Sun Life Global Investments
INSTITUTIONAL

Market Outlook 2024

Contents

Foreword

We are proud to present **Sun Life Global Investments' Market Outlook** to help inform your strategic position for 2024. We've collected unique and current views from our Multi-Asset Solutions Team and some of our sub-advisors on what's ahead for this year.

Oricia Smith
President, SLGI Asset Management Inc.
and Senior Vice-President, Investment Solutions,
Sun Life Canada

A look back

Our purpose is to help Canadians achieve lifetime financial security to live their most meaningful lives. This was a key driver of our latest enhancements to Sun Life Granite Target Date Funds (Granite TDFs). In 2023 we:

- Moved to a unit trust structure for more flexibility and a broader investment universe
- Optimized retirement outcomes through robust glidepath stress-testing
- Increased equity across the glidepaths and landing points to gain growth potential
- Added liquid alternatives and direct real estate and infrastructure to our strategic asset mix*
- Created conservative, moderate and aggressive retirement options
- Varied our manager diversification by including different styles and investment processes

* These asset classes will be gradually added over 2024.

We are confident that these changes will deliver stronger retirement outcomes for all plan members invested in Granite TDFs.

Our strengths

Our strengths remain the same. We know our open architecture, multi-manager approach, and our continual focus on retirement outcomes gives us–and our Clients–an advantage. And we continue to build on our strong foundation. These strengths contributed to the many enhancements in Granite TDFs, and also to Granite income funds with additions of a new U.S. options strategy, private fixed income and commercial mortgages.

Responsibility

We have a responsibility to investors who trust us to act with honesty, in good faith and always in their best interest. Factors such as regulatory

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Foreword

change, climate risk and opportunities, and corporate responsibility can have a material impact on an investment's performance. This is why we consider environmental, social and governance (ESG) issues across our investment process - and why we have committed to achieving net zero greenhouse gases by 2050. We have added a number of new strategies within Granite TDFs to capitalize on opportunities in this area and to further our net zero commitment. We will continue to engage with our existing managers to affect change, as well as explore opportunities with new managers to continually progress our commitment.

Paving a path to decumulation

We want to be there for our Clients and support them at all stages of the plan member retirement journey. We continue our goal of helping Canadians manage their wealth in retirement – a phase that doesn't always get the attention it deserves. This means developing investment solutions designed to help plan members withdraw from their investment savings, and designed to help ensure that their money lasts as needed. It's a retirement outcome that's important - we have some exciting plans this year on that front and will soon share more details.

What's next?

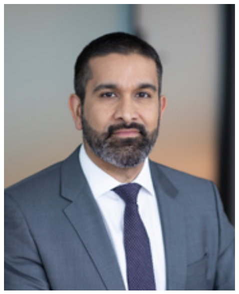
We all want to know what this new year holds. Will we achieve a soft landing or are we entering a recession? Will interest rates start to fall? You can follow more insights from our portfolio managers in our *From the Desk* LinkedIn newsletter.

Although we can't predict the future, we will strive to be a leader in decumulation and strengthen retirement outcomes for our Clients. We will continue to evolve and strengthen our flagship Granite TDFs. And we'll continue to capitalize on opportunities and execute on the initiatives that will give our Clients confidence in their financial futures with us.

Thank you for your partnership and we hope you find this Market Outlook insightful. We look forward to working with you through 2024.

We want to be there for our Clients and support them at all stages of the plan member retirement journey. We continue our goal of helping Canadians manage their wealth in retirement – a phase that doesn't always get the attention it deserves.

Key themes for 2024



Chhad Aul
Chief Investment Officer and
Head of Multi-Asset Solutions,
SLGI Asset Management Inc.

What's ahead this year?

- Soft vs. hard landing
- Economic divergence
- Systemic stress event
- Diversification returns
- An environment for active management

1. Soft vs. hard landing

- In 2023, one of the major debates was whether economies would experience a hard landing (recession) or a more muted soft landing. In 2024, we will finally get the answer.
- The definition of a soft landing was a moving target in 2023. In our mind, a slowdown that reins in inflation without a significant spike in the unemployment rate would qualify as a soft landing.
- Economies were resilient to high interest rates in 2023 due to large accumulated household savings and loans that were locked into low rates during the pandemic. These supports continue to fade as excess savings are consumed, and loans continue to mature.
- We're cautious of a soft landing "goldilocks scenario" as it is rarely achieved. But, we're open to the idea that if inflation continues to normalize, policymakers could pivot to easing monetary policy. We will pay close attention to leading labour market indicators.

2. Economic divergence

- Even if we achieve a soft landing, it may not occur evenly across global economies.
- The U.S. is most likely to achieve a soft landing as its growth is still strong, compared to Canada and Europe that are showing some signs of struggling.
- If U.S. bond yields remain higher for longer, global yields may also move higher and elevate borrowing costs in weaker economies (like Canada and Europe), exacerbating economic divergence. This would be positive for U.S. dollar assets.

3. Systemic stress event

- 2023 saw little in the way of systemic stress in the market. The failure of several U.S. regional banks in March provided a bit of a test; however, policy makers moved quickly to contain the issue.
- Market consensus is that a systemic stress event is unlikely in 2024. By their very nature, these are low probability tail events.
- After the historic rate-hiking campaigns of 2022/2023, is a systemic risk event possible? Could it be a "known unknown" like U.S. regional banks, commercial real estate or a series of high-profile credit events? Or could it be an "unknown unknown"? We remain vigilant and continue to assess.

Key themes for 2024

4. Diversification returns

- Traditional diversification rules have been challenged in the past two years of higher inflation. When high inflation is the main driver of yields, bond prices and equities tend to be correlated.
- As inflation continues to cool, economic growth becomes the predominant driver of bond yields and the diversification benefit of bonds against equities typically reasserts itself.
- Importantly, if markets are wrong and we experience a hard landing, stocks will fall as earnings expectations are marked down. But bonds stand to perform well as interest rates drop.
- Cash is earning a decent yield for the first time in many years. But investors with a large cash allocation face reinvestment risk, as central banks may decide to cut interest rates soon. As cash rates fall, these investors are likely to miss out on some strong performance from more balanced portfolios - now is the time to plan for redeployment of cash into a more broadly diversified portfolio.

5. An environment for active management

- 2023 was marked by exceptionally low breadth within markets. While the breadth improved in the last two months of the year, seven U.S. stocks popularly called the “magnificent seven” drove a significant portion of the S&P 500 gains.
- With this narrow leadership, particularly among the largest stocks in the market, it’s very difficult for active managers to add value above and beyond market-cap based passive indexes.
- In 2024, we believe market breadth will expand. In an economic soft landing scenario, broader sections of the market could rally and relative 2023 laggards may catch up. On the other hand, if a hard landing unfolds, high-quality companies with strong balance sheets and resilient earnings could outperform their risker counterparts.
- Both scenarios provide an ideal backdrop for disciplined active managers to outperform.

Canadian fixed income

PH&N Investment Services

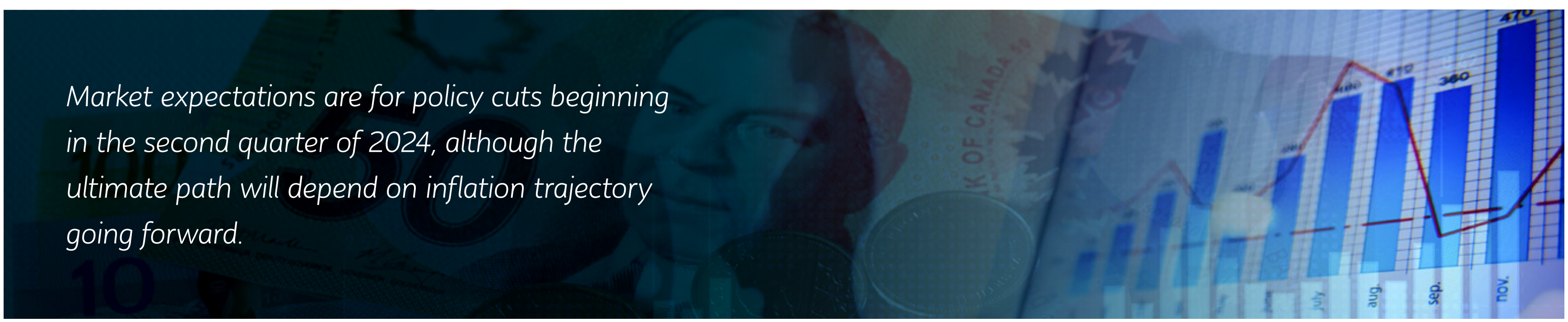
Canadian fixed income headwinds 2024:

- The U.S. economy is still growing and odds of a soft landing (vs. a recession) have increased. The Fed is shifting its focus from fighting inflation to balancing economic growth.
- The fourth quarter rally in fixed income and equities is contributing to easing financial conditions. The large magnitude of the rate rally lends itself to the possibility of a partial reversal in the first half of 2024, especially if accompanied by upside inflationary surprises.
- Geopolitical events carry inflationary risk (oil price shock, supply chain disruption) which, if realized, could slow the implementation of anticipated central bank rate cuts.

Canadian fixed income tailwinds 2024:

- Inflation continues its descent from 2022 peaks as higher interest rates have reduced price pressures on goods and services. Market-implied inflation expectations are now down to 2.2% (5yr) and 1.8% (30yr).[1] Structural effects (i.e., demographics, technology) are also contributing to downward pressure on inflation.
- Interest rates remain elevated by modern standards and recent data show that consumers and businesses are feeling pressure from higher rates. Bank lending standards continue to tighten. The economy is expected to continue slowing through the first half of 2024.
- The Bank of Canada acknowledged in November[2] that the economy is no longer in a state of excess demand. Market expectations are for policy cuts beginning in the second quarter of 2024, although the ultimate path will depend on inflation trajectory going forward.

[1] Source: RBC GAM as of December 31, 2023
[2] Bank of Canada, November 22, 2023: https://www.bankofcanada.ca/2023/11/ending-the-pain-of-high-inflation/



Fixed income: U.S. investment grade

SLC Management

Markets eye the Fed's policy directions, but there are risks to following rate signals and predictions

The 2023 calendar year might be characterized by an expected recession that never was. The strength of the U.S. consumer helped both equities and credit spreads to shake off successive threats from inflation, geopolitical conflicts, three large bank failures and sectoral challenges in healthcare, cryptocurrencies and office properties.

As we enter 2024, most financial companies have leaned into predicting either a soft landing or mild recession, largely predicated on a gradual slowing of 2023's results combined with confidence that the U.S. Federal Reserve (the Fed) will be able to cut rates just in time. However, soft landings are historically rare and all previous examples in the U.S. relied heavily on factors that may not exist today, such as heavy spending on the welfare state, strong foreign economies that provided external stimulus or major technological progress.

Implications of an end to the rate-hiking cycle

Whether or not central banks like the Fed have hit peak rates, and if rate cuts are on the horizon in 2024, remain central questions at the beginning of this year.

Post a rate-hiking cycle, investors generally experienced a decline in aggregate yields and a widening of spreads. However, while it might seem intuitive to assume that history will repeat itself, it is important to note that expectations were similar last year, and the widening did not last long. Despite some dovish signals from the Fed at the end of 2023, a negative inflation surprise and/or increased strength in consumer spending could move out the time horizon for rate cuts or result in a "higher-for-longer" environment - which is not mutually exclusive to one or more rate cuts, given the overall restrictive nature of the Fed's policy actions to date.

Risk assets could see a strong 2024

As we head into the new year, the risks from potentially escalating geopolitical conflicts remain, posing possible threats to global safety and security as well as to economic stability. Notwithstanding any such escalations, we believe that risk assets could continue to exhibit resilience in early 2024. If a recession is avoided this year, this could signify the start of a rally rather than a blip in a bear market.

In credit markets, we think spreads remain somewhat attractive and could easily test the tights of 2023. In our view, supply/demand dynamics are still strong. Fundamentals are somewhat worse but not enough to be overly concerned about and, perhaps most importantly, lower rates can help heal bank balance sheets at a time when commercial real estate valuations are in decline - a helpful offset to potential bad loans.

Source: Bloomberg, 2023.

Fixed income: U.S. below investment grade

CRESCENT | Crescent Capital Group

End of the rate-hiking cycle leaves credit poised for stronger results

Inflows to credit were light by volume throughout 2023, though they did see some pickup in the latter stages of the year as it became more apparent that a U.S. recession was not happening in the near term, giving way to expectations of a mild recession or soft landing in 2024 instead. A more sanguine outlook on the rate environment also helped drive volumes, with market sentiment reflecting the belief that central bank tightening may be at its peak.

We began to see more constructive below investment grade public markets in the final months of last year, particularly with respect to single-B-rated credits. That has resulted in some tighter pricing in high-yield and bank loan new issues, and there remains considerable potential for the market to further benefit from these tight conditions given the still-light volumes and significant demand from the collateralized loan obligation market.

Possible impacts of higher-for-longer rates

The high-yield market itself has experienced some headwinds from rising rates, given the fixed rate nature of these bonds, but we expect returns from the asset class to improve in an eventual rate decline. One space in below investment-grade public markets garnering interest is that of broadly syndicated loans, which offer the benefits of floating rate structures. The debt securities in this sector that have been coming to market since late 2023 have been of higher quality and feature more conservative leverage structures, according to our analysis, amid a high-rate environment.

Solid ground ahead, but caution still required

In our view, the environment for credit in 2024 looks to be constructive. Credit fundamentals remain positive heading into early 2024, although some of this strength is expected to moderate as U.S. economic growth cools. We continue to expect most borrowers to exhibit revenue and cash flow growth going forward, resulting in stable leverage ratios. Coupons, or the rates borrowers pay, are likely to be at or near their peaks with the rate-hiking cycle concluding in the U.S. While still-high interest rates may pressure certain borrowers, many have adequate liquidity and would benefit from private equity sponsor support, if needed. Credit defaults are relatively low and are likely to hover around their long-term average in 2024. With low recession risk, defaults at or below historical average and monetary policy leaning toward rate cuts rather than additional hikes, high-yield bond and bank loan investors could see positive returns in 2024.

Sources: Bloomberg, JP Morgan, 2023.

Global fixed income

WELLINGTON MANAGEMENT® | Wellington Management®

U.S. and Europe potentially diverging

Given growing concern about avoiding a deep recession, we believe central banks may take weak economic growth (or a recession, no matter how shallow) as a cue to cut rates, particularly as monetary policy appears to be achieving its objective of bringing inflation sustainably down toward 2%. While the first half of the year may see the U.S. Federal Reserve (Fed) setting the trend for cuts among global central banks, we could witness growing divergence between countries later in the year.

Europe has experienced a persistent drop in inflation over the course of 2023, albeit to a lesser degree in the UK. Growth has flatlined and some countries - most notably Germany - are flirting with a technical recession.

While markets are pricing in rate cuts, we could, in fact, see the European Central Bank keep rates where they are unless there is significant deterioration in labour markets. The Bank of England may also be forced to pause after a few cuts. We expect a continuation of the steepening trend, either through rallies at the front end or through moves up in long-end yields as economies withstand more persistent inflation in the long term.

Japan remains the exception

The notable exception to cooling inflation in developed countries is Japan, which is seeing significant reflation as the Bank of Japan (BOJ) has been unfazed in shifting away from accommodative policies at its own pace, rather than joining global central banks in their hiking cycles. While yield curve control has been significantly adjusted, we will still start 2024 with negative BOJ rates and markets having so far been unsuccessful in putting pressure on policymakers. While the direction of travel is clear – abandonment of yield curve control and exit from negative rates – the question remains as to how and when policy normalization will occur.

Emerging markets in a more comfortable position

In emerging markets, central banks have been successful in front-loading hikes during this cycle, putting them in an enviable (from other policymakers' perspective) position where they can gradually bring down rates without the risk of entrenching inflation in the system. In this context, emerging markets' currencies could struggle, not only because of reductions in interest rates,

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Global fixed income

but also because end-of-cycle dynamics generally favour the U.S. dollar, Swiss franc and Japanese yen, which markets perceive as safe-haven assets. However, the carry trade could continue for some time.

China's systemic challenge

Chinese policymakers were slow to respond to a disappointing reopening in the first half of 2023 but are now more engaged in combatting the domestic slowdown, as they seek to shift the economic model toward consumption and manufacturing of higher-value-add goods for export. The slowdown observed so far is multifaceted, as issues in the property market have combined with deteriorating balance sheets and a surprisingly high unemployment rate among younger cohorts. The People's Bank of China has taken a number of steps so far to address liquidity concerns, but we believe monetary policy alone will not suffice to resolve these more systemic challenges.

Continued normalization, but beware potential surprises

The past year has shown that economies can withstand higher interest rates for longer, and may continue to see positive growth. Yield curves may steepen further, especially if inflation shows any signs of reaccelerating, while we note an increased potential for policy errors as central banks and markets navigate a treacherous trade-off between inflation and growth. Tracking these potential developments closely will be crucial for portfolio positioning in 2024.

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Canadian equities

MFS Investment Management

Canadian equities, as measured by the S&P/TSX Composite Index, grew more than 11% through 2023, but lagged the S&P 500. While the first half of last year was marked by resilient economic growth and strong jobs and wage growth, equities experienced a sell-off in the third quarter as Canada's economy contracted, inflationary pressures persisted and higher rates started to take a toll on consumers. Canadian consumers have one of the highest levels of household debt among the G7 countries and are starting to feel the pain of higher mortgage payments and borrowing costs. We are starting to see consumer spending soften, particularly on discretionary items, which will likely continue to persist in the coming months - a headwind for profitability. While we anticipate that a slowing economy will put downward pressure on equities through the first half of 2024, expectations of declining inflation and potential rate cuts in the second half of the year will likely be constructive for equity markets in the latter part of the year.

Canadian companies' revenue growth and profitability will likely remain challenged over the next several months in the "higher for longer" regime. Companies on average have reported negative earnings since the end of 2022 and forward-looking earnings appear muted. The materials sector, which has been struggling due to weak demand from China, is likely to continue to feel pressure as slower economic activity in China weakens demand. The consumer discretionary sector may underperform in 2024 amid diminishing excess demand and curbed discretionary spending. Furthermore, several major Canadian banks, which make up a large share in the Canadian equities space, are expected to have stagnant to negative growth in 2024. As companies navigate the current economic landscape, there has been a dry spell in new IPO deals, with only one company issuing an IPO in 2023, the lowest since 1993. This signals emerging struggles for companies to grow and expand in this environment that is likely to remain an obstacle for the equity market for the foreseeable future.

A more positive outlook for Canadian equities is in the growing technology sector, which returned around 60%[1] through mid-December. In a bid to enhance the country's tech ecosystem, Canada has welcomed an influx of tech-oriented immigrants over the past few years and is on track for strong growth in the industry with revenue for several tech companies projected to continue to grow. While Canadian equities have had relatively low exposure to technology, the sector's weight has substantially increased over the past 10 years.[2] The energy sector, equipped with improved production capacity and reasonable capital expenditure, is well positioned to potentially have stronger earnings in 2024. Another bright spot for Canadian equities is valuations, which are below long-term averages and appear relatively cheap versus the United States, making them an attractive asset class for Canadian investors.

[1] Bloomberg S&P/TSX Index 31 Dec 2022 to 12 Dec 2023
[2] FactSet. Data as of 11 Dec 2023

U.S. equities

MFS Investment Management

U.S. equities head into 2024 having largely reversed the losses posted in 2022. From a high level, the culprits behind the volatility of recent years are easy to pinpoint: inflation and interest rates. Markets struggled in 2022 as inflation skyrocketed due to COVID-inspired supply chain disruptions and extraordinary levels of monetary and fiscal stimulus. In 2023, most supply chains normalized while monetary policy continued to tighten through the middle of the year as inflation maintained the decline begun in mid-2022. Toward the end of 2023, investors grew increasingly confident that the U.S. Federal Reserve was on course to achieve an economic soft landing, setting the stage for easier monetary policy by the middle of 2024. The resulting rally in U.S. Treasuries helped fuel an equity rebound which took share prices within a few percentage points of the all-time highs set at the start of 2022.

One of the factors propelling cap-weighted indexes higher in 2023 was the market's embrace of the promise of artificial intelligence (AI). A late-2022 breakthrough in AI led to the wide scale availability of large language models to businesses and individuals. What appears to be the dawn of an AI revolution sparked a strong (but narrow) rally, concentrated mainly in large-cap technology stocks, the so-called "Magnificent Seven." However, as the drag from higher interest rates lessened late in 2023, even the neglected 493 or so "other" members of the S&P 500 Index began to tentatively participate in the rally, a trend investors hope will persist in 2024.

Looking ahead to 2024, in the current market environment we like higher-quality large cap stocks that are less cyclically sensitive, as well as exposure to lower beta and growth-at-a-reasonable-price strategies. Should the lagged effects of higher interest rates eventually result in an economic slowdown, we would prefer defensive companies in aerospace and defense, food and beverage and electrical power to more cyclical value companies.

Given the divergent makeup of the U.S. and Canadian equity markets, Canadian investors may benefit from exposure to U.S. equities. This is because the Canadian market offers investors much lower exposure to the information technology, health care and consumer discretionary categories than the U.S., while the U.S. market has lower relative exposure to sectors that make up the lion's share of Canada's market cap, such as financials and energy.

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International equities

JPMorgan Asset Management

As we head into 2024, a combination of solid economic activity and falling inflation has seen the market narrative increasingly shift towards the prospects of a soft landing.

Looking at valuations in international markets across the style spectrum, the growth end of the market has given back some of the premium versus value since the end of 2021, but still looks elevated; particularly in the context of real rates being higher than at any point during the previous cycle. There is credibility to the case for higher real rates this cycle because of tighter labour markets, higher budget deficits, higher capital expenditure intensity of the global economy, slower reserve accumulation in the developing world and a slowing in the upward skew of U.S. income distribution. However, it will be prudent to assess the risk to valuations if the current real rate environment persists or gets worse. If this is the case, then one of the plausible scenarios is not just that valuation spreads normalize back to previous cycle averages, but that the spread is much narrower than the previous cycle.

In the event of a downturn in 2024, a resurgence of inflation would likely be negative for risk assets as it would keep central banks in tightening mode and could induce a recession. In the event of further interest rate increases, this would be negative for equity valuations. We believe that EAFE equities, however, are better positioned given the starting point in terms of valuation and because of the sectoral composition. The EAFE universe has a much higher weighting to commodity-related sectors which could be the source of inflation and financials that benefit from any rate rises used to quell inflation.

Looking forward, we have a somewhat conservative outlook. The risks to the global economy have certainly not disappeared and a quick look at various macroeconomic indicators point to diminishing economic momentum.

Uncertainty over profits is another reason; the dynamics of the post-COVID economy and the extraordinary surge in corporate profits are still complicated and make forecasting unusually difficult.

With still elevated uncertainty around the path for the economy in 2024, a regionally diversified approach appears prudent. A softer landing for the economy is likely to benefit more cyclical regions such as Europe and emerging markets, while in the event of a deeper downturn, the more defensive characteristics of the UK market may come to the fore.

Additionally, with a transformation unfolding in Japan, we believe this presents one of the most exciting opportunities for investors in over 20 years. The opportunity has been mainly driven by efforts to improve corporate governance, with companies adopting higher standards and doing more to improve dividends and share buybacks. We are also starting to see signs of improvements in the domestic economy, with inflation and wage hikes which could help boost the economy. This less conservative approach to balance sheet management and shareholder returns has revived enthusiasm for Japanese stocks, further supporting the case for international diversification.

In the wake of the broad market sell-off in 2022, lower valuations presented investors with a new slate of opportunities across equities in 2023. As investors assess positioning for 2024, it's important to assess both risks and opportunities after this year's market rally. Our highest conviction view across equity markets is a focus on higher quality stocks - those with robust balance sheets, proven management teams and a stronger ability to defend margins.

Emerging markets equities

Schroders | Schroders

Where now for emerging markets?

Structural considerations: China, India, technology, supply chain diversification

Let's begin with China, which currently accounts for 30% of the MSCI Emerging Market benchmark.

China faces slower growth in the coming decade. Its economy needs to transition away from an investment-led growth model. Investment share of GDP is unsustainably high: infrastructure is considerably built out, while a years-long real estate boom has led to oversupply in many parts of the country. Debt levels are high and demographic trends are an increasing drag, with China facing a shrinking working age population, a marked fall in its birth rate and a rapid increase in its dependency ratio as the population ages.

What's more, China is facing the "middle-income trap." As wage costs have risen China has become less competitive in low-end manufacturing and needs to continue to move up the value chain.

Geopolitical tension with the U.S. is adding to the economic headwinds. It contributes to supply chain diversification, impedes access to advanced technology and knowledge transfer, has triggered aggressive U.S. industrial policy and impedes foreign direct investment (FDI).

However, China is a US$18 trillion economy with a very large domestic market and the scale to support its own industrial policy. If any country can move through the middle-income trap, China can.

China is highly integrated into the global economy and remains highly competitive, so supply chain diversification will take years to play out. The country is innovative and is a major potential beneficiary of decarbonization: it manufactures 80% of the world's solar panels, sold two-thirds of the world's electric vehicles in 2022, controls 75% of the world's battery cell production capacity and dominates large parts of the renewables supply chain. It has a high savings rate, and a controlled capital account so is not reliant on external capital for growth. Together with its control of the financial system, this gives China significant policy flexibility. Finally, in such a broad and deep market, there will always be opportunities at the company level.

India – the counterpoint to China

Having been outstripped by China over the past 40 years, maybe it is now India's turn in the sun. India is coming off a low base. Urbanization is low and represents a significant medium-term productivity opportunity. Returns from infrastructure investment are high. Demographics are supportive, and labour is abundant and cheap. Government policies to improve fiscal efficiency, increase infrastructure investment, reduce friction for trade between Indian states and drive import substitution have improved the prospects for growth. Meanwhile, digitization and smartphone penetration creates the opportunity to improve economic formalization and improve financial intermediation, education and price discovery.

However, caveats are required: issues of infrastructure, bureaucracy, protectionism, labour skills and labour code persist and despite its scale, India is not necessarily the first choice for export manufacturing FDI. But India's prospects for the next decade look promising.

Korea and Taiwan

Korea and Taiwan are markets exposed to trade and in particular technology. We have a positive structural view on technology as the world becomes increasingly digitized. 70% of the benchmark in Taiwan is technology, while in Korea it accounts for 50%, as at October 2023. Meanwhile, Korea also has strong battery companies with excellent long-term growth prospects from decarbonization.

Emerging markets equities

Other countries in EM are beneficiaries of supply chain diversification. While India might not yet be a first-choice destination for export manufacturing FDI, a mix of infrastructure, skilled labour and geographic proximity supports the prospects for Mexico, Central Europe, and the Association of Southeast Asian Nations (ASEAN). Manufacturing in developed markets can be very expensive both to build and operate, for example reshoring chip and battery production to the U.S. requires enormous fiscal support. Hence deglobalization is likely to be more about near-shoring and friend-shoring than it is about reshoring. It is also more about de-risking supply chains.

The impact of commodities in EM has diminished markedly. But the investment requirements of the energy transition will strongly support certain commodities to the benefit of some markets, primarily in Latin America.

Finally, even though the Middle East will face challenges from the energy transition due to its economic dependence on oil production, interesting opportunities derive from a strong government focus on economic diversification, with significant fiscal support and reform in Saudi Arabia and the UAE.

Cyclical opportunities: China, Brazil and technology

Hence, structural opportunities abound in EM. But investing in this universe is as much about the cyclical as the structural, which is one of the reasons we believe that style-agnostic active management is so important. India represents a compelling medium-term structural growth opportunity, but valuations in that market are currently very high and we see stronger opportunities elsewhere.

This includes China. Sentiment in China is currently very negative. The structural and geopolitical headwinds are much discussed, while weak economic momentum adds to shorter-term concerns. However, this is now reflected in cheap valuations and positioning has adjusted markedly. The government has the policy flexibility to support growth, while there is a visible push to stabilise U.S.-China relations. Although the market is not without risk, we feel that there may be excessive pessimism at this time.

We also see opportunities in the trade cycle, particularly in technology where we have a material overweight. The inventory cycle is inflecting as inventories run down and production and capacity expansion are constrained. While soft developed market demand in 2024 may mute the upcycle, we have positions in companies and markets that trade at attractive valuations and which will benefit from the upcycle while also having good medium-term prospects.

Monetary cycles can also provide opportunity. Central banks in emerging markets are generally obliged to be orthodox. In some countries there is now room for significant monetary easing following aggressive rate hikes and disinflation. For example, as of end of 2023, in Brazil interest rates are currently 12.25%, while inflation in 2024 is expected to be below 4%. The central bank is expected to continue to cut rates, benefitting a market where equities are broadly cheap, and the yield curve is elevated.

Finally, we cannot speak of global emerging markets without referring to the U.S. dollar. A decade of dollar appreciation has been a headwind for EM, and this remains the case in the near term. However, the dollar now looks richly valued, while the U.S. carries significant fiscal and current account deficits. A slowing economy which triggered monetary easing and an easing in the yield curve would potentially soften the dollar, which would improve financial conditions in emerging countries. In combination with valuations that are broadly attractive, this would be very supportive of EM equity returns.

Global sustainable infrastructure

KBI Global Investors

Since autumn 2021, the world has faced an upwards trajectory of interest rates and government bond yields. This has been driven by the desire for global policy makers to normalize their monetary policy, as well as tackling inflationary pressures that have emerged post-pandemic.

Infrastructure is a "real asset" and hence, the protection it affords investors during inflationary periods is one of its key features. This benefited listed infrastructure in 2022, but investor sentiment towards the asset class waned in 2023. A primary driver of this was the perceived interest rate sensitivity of infrastructure business models. But, as we assess the prospects for 2024, we see that valuations have de-rated while listed infrastructure fundamentals are largely unchanged. We pose the question as to whether this affords an attractive entry point for investors looking to access secular growth markets like renewable power generation, the digitization of the global economy, electrification of everything, water supply and sanitation and smart cities.

As we assess the macro-outlook for 2024, we are of the view that interest rates will remain higher for longer. We do not foresee any further material moves upwards from current levels, with the economy more likely to experience a slowdown. Inflation pricing mechanisms have already started to kick in for many of our companies, and hence, the headwinds that have dragged on the asset class in 2023 are unlikely to persist in 2024. As such, we believe the strong fundamentals of the strategy will result in improving sentiment.

For those looking to make a sustainable investment, we believe that listed infrastructure offers one of the more compelling solutions. We invest in infrastructure opportunities that offer a diversified source of return in addition to stable and predictive cash flows. Our companies are high quality, are often monopolies and operate within industries and sectors that have high barriers to entry. With long-term regulatory support and multi-year secular tailwinds, we believe our global infrastructure investments will deliver attractive income combined with positive earnings growth, trading at a valuation discount compared to most risk assets. With minimal cyclical or commodity price exposure, our sustainable infrastructure companies are built to be resilient to whatever economic influences 2024 has to offer.

Direct infrastructure

InfraRed Capital Partners

Shifting long-term thematics support the case for infrastructure investment

Looking at the infrastructure asset class, either in the context of the past year or for the outlook ahead, might be best done through two distinct lenses. Both the near- and long-term perspectives offer their own set of insights into the potential risks, opportunities and challenges ahead for infrastructure investors.

In the near-term, throughout 2023 we saw a continuation of several macroeconomic themes that have been playing out over the course of the year: higher inflation, elevated interest rates and the resulting market volatility. Infrastructure assets are historically more resilient to these factors than other types of alternative investments, and infrastructure's performance during bouts of pressure in 2023 were consistent with this characterization.

It is important at this point to be reminded of the characteristics of infrastructure investments that help them maintain their resilience amid uncertainty. We expect that high-quality infrastructure investments may be more insulated from the broader economy and policy landscape given both their long-term and conservative debt structures. These are generally less sensitive to rate fluctuations, and often contracted revenues, that may be correlated to inflation.

Macro concerns could lessen, but likely to remain

We have seen some stabilization in the macroeconomic environment, though we also caution that some risk factors remain, such as further escalations in geopolitical conflicts. Moreover, market volatility, underlying inflation and rate uncertainty could continue to affect asset pricing and investor demand in 2024.

With respect to inflation, our observations of market sentiment suggest some confidence that we are at, or perhaps even past, the point of peak rates. However, we also see evidence that even if inflation comes off its highs, it will likely remain sticky and range-bound for the near term.

An evolution in thematics

Shifting to the longer-term lens, while we believe the thematic megatrends, such as decarbonization, digitalization and demographic changes should continue to drive markets, 2023 saw some changing dynamics that could further shape infrastructure demand. The greater role of public policy within megatrends such as decarbonization - through initiatives like the Inflation Reduction Act in the U.S., the European Green Deal and the COP28 agreement on transitioning away from the use of fossil fuels - had an increasing impact in the past year and into 2024.

These policies have created an environment of intensified competition between countries for infrastructure investment capital and expertise. Coupled with numerous geopolitical security concerns around the world, we are seeing evidence of a "deglobalization" effect around infrastructure investment. A growing number of distinct regions are seeking to attract more of what may be a finite amount of available capital in a given thematic sector, for example, in opportunities arising from onshoring the supply chain in logistic facilities, intermodal transportation and other operational enhancements. This represents a considerable tilting of the demand-supply balance, and we expect such developments to serve as medium- to long-term positive drivers of infrastructure investment.

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