuts and the oil price fell back sharply. Average US gasoline prices fell over 12% over October and November during a feelgood factor for the US holiday season. On Black Friday (the day between Thanksgiving and the weekend) and Cyber Monday (the following Monday), e-commerce sales grew year-on-yea, partly at the expense of in-store sales. Consumers are spending more on their credit cards rather than further depleting their saving pools.

 All market data to 30 November 2023 unless mentioned otherwise

Theme of the month

Finding diamonds in the rough



Source: Refinitiv Datastream, Robeco

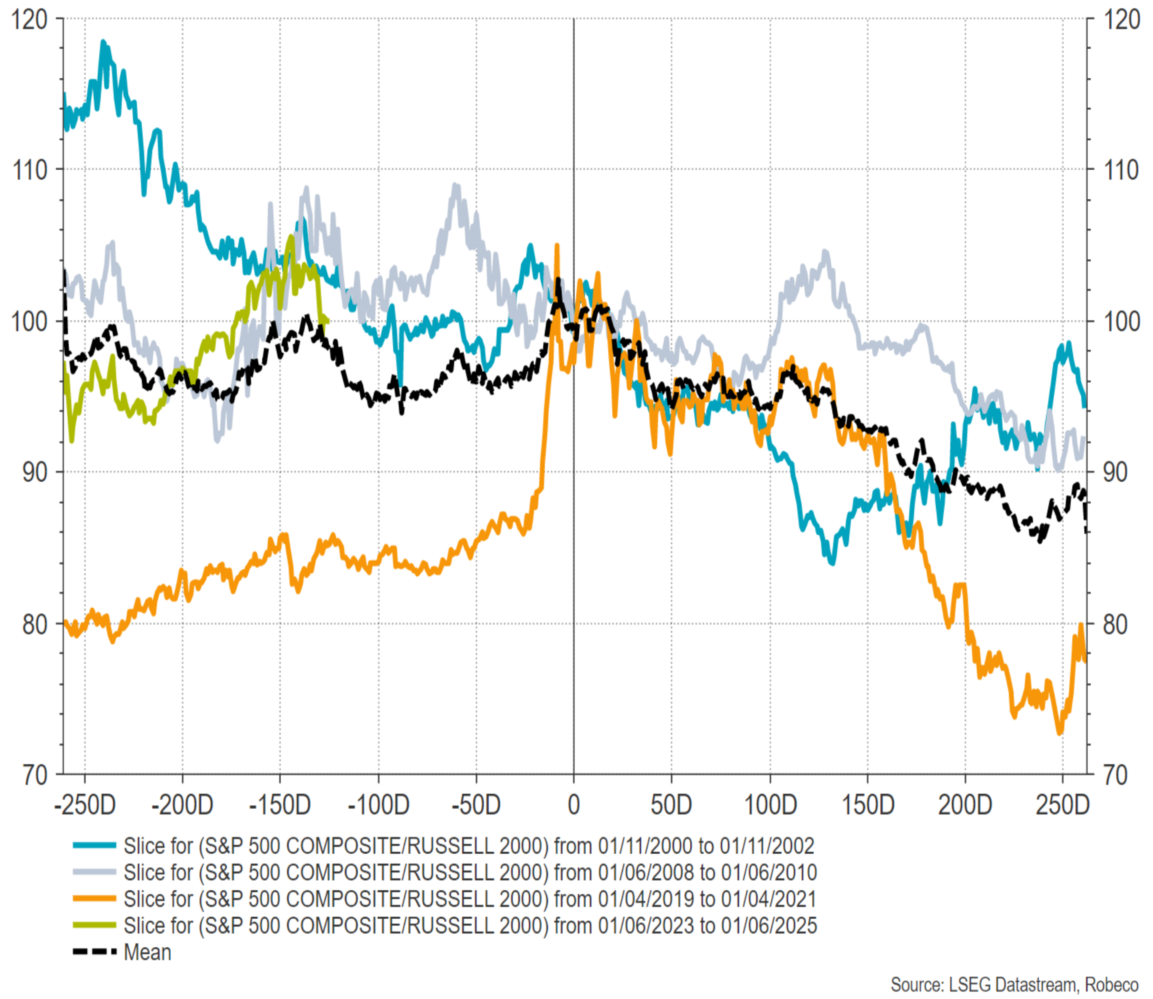
In contrast to large caps, we think that small caps – more specifically the Russell 2000 – have by and large already discounted the mild recession that we in the Robeco multi-asset team do anticipate in 2024. Sure, not all of its constituents are exactly diamonds, since around 40% of Russell 2000 companies are loss-making. Investors willing to weed through the rough could pick up some gems nonetheless.

First, looking at the historical relative performance of the Russell 2000 versus the S&P 500, we observe that the Russell 2000 currently almost matches the average peak-to-trough relative performance prior to the onset of an NBER recession. Since its cyclical peak versus the S&P 500 in March 2021, the Russell 2000 has lagged by 29%. This implies that the Russell 2000 already has discounted 93% of the typical recessionary peak-to-trough of 31%. Of course, history may not rhyme, as index ratios may not be a stationary time series, since fundamental shifts in the economic structure may have caused structural breaks. For instance, small caps could face additional downside relative to large caps in a persistent above-target central bank inflation regime, where large-cap firms with the highest pricing power continue to take it all.

Second, we observe that the Russell 2000 tends to outperform the S&P 500 after the trough of an NBER recession. If our mild recession call in 2024 proves to be correct, next year could see a major inflection point, as the Russell 2000 has seen an average outperformance of 10% in the 200 trading days following a US recession trough.

Theme of the month

The S&P 500 has lagged the Russell2000 after a trough in a NBER recession



Source: Refinitiv Datastream, Robeco

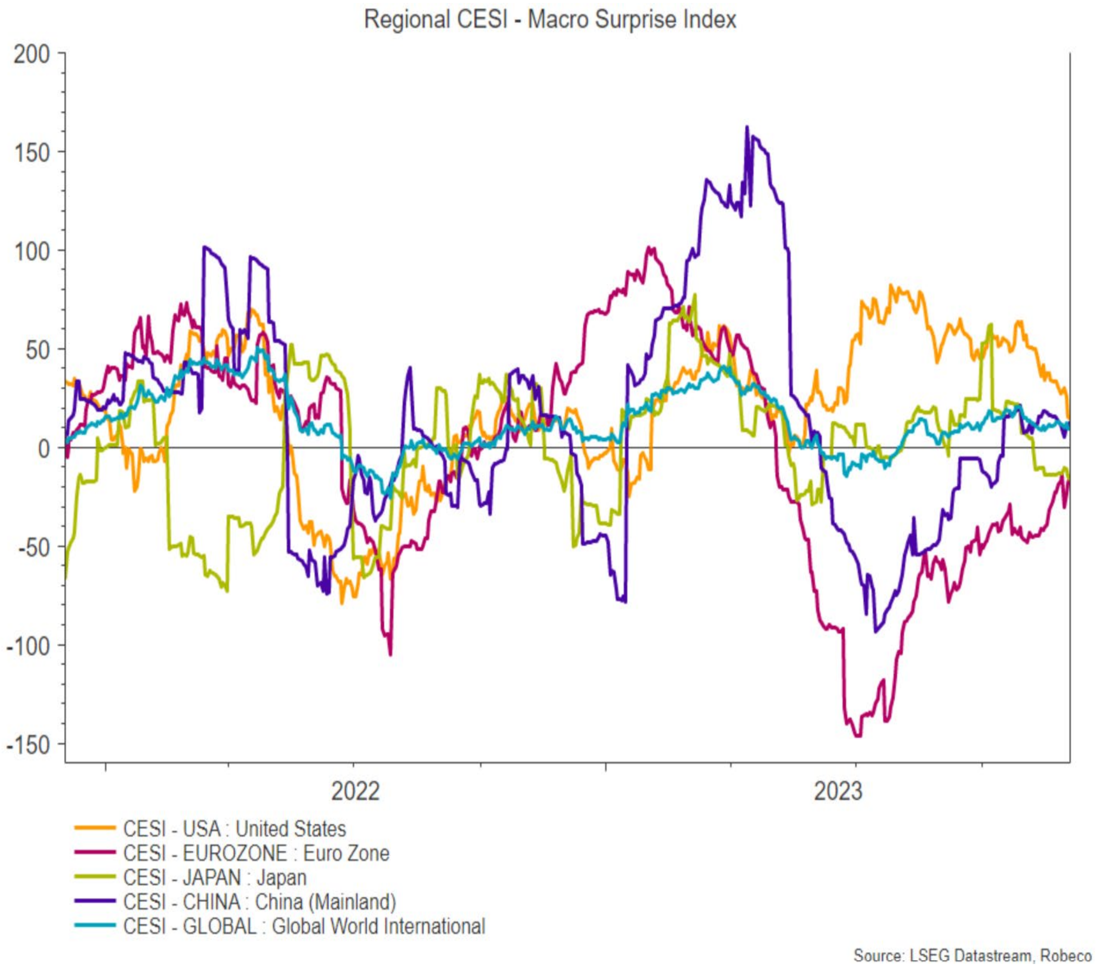
This observation is corroborated by our business cycle monitor which discerns four phases of the business cycle: recovery, expansion, slowdown and recession. Data since 1988 confirms that during the recession and recovery signals, the S&P 500 typically lost ground to the Russell 2000. The S&P 500 lost on average 0.2% on a monthly basis against the Russell 2000 when our business cycle monitor signaled recession. Applying the same analysis to the MSCI small caps 1750 index versus the MSCI large cap 300 index yields similar results.

Third, while we agree that Russell 2000 companies are more leveraged compared to the average large-cap company, and have higher refinancing risks, we are a bit more sanguine on the additional earnings fall-out for Russell 2000 constituents that will emerge as we move closer to a US economic downturn. The relative performance of the Russell 2000 versus the S&P 500 already seems aligned with the degree of excess tightening by the Fed, as measured by the difference between the actual Fed policy rate and the Taylor Rule formula tying the interest rate to levels of inflation and economic growth.

From a valuation point of view, the well-flagged concerns about the Russell 2000's higher rate sensitivity are largely discounted in relative performance. Of course, in a bear case scenario, additional downside risks could prevail for the Russell 2000 if the Fed refuses to swiftly change tack in face of a recession – perhaps because of sticky core inflation. By leaving real rates too high for longer, additional excess tightening by the Fed would likely delay the typical inflection point for small caps.

Economy

Eurozone data comes in stronger, US weaker



Source: Refinitiv Datastream, Robeco

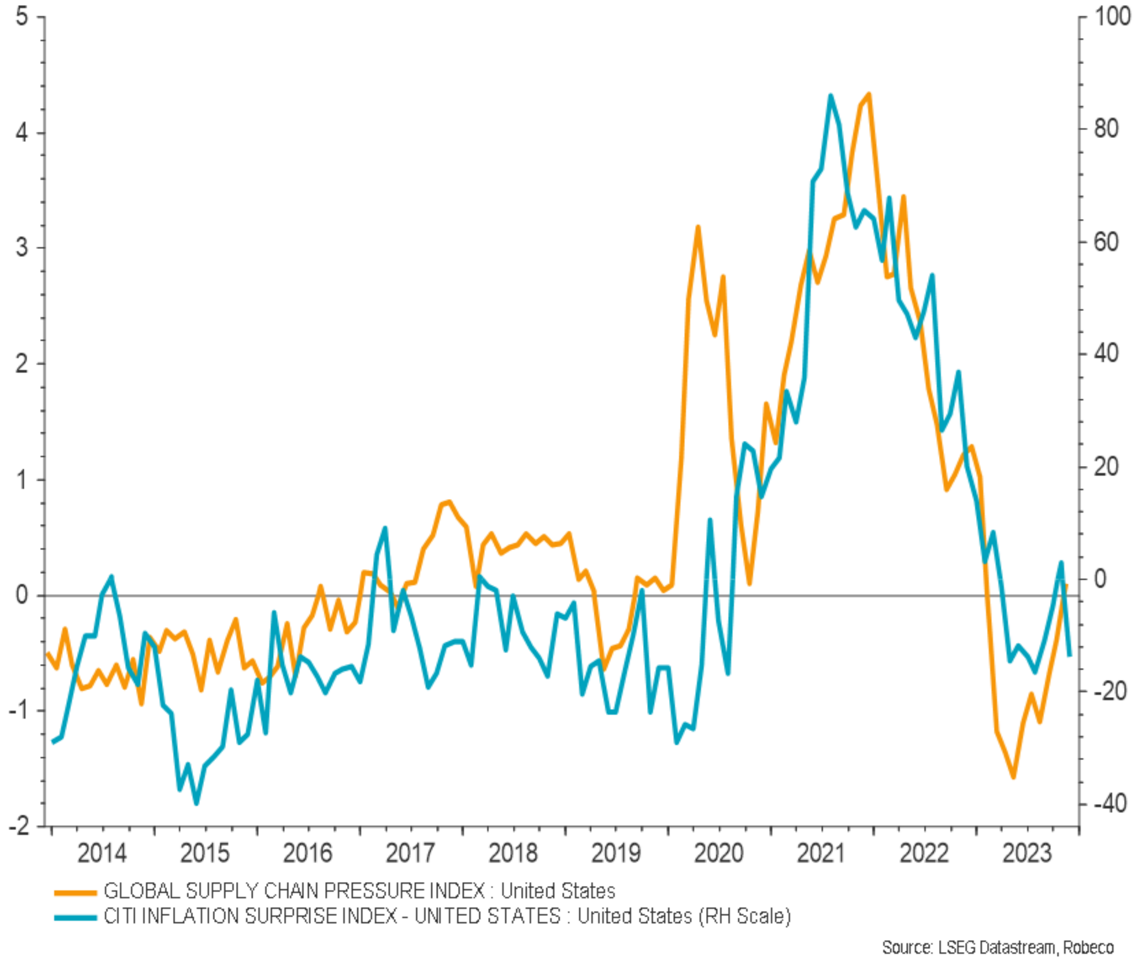
The global economy is firmly in the slowdown phase of the business cycle. Yet, the G7 economic slowdown has been far less pronounced compared to prior expectations. This is reflected in global macroeconomic surprises which have remained in positive territory in the year to date. Increasingly, these upward surprises are mainly concentrated in Europe and China, while the degree of upward macro surprises in the US and Japan have started to disappoint. Leading indicators for both services and manufacturing in the private sector have improved, hinting at a firming of China's recovery.

In Europe, the S&P Global composite PMI came in at 47.6, signalling decelerating contraction. A nascent recovery in US manufacturing activity seemed to stall, with the ISM manufacturing remaining stuck at 46.7 in November. While Europe is less stagnant than expected, the Eurozone has likely entered a technical recession by Q4, while the US economy still has a lot of momentum after the exceptional 5.2% Q3 GDP growth. The services leading indicator at 52.7 showed accelerating expansion in November, while the uptick in the employment sub-index to 50.7 also indicated that labor demand in the services sector is not outrightly contracting yet.

Our 2024 outlook does envisage reinvigorated disinflationary efforts by central banks to coincide with higher employment costs. Lags between monetary policy tightening and subsequent real activity have proven exceptionally long in this cycle. Initial cracks in the employment situation (declining jobs per unemployed, lower quits) are however likely to widen, instead of being glossed over by a soft landing.

Economy

US inflation surprises are no longer on a firm downtrend



Source: Refinitiv Datastream, Robeco

While the process of disinflation has so far run smoothly for central banks, extrapolating past results into the near term is dangerous, and the retreat from hawkish language by several developed market central bankers might prove to be premature. Looking at the Citi inflation surprise index, the steady drop towards net negative surprises was recently dented. While this might only amount to a pause in the disinflationary process rather than herald the onset of a second inflation wave, it could wrongfoot central bankers and financial markets.

Several indicators we look at suggest that inflation surprises in the near term could turn positive in the US. First, global supply chain pressures have turned around and are increasing again. The recent attacks on ships in the Red Sea by Houthi rebels is just one example illustrating that the probability of negative supply shocks (that could deliver a cost/push inflation impulse) remains elevated. Second, an increasing percentage of US corporates intend to raise prices again, suggesting that core inflation could remain elevated in the near term as demand is deemed strong enough to absorb price changes. Third, the recent notable easing of financial conditions amounts to conventional policy rate cuts which is reflationary via the wealth effect.

While the Goldilocks sentiment reigns supreme, we think the US economy will cool much faster than the soft landing camp holds in 6-12 months time, while core inflation won't cool as much on a 1-6 month horizon.

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