COLUMBIA THREADNEEDLE INVESTMENTS

2024 EQUITY MARKET OUTLOOK

With macro risks elevated it's all about stock selection

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There are plenty of macro drivers that will create equity volatility in 2024. To succeed, investors will need to maintain a resilient portfolio

Heading into 2024, inflation, recession, elections and geopolitical risk are all potential drivers of dislocations in the equity market. Rather than approaching this environment by making calls on growth versus value, or large cap versus small, we think that managing a portfolio that can deliver alpha despite these macro challenges is the path to success for 2024. Here's why we're focused on fundamentals:

Higher for longer rates will create clearer winners and losers

In the US it looks like we've finally reached a plateau in Federal Reserve rate hikes. But with inflation sticky and employment and growth relatively strong,

the Fed may pause for longer than expected. The continued effort to keep inflation in check has a direct impact on companies.

First, there is a significant impact on demand as consumers who have worked through their savings feel the pinch of higher credit costs. This will have impacts beyond just consumer discretionary companies.

Second, the cost of doing business will stay at elevated levels. Higher borrowing costs may be particularly challenging for smaller companies that rely on short-term financing to support operations.

And third, pricing power, which has kept profits aloft for many businesses, is likely to weaken as firms find it more difficult to pass higher costs of doing business on to the consumer.

We think the biggest risk for markets is that investors are underestimating the potential magnitude of an economic slowdown. Getting back to the Fed's 2% inflation target from current levels of economic activity without a (possibly severe) recession seems unlikely at this point. Against these pressures, the key to separating the winners from the losers will be finding companies that have resilient balance sheets and demonstrate multiple drivers for growth – not just cutting costs (Figure 1).

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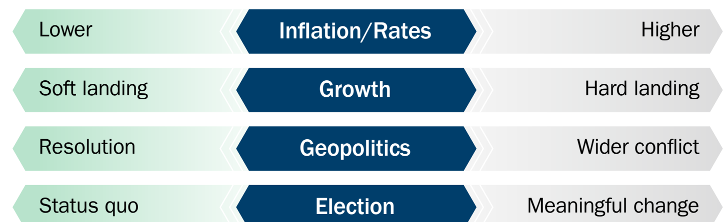
Figure 1: there's no shortage of macro drivers in 2024



Source: Columbia Threadneedle Investments, November 2023

US market performance will broaden outside top tier tech

A handful of tech high fliers drove most of the S&P returns in 2023, spurred on by overly optimistic dreams of an imminent AI-enabled paradise. We do believe artificial intelligence has the potential to be a transformational force for growth across the wider economy, not just in tech. But we also think the market's timeline is unrealistic. In our view, we are more likely three to five years away from this rather than the 12 to 24 months we saw priced into a narrow group of companies this year.

The concentration in performance in 2023 has created opportunities for research-based investors, as the pool of companies within tech and other sectors likely overlooked by the market is larger. When growth comes back, we think the market will be less monolithic, with opportunities spread out more widely.

In a world where inflation is likely to be higher, investors will need capital appreciation along with income to meet long-term goals

What about elsewhere?

Ahead of a potential slowdown, we also see opportunities to add to strategic allocations outside the US, particularly emerging markets, and in small caps – areas we think many investors are under allocated. Small caps are currently cheap for a good reason – in a recession they would be the first ones affected. But we think there are good stock selection opportunities in both small cap growth and value. Meanwhile, valuations in Europe, on a price-to-earnings basis, are more attractive than the US, but stocks may be more sensitive to macro factors and rates. Once again, careful stock selection will be critical.

When investors allocate away from cash, they'll need dividend growers

Yields on cash and money markets are at 15-year highs and investors have flocked to these instruments. However, in a world where inflation is likely to be structurally higher, investors will need capital appreciation along with income to meet long-term goals. Cash may be offering a compelling yield now, but it will fall when central banks eventually cut rates.

Dividend stocks, on the other hand, can replace that income and also offer capital appreciation. All dividend-paying stocks are not the same, however. Finding dividend growers with balance sheets that can sustain dividend payments through more volatility is a must for achieving sustainable income.

Figure 2: finding quality companies can help drive outperformance during recessions
(S&P 500 cumulative factor average returns, average %, during recessions)

Factors	Rank
Free cashflow to enterprise value	1
EBITDA margin	2
Return on equity	3
Forward earnings/price	4
Earnings quality	5
Share buyback	5
Operating cashflow surprise	7
Prior 1-month return	8
Price momentum	9
Debt-to-assets	10
Revenue stability	11
Analyst sentiment	11
Book-to-price	13
Long-term growth rate	14
Size	15
Dividend yield	16
Beta	17

Source: Columbia Threadneedle Investments. The recession periods considered are: dot-com bubble (03/2001-11/2001), global financial crisis (12/2007-06/2009) and 2020 pandemic (02/2020-04/2020). Green is for top five performers and red for bottom five performers. Past performance does not guarantee future results. It is not possible to invest directly in an index.

The bottom line

Next year may be a bumpy road for investors, but we view equities as long-term, strategic holdings. Without active, research-based decisions to over and underweight companies, investors are guaranteeing that they will match any losses we experience in an index like the S&P 500.

Even if investors don't feel like they should add to their equity allocation next year, they also shouldn't sell on short-term volatility. If markets do come down, investors focused on companies with strong fundamentals will have opportunities to add to their long-term strategic positions at attractive prices.

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To find out more visit **columbiathreadneedle.com**

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