

An aerial photograph of a red SUV driving on a snowy road. The car is positioned in the lower right quadrant of the frame. The road is a narrow path cut through a vast, white snowy landscape. Long, soft shadows of trees and the car stretch across the snow. In the foreground, several evergreen trees are visible, their green needles contrasting with the white snow. The overall scene is bright and serene, suggesting a winter setting.

Outlook 2024

In search of quality

Outlook 2024

In search of quality

Economy

- Below-average economic growth is expected for 2024.
- Inflation is set to gradually decline further in the USA and the eurozone.
- Central banks are unlikely to start cutting interest rates before the second half of 2024.

Financial markets

- Heightened market volatility is expected over the course of the year.
- The refinancing requirements of companies will increase in the coming years. In the case of corporate bonds, this will lead to greater differentiation between issuers with good credit profiles and those with weaker balance sheets.
- In terms of equities, we favour quality stocks with high and sustainable profitability for 2024.

Risks

- A geopolitical escalation and the resulting rise in energy prices could fuel inflation once again.
- The US presidential elections in November 2024 will have global implications.
- A sharp slowdown in China and the rising levels of national debt are further areas of concern.

World economy: below-average growth

The US economy proved surprisingly resilient in 2023, despite record-high financing costs. Strong household consumption, supported by surplus savings from the pandemic, was the driving force behind this. However, this effect, as well as various fiscal stimulus measures, will end in 2024. Growth is therefore likely to be only half as strong as in 2023.

Europe's economy was already significantly weaker in 2023. Germany in particular, the former growth engine of the eurozone, struggled to gain momentum. The consequences of the energy price shock in 2022 and weaker foreign demand weighed on manufacturing. At the same time, wages were unable to keep pace with inflation, which reduced the purchasing power of private households. This should change in 2024 in view of lower inflation. Higher real income should support private consumption in 2024 and lead to a moderate recovery in Europe. However, with GDP growth expected to be slightly below 1 per cent, the outlook for the monetary union remains subdued.

Overall, in 2024 below-average growth is expected for the global economy.

Risks

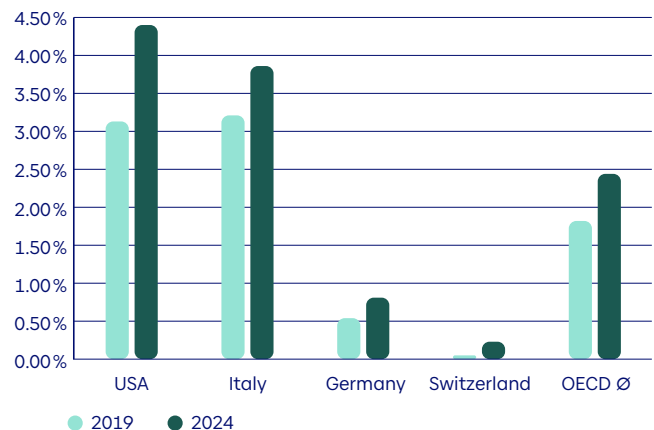
Towards the end of 2023, geopolitical risks resurfaced. These are likely to remain significant in 2024. The key risk for global economy is that rising energy prices due to an escalation in the Middle East could fuel inflation again.

The US presidential elections in November are not only likely to shape US domestic policy, but also provide important impetus for global geopolitics. If the Republicans win, for example, significantly less US aid for Ukraine can be expected. The relationship between the USA and China could also deteriorate further in this case.

There are also economic risks. China's property crisis is bringing the structural problems of the economy to light. Unlike in previous crises, the government in Beijing is focusing on targeted measures to stimulate the economy. However, the success so far has been muted. A sharp slowdown in China would significantly dampen global economic growth. Countries with strong trade links to China, such as Australia, South Korea and Chile, would suffer the most. Europe is also exposed in this respect.

Interest payments by governments are increasing

Net interest payments of the government as a percentage of GDP



Sources: Baloise, OECD as of 23 November 2023

Higher interest rates also mean higher interest burdens for households, companies, and governments. Governments in particular have increased their debt in recent years, partly due to the pandemic. On average, interest payments in OECD countries are likely to rise from 1.8% of GDP in 2019 to 2.4% in 2024. The greatest increase in the debt burden can be seen in the USA, but the Italian government is also facing renewed pressure. Discussions about national debt and its sustainability are thus likely to intensify in the coming years.

Figures at a glance, in per cent compared to previous year

		2023	2024
Switzerland	GDP growth	0,8%	1,1%
	Inflation*	1,9%	1,4%
USA	GDP growth	2,3%	1,0%
	Inflation**	3,2%	2,3%
Eurozone	GDP growth	0,5%	0,7%
	Inflation*	3,2%	2,2%
China	GDP growth	5,2%	4,5%
	Inflation*	0,5%	1,8%

*Year-end value. **Measured on the consumption deflator.

Sources: Baloise, Bloomberg Finance L.P., as of 22 November 2023

Monetary policy: No interest rate cuts before mid-2024

After central banks have tightened monetary policy significantly over the last two years, policy rates are likely to be lowered again in 2024 thanks to an easing of inflationary pressure. However, a rapid turnaround is not to be expected.

Lower inflation, but not there yet

Inflation rates fell significantly in 2023. In the eurozone, for example, they fell from over 8% in January to below 3% in October. This is due to base effects, lower energy prices and the easing of material and supply bottlenecks.

For 2024, we expect a further gradual decline in inflation rates in the US and the eurozone towards 2%. However, these effects will no longer dominate the inflation trajectory. Instead, the dampening effect of higher interest rates will drive the further decline and should only come into play gradually. A rapid and sharp decline from current rates is therefore not expected.

In Switzerland, we expect prices to rise slightly, meaning that inflation in Switzerland is likely to be slightly above 2% again at the start of 2024. This will be driven by higher rents, rising electricity prices and the VAT increase. However, inflation expectations are not expected to rise significantly, as inflation is likely to decline slightly towards the end of the year.

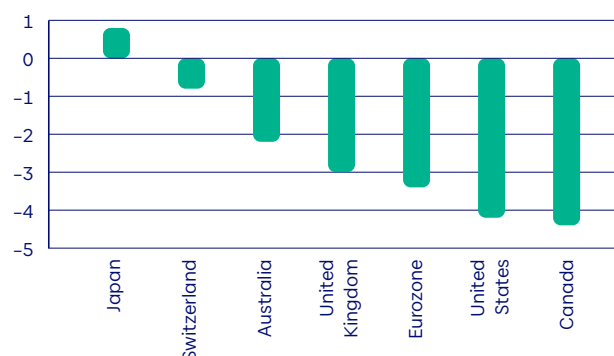
Policy rates at high levels for the time being

For the central banks, this means that they will continue to pursue their restrictive policy in the coming months. Interest rate cuts are not expected before the second half of the year if the economy develops as expected. However, the US Federal Reserve is already expected to cut interest rates four times in the second half of the year. Analysts also expect at least three rate cuts from the European Central Bank.

The economic risks also come into play here (see “World economy” section). A geopolitical escalation would tend to have an inflationary effect and delay the first interest rate cuts. A further weakening of the global economy triggered by even weaker demand from China, on the other hand, would argue in favour of earlier interest rate cuts.

Expected change in interest rates until the end of 2024

Number of interest rate increases/decreases of 25 basis points according to consensus forecasts



Sources: Baloise, Bloomberg Finance L.P. as of 23 November 2023

Bonds: companies' refinancing needs - when the clock is not ticking at the same speed for everyone

Following the significant easing of monetary policy over the last 15 years, both governments and companies have taken on more debt. This was the right strategy in the zero and negative interest rate environment but is increasingly taking its toll on short-term debt in the current market environment.

The abrupt increase in policy rates by the central banks tends to have a negative impact on companies' margins and therefore on the quality of a loan. In view of the geopolitical uncertainty, investors are also demanding a higher risk premium. This particularly affects cyclical sectors (e.g. automotive or catering), sectors with high capital intensity (e.g. utilities or telecommunications) and business models with a high level of debt financing (e.g. real estate). On the global bond market, we are observing increasing differentiation according to credit

quality. This means that the differences in credit risk premiums between high-yield bonds and companies with good to very good credit ratings and higher liquidity buffers have widened.

From an investor’s point of view, the mixture to avoid now is companies with a high debt burden and a concentrated maturity structure, weak operating cash flows and less robust balance sheets. This is very often the case with high-yield issuers, which naturally have a high level of debt. In addition, at the height of the Covid crisis, many high-yield issuers in the US market took out leveraged loans with variable borrowing costs. It is therefore not surprising that credit analysts and rating agencies¹ see global default rates continuing to rise into the first half of 2024.

How fast is the debt clock ticking? Investment grade companies have more room for manoeuvre. They can refinance themselves on the capital market more frequently and for longer terms and, if necessary, sell assets from their balance sheet.

However, a well-founded credit analysis remains central here too. This is typically done using defined criteria such as the interest coverage ratio. This shows how well a company can cover its interest payments from its profits². We also look at the distribution of the debt burden (“the longer it is spread over the years, the better”). The traffic lights are currently green for investment grade issuers. For high-yield borrowers, on the other hand, the traffic lights are increasingly amber for larger borrowers and often already red for smaller ones. The short-term refinancing requirements for 2024 and subsequent years are high to very high (see chart), and margins will come under further pressure as financing costs rise.

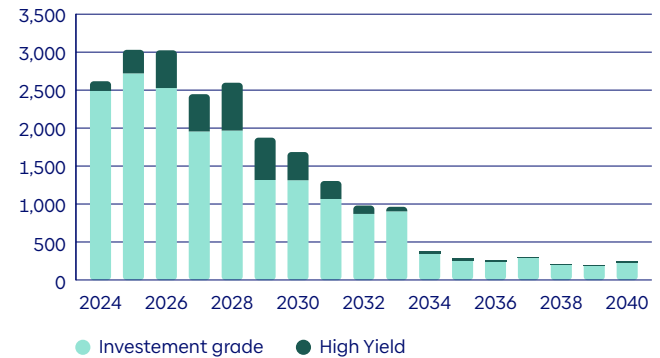
¹ Credit Benchmark (2023): Default Rate Forecast for Q3 2024: US and UK Speculative Grade Corporates, URL: [https://www.credit-benchmark.com/default-rate-forecast-for-q3-2024-us-and-uk-speculative-grade-corporates/#:-:text=S%26P%20will%20report%20provisional%20Q3,4.25%25\)%%20by%20Q2%202024%2C](https://www.credit-benchmark.com/default-rate-forecast-for-q3-2024-us-and-uk-speculative-grade-corporates/#:-:text=S%26P%20will%20report%20provisional%20Q3,4.25%25)%%20by%20Q2%202024%2C) [16.08.2023] and

Fitch Ratings (2023): U.S. HY Bond Defaults to Rise, Despite Dip in Concern Lists, URL: <https://www.fitchratings.com/research/corporate-finance/us-hy-bond-defaults-to-rise-despite-dip-in-concern-lists-14-06-2023> [14.06.2023]

² This ratio consists of earnings before interest, taxes, depreciation and amortisation (EBITDA) divided by the gross interest payable. An EBITDA multiple of five or higher is regularly expected for investment-grade issuers (“the higher the better”). The aforementioned threshold is currently well met by investment-grade companies, but declined in the first half of 2023.

Maturity profile of bonds by rating class in hard currencies*

in CHF billion



*Bonds in USD, EUR, GBP and CHF with existing credit rating and outstanding volume of > CHF 100 million

Source: Ratingmonitor as of 17 November 2023

Are high-yield bonds unattractive against this backdrop? No, on the contrary, in the current environment default risks are being better compensated again. In the past, this has typically signalled a good time to invest. We favour investment grade companies and high-yield issuers with a credit rating of at least BB-. Here, the clocks tick reliably, and we consider the (lead) time for refinancing on the market to be sufficient even in difficult markets.

In conclusion we expect an even greater differentiation between issuers with good credit profiles and those with weaker balance sheets in 2024.

Equities: Interest rates as a risk but also as an opportunity

The path of interest rates is the most important risk factor, but also the greatest opportunity for equity markets in 2024. Higher refinancing costs are putting pressure on corporate profits. The most important central banks are likely to start lowering their policy rates in the second half of the year. This turnaround in monetary policy would support companies’ shrinking profits and margins and thus share prices. However, it is uncertain how quickly and to what extent the central banks will ultimately cut key interest rates.

We therefore expect the stock markets to be volatile in 2024, with a sideways to slightly positive trend. Despite a slowdown in growth, we consider the US market to be better positioned than other markets due to the expected corporate profits. In the subdued growth environment, the Swiss equity market should also prove its resistance to the crisis once again. In contrast, we expect a difficult

2024 for the eurozone equity markets due to the ongoing weak growth, which is likely to be reflected in shrinking corporate profits over the next few quarters.

We continue to favour quality stocks with high profitability next year. In Europe, we also favour more defensive stocks, while in the USA we would avoid stocks with excessively high valuations. Caution is particularly warranted with the so-called “magnificent seven” (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta Platforms and Tesla). These stocks were responsible for almost all the growth in the US equity market in 2023 and all have two things in common: they are leaders in their sector and have a high weighting in cap-weighted indices.

The rise of these stocks has resulted in higher market concentration. This means that fewer and fewer stocks are driving the return of an overall equity index. As a result, the diversification effect decreases, and volatility increases. This concentration phenomenon can be measured using a concentration measure known as the Herfindahl-Hirschman Index (see chart). Of the approximately 1,500 shares in the MSCI World Index, only around 120 (8%) are currently driving performance. However, history teaches us that such heavyweights do not perform above average forever and that phases of high excess returns can often be followed by volatile phases with equally high below-average returns.

MSCI World: Fewer stocks drive overall return

Effective number of shares according to the standardized Herfindahl-Hirschmann Index



Sources: MSCI, Baloise

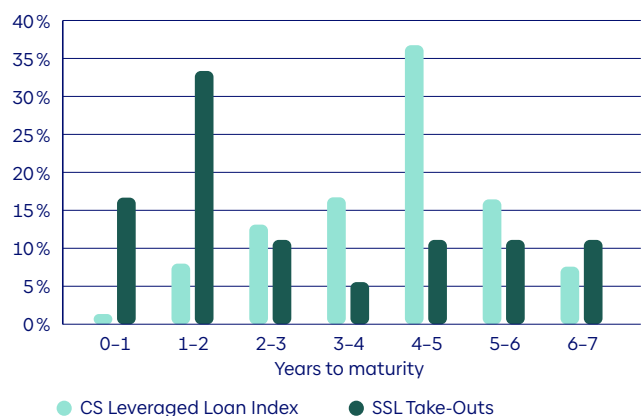
Private assets: Shift from senior secured loans to the direct lending market

The outstanding volume of US Senior Secured Loans (SSL) decreased in 2023, which can be attributed to several reasons. One of the main reasons is as follows: In 2023, numerous companies left the senior secured loans (SSL) market and borrowed on the private credit market (corporate direct lending). Are “weak” companies now migrating away from the SSL market as they are unable to refinance at the higher interest rates? Will this migration trend shift higher future default rates from the SSL market to the corporate direct lending market? What are the consequences for investors in the SSL and corporate direct lending asset classes?

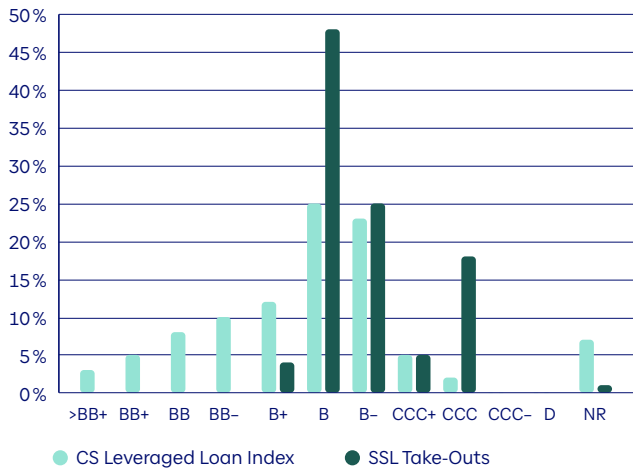
An analysis of the 18 largest US transactions (“SSL take-outs”) in the years 2022-2023 reveals the following:

- It is by no means the case that only weak companies are turning their backs on the SSL market. The credit ratings are broadly diversified.
- However, some of the companies with outstanding CCC-rated SSL would have had to refinance in the next two years. This would have been difficult in the current environment. The opportunity to refinance in the private market was therefore very welcome for these companies.
- The migration trend could lead to lower default rates on the SSL market. However, there is no clear picture, which is why we assume that this effect will only be marginal.

Maturity profile of loans



Ratings



In % of the outstanding nominal value.

Sources: Bloomberg, Credit Suisse, own calculations as of 31 October 2023

This has the following implications for investors in SSL and corporate direct lending:

- The observable migration trend of some companies from the more mature SSL market to the younger corporate direct lending market is the result of an optimisation of their financing structure. The two markets, SSL and corporate direct lending, are complementary and there is no systematic crowding out.
- However, this trend needs to be monitored further to better understand the shift in debtor quality.
- Whenever disruptions emerge in markets, opportunities open for “good” managers – while it becomes difficult for “weaker” managers. The importance of careful manager selection is therefore even more important.

Real Estate Switzerland

Real estate investors will continue to focus on interest rate trends and the associated reassessment of risk premiums for properties in the coming year. However, due to the upward trend in rental income, particularly in the residential segment, income yields on properties are likely to remain attractive in 2024.

Immigration is expected to remain at a high level. This, coupled with the increasing need for living space per inhabitant, is likely to have a positive impact on the demand for rental flats. Additionally, the extended construction stagnation, fuelled by higher interest rates and regulatory obstacles hinders the supply side. As a result, asking rents are likely to rise further.

The market for office space in peripheral locations continues to come under pressure, resulting in lower rents. This is a result of modest economic growth and the increasing number of companies allowing employees to work from home. Rents are expected to remain stable in centre locations such as Zurich, Basel, Bern and Geneva.

Retail space in peripheral locations remains under pressure, which has a negative impact on prices on the one hand, but also encourages owners to repurpose the space on the other.

Trend: Sustainability

Sustainability continues to be another focus topic for property investors. For directly held properties, there is a need to explore ways to reduce energy consumption and refurbish them in a CO₂-neutral manner, aligning with regulatory requirements. Property strategies need to be developed that take both ecological and economic criteria into account.

The sustainability requirements for indirect property investments are also constantly increasing. The focus here is on creating transparency and thus comparability of the individual products. On the one hand, transparency is ensured by benchmarks such as the “Global Real Estate Sustainability Benchmark” (GRESB), which assesses not only the resource consumption of a portfolio (environment) but also social sustainability (social) and responsible corporate governance. Simultaneously, regulation in sustainability is also increasing. From 2024, the Asset Management Association Switzerland (AMAS) will require the publication of environmentally relevant key figures such as energy consumption and intensity.

Implications for the portfolio

Thanks to falling interest rates, we expect at least moderately positive overall performances for the most important asset classes of mixed portfolios in 2024.

With the end of the low interest rate environment, investors’ hitherto inevitable focus on equities and property shifted back towards bonds. Various yield curves reached record highs in 2023, not only in shorter maturities.

A significant underweight in high-quality bonds therefore no longer seems appropriate, also thanks to the prospect of falling hedging costs. Of course, it should be noted that volatility in the bond market remains above average. A stagflationary scenario, for example triggered by a war-related oil crisis, cannot be completely ruled out in 2024.

The situation regarding equities and property is more uncertain in the wake of the economic slowdown and the new interest rate situation.

Thanks to generally fair valuations and investors who have been cautious to date, we do not consider the risk of sharp price falls to be above average and are therefore only slightly underweight in equity investments (details in the “Equities” section). Of course, it is important to keep an eye on systemic risks in the wake of the extremely rapid rise in interest rates and the impact on sovereign debt, banking stability and corporate insolvencies.

With the predicted end of the rise in interest rates and the significant devaluations abroad, which have only been modest in Switzerland, opportunities are also arising

again in real estate investments. In Switzerland in particular, the fundamental data for the property market remains positive and we are taking selective tactical overweights in this asset class.

The return expectations of the various investment segments have moved closer together overall with the rise in interest rates, which makes it advisable to take a broad view of asset classes. At the same time, we see the opportunity and the need to increasingly utilise fluctuations in asset classes with tactical positioning and to temporarily hedge portfolios against risks with efficient hedging strategies.

Editorial office

Melanie Rama

Senior Economist, Investment Strategy
melanie.rama@baloise.com

Samuel Müller

Portfolio Manager Private Assets
samuel.mueller@baloise.com

Lukas Staehelin

Portfolio Manager Real Estate
lukas.staehelin@baloise.com

Dominik Schmidlin

Head Investment Strategy
dominik.schmidlin@baloise.com

Cédric Willi

Senior Portfolio Manager Fixed Income
cedric.willi@baloise.com

Andreas Bertschi

Senior Portfolio Manager Multi Assetss
andreas.bertschi@baloise.com

Dominik Sacherer

Portfolio Manager Fixed Income
dominik.sacherer@baloise.com

Philippe Oster

Senior Portfolio Manager Fixed Income
philippe.oster@baloise.com

Baloise Asset Management Ltd

Aeschengraben 21, 4002 Basel
baloise.ch

Appearance

Editorial deadline: 23 November 2023

Disclaimer

Baloise Asset Management Ltd assumes no liability for the key figures and performance data used. The content of this publication contains opinions on market developments and is intended solely for information purposes and not as investment advice. In particular, the information in no way constitutes a purchase offer, an investment recommendation or a decision-making aid in legal, tax, economic or other matters. No liability is accepted for losses or lost profits that may arise from the use of the information. SIX Swiss Exchange Ltd (SIX Swiss Exchange) is the source of the Swiss Market Index (SMI) and the data contained therein. SIX Swiss Exchange was not involved in any way in the preparation of the information contained in this report. SIX Swiss Exchange makes no warranty and disclaims all liability (whether arising from negligence or otherwise) in relation to the information contained in this report – including, but not limited to, its accuracy, adequacy, correctness, completeness, timeliness and fitness for any purpose – and in respect of any errors, omissions or interruptions in the SMI or its data. Any distribution or dissemination of information originating from SIX Swiss Exchange is prohibited.