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MEDIA RELEASE

As geopolitical risks rise, challenges high for equities; bonds could gain on rate cuts

Local and global equity markets face a challenging year ahead, but hopes are building that an easing in monetary policy could support current equity and bond valuations, though volatility is likely to rise given rising geopolitical risks and economic uncertainty, according to GSFM and its fund manager partners Tribeca Investment Partners, Man GLG and Payden & Rygel.

Moderating inflation in the United States (US) and the prospect of policy rate cuts may provide a more positive environment for equities, but that should be weighed against the possibility that substantial policy rate reductions are reflected in current valuations, according to GSFM investment strategist Stephen Miller.

"With geopolitical risks remaining elevated, and structural forces likely to keep inflation higher, there will inevitably be episodes of volatility.

"There is a plethora of elections to be conducted around the globe this year, led by US Presidential elections.

"At the same time, conflict in Gaza and Russia-Ukraine and increasing tensions between China and Taiwan and on the Korean peninsula could all weigh on global economic activity and keep prices elevated and add to supply bottlenecks.

"The consensus view is of a "goldilocks" or resilient economy in which inflation declines to an extent that central banks can make cuts to policy rates. In this scenario, bond yields may fall and support equity markets. But the "goldilocks" scenario is largely priced and could potentially be upset by any number of variables from geopolitical challenges, structural forces keeping inflation higher and shifts in national and international regulatory regimes.

"Alternately, recession risk, while one side of the risk continuum, is probably non-trivial. Much of the resilience in the US last year may have reflected a fiscal "sugar hit" as the US budget deficit grew to 7 per cent of GDP despite the economy hovering at full employment. That may well abate this year, perhaps occasioning a sharper than anticipated growth slowdown" said Mr Miller.

Such an environment emphasises the importance of diversification. It should also increase the potential return from skilled active stock-picking as volatility leads to greater dispersion of individual stock returns.

Tribeca Investment Partners' lead portfolio manager, Jun Bei Liu, anticipates a robust upswing in the equity market, driven by further strides by central banks in curbing inflation and the start of interest rate cuts.

“We expect a short, contained economic slowdown rather than a prolonged one. We don’t think central banks or governments need to solve all the world’s concerns. Incremental gains are enough to allow many stocks that are discounted for a more severe downturn to trade higher particularly within the cyclical space or in areas where higher inflation and rates remain priced as structural rather than short term,” she said.

“Furthermore, because the economic slowdown has taken its time to unfold (rather than via a large shock), different stocks and sectors are at different stages of the cycle. This provides some resiliency when viewed across the market as some stocks can perform well while others come under pressure.

“We think equity valuations are reasonable. For equity investors, we should focus on incremental improvement as catalysts for upside and we think 2024 will see plenty of this.”

Ms Liu notes that across the broader Australian equity market, many stocks are trading at their cheapest levels in many years. In terms of individual sectors, she likes retail stocks.

“Despite an expected weaker first half, underlying earnings should begin to reflect economic reality while heading into a better environment within six months or so,” she said.

“The resource sector is also going to be another outperformer – with China turning the corner after substantial policy stimulus that is targeted at housing and the consumer,” she said.

“Alongside an improving equity outlook, we think government bonds will also provide reasonable returns for investors who have been hit hard by rising rates in the lag two years. Extending duration in government bonds also provides a hedge against growth risks should our central case prove incorrect,” she said.

Man GLG Asia Opportunities Fund portfolio manager, Andrew Swan, said some of the most promising markets in global equities include the emerging markets of India and Indonesia.

“I think South Asia is probably the most promising part of Asia, and I think even relative to most markets globally, there is quite a bit of opportunity in these economies. Indonesia and India have continued to grow in the last couple of years, because of low debt levels, young demographics and mostly domestic demand-driven economies.

“In addition, these economies do not have an inflation problem. But while there is no inflation problem in these economies, interest rates are high relative to their historic levels. The opportunity therefore is as the US Federal Reserve comes to a halt in terms of rate increases and potentially even starts to cut rates, central banks in India and Indonesia and other Southeast Asian nations will be empowered to cut rates quite aggressively, and that will stimulate further demand within these economies,” Mr Swan said.

Ehsan Iraniparast, senior vice president and emerging market analyst with Payden & Rygel, says the combination of a fairly stable US labour market, moderating inflation, a bottoming in US manufacturing activity, and less hawkish global central banks all support of softer economic landing outcome in coming months rather than a hard economic landing.

“We feel that emerging market central banks gained good credibility in the latest macro cycle, responding earlier than developed-market peers to the inflation threat. This enabled them to begin monetary easing in 2023 amid dissipating inflation pressures, a trend we expect to continue in 2024.

"Lower rates can help emerging market growth stay resilient, despite a busy election calendar and pockets of geopolitical risk. Credit spreads in emerging markets performed well through end-2023, leaving valuations less interesting to start 2024, but nevertheless all-in yields in hard currency fixed income are compelling.

"We think uncertainty around global growth and inflation make the carry and duration in local government bonds favourable relative to other opportunities." he said.

Either way, according to Mr Miller, greater financial market volatility will create greater opportunities for investors.

"Indeed, the number of 'known unknowns' and the certain existence of 'unknown unknowns' implies at the very least episodic bouts of volatility. This could lead to higher dispersion of returns for assets, creating opportunity for skilled active fund managers.

"Higher volatility too underscores perhaps the most important and over-arching principle of investing: diversification. That doesn't just mean via security selection within a particular asset class or sector but also diversification away from both bond and equity risks within multi-asset portfolios," he said.

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