Verus

Sound Thinking

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Ten thoughts for 2024

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Every January we write a list of 10 things we expect to be important in the coming year. Many firms do this—we do something unusual, which is mark ourselves on the success or failure of the previous year's predictions. Some years we do well in our predictions, some years less well, but we find the self-enforced humility worthwhile when taking on the task of forecasting.

This year is no different. We can look back with some pleasure: in a year where many forecasts went awry, five of our ten forecasts can be counted as a success, with two more a partial success, and three misses.

So let's look at what we expected and what actually happened.

1. **Inflation: down, bumpily**

   We predicted inflation would drop during 2023, with an expectation it would be at or below the mid-3% range by the end of the year, although the ride would be bumpy. Sure enough, by November, headline inflation was 3.1%, with core inflation at 4%. December's number came in slightly higher at 3.4%, and month-to-month inflation data has delivered a volatile ride, showing the bumpiness we predicted.

   We can count this as a success.

2. **A landing: but what kind?**

   We predicted that the economy would either narrowly avoid a recession or would have a mild recession: we were in good company in this view. In fact, the economy was remarkably resilient and grew significantly: certainly much more than could be described as a narrow miss. If we're going to miss a forecast it's better for it to be a positive surprise than a negative one, of course.

   This is, therefore, a miss, but a pleasant surprise.

3. **Rates: lower but slower**

   We predicted there would be a policy rate decrease from the Fed by the end of the year. This was

of course tied to our expectation of a weaker economy, but even though we did not get a formal rate cut, we had the "Fed Pivot" surprise in December. This provoked a very strong market reaction, which was seen by investors as effectively the first step towards loosening.

Although the market seems to have widely acknowledged the start of rate cuts, we will count this as a miss.

4. **Zero makes heroes: funded foolishness failing**

   We expected to see the failure of major entities which had achieved funding from the markets (public and private) based on rosy forecasts of the economy in the low interest rate regime, due to the tightening of economic conditions. In practice, many of these firms have remained intact for now, having raised enough to be able to keep moving, and given the ongoing strength of the economy. At the same time, parts of the financial system were hit by significant pain and the failures early in the year can be tied to the theme we identified.

   This counts, then, as somewhere between successful and neutral.

5. **More office pain**

   We expected exit queues for core real estate funds with major exposure to the office sector would remain long, and expected prices would continue to correct lower, but that 2023 would not be the last of the crisis in this space. This is certainly what happened. We continue to see long queues in these vehicles and it will be some time before the pain in this market subsides. On a brighter note, we have begun to see liquidity appear, and buildings have been trading at much lower levels than they have historically. We believe more is to come, however.

   This was a success.

6. **International markets of mystery: or opportunity**

   We expected to see international equity markets do as well or better than U.S. markets. This simply did not happen, with U.S. equity up 26.3%, EAFE up 18.2%, and EM up 9.8%. Again the astonishing strength of the U.S., and in particular the Magnificent Seven, delivered under-performance for the rest of the world.

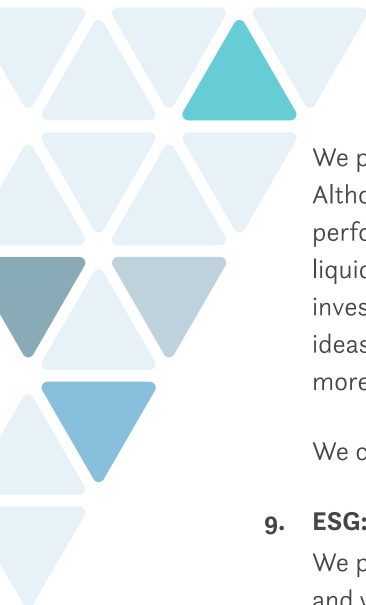
   This was a clear miss.

7. **Active opportunities: decision making matters**

   We expected 2023 to be a good year for active management, with a broader range of disparity between top and bottom quartile managers than usual. This was the case in U.S. equity and in some other active manager universes although some, such as Core Bonds, did not show the same result. The effect was prevalent enough across enough universes though, and we can say it was broadly correct.

   We can count this as between neutral and a success.

8. **Private pain: a drag for a while**



We predicted private elements of portfolios would produce below-average returns for 2023. Although this is difficult to measure exactly due to the lagged nature of private market performance, it is fairly clear that this was a correct estimate. Compared to the strong result from liquid equity markets, private markets are having a much more difficult time. Importantly, many investors found they had over-allocated to under-performing vehicles: this issue features in our ideas for 2024. Fund selection always matters—in these markets and these times it matters even more obviously.

We can count this as a success.

9. **ESG: louder not quieter**

   We predicted continued discussion, disagreement, and coverage of this topic across the industry, and we certainly observed this. The discussion will be ongoing, but the volume and vigor of the debate is clear.

   We can count this as a strong success.

10. **Simple beats complex: with a twist**

    Finally, we predicted a global 60/40 portfolio would do better in 2023 than the 30-year average. With a 30-year average of roughly 7% and a global 60/40 portfolio returning 16.7%, this certainly happened.

    We can count this as a strong success.

Our 10 ideas for 2024

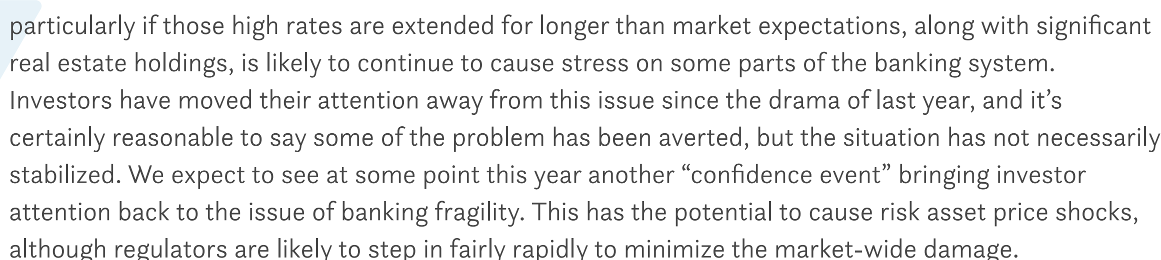
STRONGLY WEAK OR WEAKLY STRONG

Calendar year 2023 was characterized by astonishing U.S. economic resilience, and the positive data has continued to flow into the beginning of 2024. The economy has dealt remarkably well with a rapidly rising interest rate environment, and there are few areas where skeptics can identify obvious immediate catalysts to a downturn. Investors, at the same time as they have seen this strength, have also observed falling inflation, which has led them to expect rapidly dropping interest rates this year. This is not a typical combination (surprising strength, falling inflation, and falling rates) and these expectations are likely to come into doubt.

Our expectation is for strength in the economy to continue in the first part of the year, but this will come with fewer and less rapid cuts to interest rates than the market currently expects. We also expect to see the decline in inflation interrupted during the year, perhaps not permanently, but enough to cause investors to reconsider their model regarding the path of the market. The second part of the year, however, is likely to show weaker economic results as the higher rate environment persists: this negative economic data may well spook markets and lead to a bumpy autumn for investors.

RESURGENT BANKING PAIN

The combination of high interest rates damaging the value of bond holdings on bank balance sheets,



particularly if those high rates are extended for longer than market expectations, along with significant real estate holdings, is likely to continue to cause stress on some parts of the banking system. Investors have moved their attention away from this issue since the drama of last year, and it's certainly reasonable to say some of the problem has been averted, but the situation has not necessarily stabilized. We expect to see at some point this year another "confidence event" bringing investor attention back to the issue of banking fragility. This has the potential to cause risk asset price shocks, although regulators are likely to step in fairly rapidly to minimize the market-wide damage.

INTERNATIONAL DISAPPOINTMENT

International equities as an asset class have benefited from the gains of the Japanese equity market, but the reality is that in 2024, investors reaching to harvest high returns from developed international equity markets are likely to be disappointed. Continued good news from Japan is possible, but we believe the challenges in Europe will continue and investors stand a significant chance of pain from their European portfolios—both the economy and markets are likely to suffer weakness and below-average growth and returns.

SUPPLY CHAIN VS. MONEY SUPPLY

The last few years of spiking inflation have given strong emotional validation to monetarists, who believe inflation is always caused by too much money printing. They are of course correct, but we often forget that **inflation** (a monetary effect) and **sudden price rises** (caused by supply/demand imbalances) are not exactly the same thing. Changes in prices for something because the thing has become scarce is not the same as general changes in the level of prices across the whole economy. The interesting thing about price changes over the last few years is the extent to which they were driven by both effects—there was general price inflation caused by too much money, and there were also rapid changes in prices of things because supply chains broke down (supply/demand imbalance). As supply chains have become more normal and interest rates have started to have an effect, inflation has fallen. This year, however, this story is likely to get more complex. Some important supply chains are currently under stress—for example, trouble in the Middle East can make shipping costs rise rapidly and cause difficulties in the oil market—and this could cause surprise spikes in the inflation rate even if temporarily. At the same time, tighter money is acting in the other direction, pressuring the general inflation rate down. We expect, then, to see continuing drops in inflation, but for this path to be less smooth than markets would like—one or more surprisingly strong inflation prints on the way down, and possible temporary blips up in the inflation rate due to supply chain pressures.

GLOBAL FRAGILITY

The last topic ties to the next one—we believe the geopolitical environment is likely to be more difficult during 2024 and for this to potentially cause real-world consequences. There are many areas of current tension—most specifically in the Middle East, but also in Asia (e.g., China vs India, China in the South China Sea) and Europe. In a more normal environment, we could expect geopolitical issues to have only a minimal effect, but the world today has more fragility built into it than is normally the case: the systems which would typically allow for peaceful resolution of tensions seem to be working much worse than usual, and this raises the danger of a miscalculation causing significant supply chain disruption or a spreading conflict. We expect this trend to continue.

RECONSIDERING CHINA

Partially driven by the geopolitical, competitive, and ethical issues, and partially driven by the economic challenges that the country is clearly facing, the role of China in portfolios is likely to continue to come under closer scrutiny this year. An increasing number of investors are beginning to consider removing China from emerging market exposures, and while this is clearly not without consequence (for example, it reduces the number of companies in the EM index significantly, and it materially increases tracking error at the EM level), at a total portfolio level it likely has a small effect. Political friction with China is likely to escalate and there appears to be bipartisan consensus on many of the issues. We expect to see further pressure on institutional investors, which will be exacerbated if the current economic and market weakness in China continues.

OFFICE REAL ESTATE—SOME (BUT NOT ALL) SHOES DROPPED

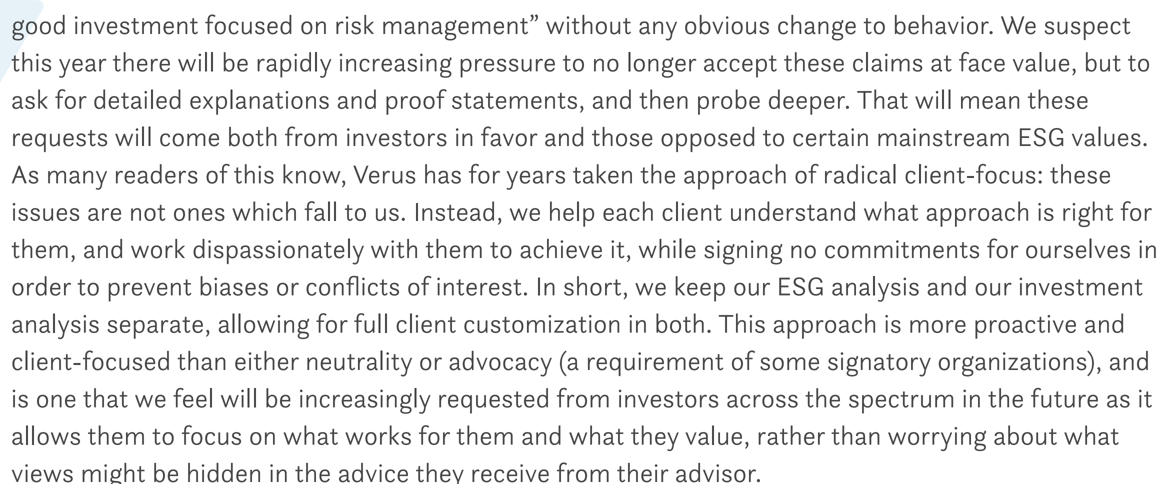
Acceptance is an important part of the grieving process—during the latter part of 2023 we saw parts of the institutional real estate office market begin to confront the need to accept the new reality. We have begun to see more deal flow in this space, with deals trading at huge discounts relative to where they might have sold pre-Covid. As pressure continues to grow on owners in this space, this deal flow will continue. We expect 2024 to be a year of greater acceptance, and to see higher deal volume at lower prices. We suspect 2024 and 2025 are the years to be identifying and partnering with GPs who have real skill in taking the other side of these distressed sales—even if we are not at the bottom yet we are likely far enough from the top that time spent finding new managers and giving them fresh funding is likely to be rewarded.

AVOIDING OOPS

Geopolitics is not the only possible source of unexpected disruption in 2024—we are in a Presidential election year and it seems likely we will see a well-fed 24 hour news cycle. Impolite elections are one thing, but the degree of bi-partisan dysfunction appears much higher than normal, and it is reasonable for investors to be concerned about the possible implications of political disruption. The concern is less around something bad happening on purpose, but more the danger that the parties might find themselves unable, for political reasons, to solve a critical time-sensitive problem which requires collaboration. A wholesale failure of the system this year seems unlikely. What we believe is more probable is that there will be even more tension and brinkmanship than usual, and entirely new types of conflict in the election cycle.

PLEASE SHOW YOUR WORK

ESG has been a topic for years, but the conversation has changed recently. Many investors are now precluded from ESG investment—they want to ensure the service providers they use are not taking positions they regard as political with their money. Yet at the same time, other investors want to ensure the same providers are fully engaged with a range of issues, from Net Zero to Sustainable Development Goals (SDGs). This poses problems for many service providers (including consultants). The response from many service providers has been to say to investors unable or unwilling to invest in ESG issues that all the ESG activity they perform is focused on risk management or investment outcomes—this is often expressed by saying “we’re not really using the word ESG anymore, it’s just



good investment focused on risk management" without any obvious change to behavior. We suspect this year there will be rapidly increasing pressure to no longer accept these claims at face value, but to ask for detailed explanations and proof statements, and then probe deeper. That will mean these requests will come both from investors in favor and those opposed to certain mainstream ESG values. As many readers of this know, Verus has for years taken the approach of radical client-focus: these issues are not ones which fall to us. Instead, we help each client understand what approach is right for them, and work dispassionately with them to achieve it, while signing no commitments for ourselves in order to prevent biases or conflicts of interest. In short, we keep our ESG analysis and our investment analysis separate, allowing for full client customization in both. This approach is more proactive and client-focused than either neutrality or advocacy (a requirement of some signatory organizations), and is one that we feel will be increasingly requested from investors across the spectrum in the future as it allows them to focus on what works for them and what they value, rather than worrying about what views might be hidden in the advice they receive from their advisor.

PUSHING THROUGH THE PAIN

Finally, we move on to the challenges which segments of the private markets are suffering due to the rise in interest rates and changes in funding. When low or negative asset price returns and higher rates of illiquidity combine, the result can be unexpected pain for unprepared investors. This can lead to forced sales and imbalanced books. So, what should investors who find themselves in this situation do? We think the correct approach is in general to push through the pain, but by this we do not mean simply charging blindly into private markets without reassessment. Instead, we mean these investors should work hard to stay on track, adjusting their commitments and exposures to avoid excessive liquidity challenges, but remain focused on the long-term role of private markets in the portfolio. This may require altering approach, changing advisor, or rethinking portfolio structure. But in general that reassessment should stay focused on how best to navigate through, rather than reduce exposure because of, challenging markets. Overall, 2024 is an excellent year to take action. Pushing through the pain requires focus and careful risk assessment, but races are never won without some pain being tolerated.

Conclusion

2023 surprised us to the upside—2024 has begun doing so already. How long that will last remains to be seen. Although we have no signs of imminent problems, we remain concerned: each expansion contains the seeds of its own demise. Focusing on the topics we have outlined above should help investors stay on track, whatever this year throws at us.

Whatever happens in 2024, the benefits of simplicity, clarity, good planning, good risk management, and excellent communication are likely to continue to show through.

ABOUT THE AUTHOR

Mr. Toner has a degree in Law from the University of Oxford in the United Kingdom and is a CFA charterholder (Chartered Financial Analyst). He is a regular author and speaker on a range of investment topics. He is a member of the Audit / Finance Committee of The Medina Foundation in Seattle. He is also a member of the CFA Institute and the CFA Society of Seattle. He is a former board member at the Seattle Metropolitan Chamber of Commerce, where he co-chaired the finance & audit committee. Mr. Toner was formerly a trustee of the Charles Wright Academy and former chair of the endowment committee. He has been happily married to his wife, Heather, for nearly 30 years, and is the proud father of two children.

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