



MIND THE GAP !

**MIND THE GAP: 2024 REVERSALS?**

Geopolitical turmoil. Chinese blunders. American resilience. Equity rallies. Bond traps. Credit denial. That was 2023.

Political adversity. Energy volatility. Dollar reversal. Equity corrections. Bond recoveries. Credit defaults. That may be 2024.

Who would have predicted such severe Chinese policy failures and solid US growth? Who would have forecast muted credit, currency, and energy markets despite geopolitical fires? And who thought equity valuations are immune from interest rates?

We are inspired by resilient consumers, growing investments, the advancing energy transition, rising productivity, and new dreams from supercomputing, AI innovations, and biotechnology. Looking at 2024, can politics and policies become more aligned to support those unexpected 2023 results, or do we face reversals? Let us look at ten surprises we had this year which could define a new trajectory for 2024:

1. **Pandemics:** Let us hope that Covid is firmly behind us. And let us remember the scale of failures in China, where many seniors were not vaccinated when the chaotic reopening caused at least 1.4 million deaths by February 2023, according to US [CDC research](#), while [China denies](#) 95% of those deaths. Even in the US in 2023, more people died from Covid than from opioids. Closing that tragic chapter could indeed signal a positive reversal for 2024.
2. **US resilience:** The US economy has broadly outperformed expectations, contrary to recent negative perceptions. A strong consumer and an investment boom have propelled the economy upwards by 2.5%, avoiding the anticipated recession. Unemployment remained at 4%, and also core inflation moderated to 4%. Restrictive monetary policy was mostly offset by an [expansive fiscal policy](#), as the 2023 fiscal deficit rose to 7% of GDP. Looking ahead, it is likely that 2024 financial policies will be rather more [restrictive](#), with negative implications for US growth.

3. **Chinese blunders:** 2023 has been one of China's [worst years](#) in decades, as politics has been colliding with markets. The pandemic reopening was managed poorly and policy stimulus was minimized to avoid bailouts for the [real estate sector](#), which accounts for a quarter of China's economy, and is now facing a massive restructuring. [Youth unemployment](#) officially stands at 21% but may exceed 40%. [Chinese FDI](#) has turned negative for the first time, as supply chains continue to be re-shored, Chinese deflation aggravates debt, and [US favorable views of China](#) hit an extreme low of 15%.

4. **Indian exuberance:** India has been a major beneficiary from China frictions and the Russian war, benefiting from investment re-flows and cheaper, sanctioned Russian energy. For three years, Indian equities outperformed the Nasdaq, at even more [elevated valuations](#), while Chinese equities lost half of their values (chart 1). Now India is looking at spring 2024 elections as its [FDI cycle](#) appears to have turned, despite [strong growth](#) and inflation staying above 6%.

5. **Muted credit cycle:** Strong consumer and corporate balance sheets have so far delayed a new default cycle driven by higher interest rates. However, pressures are building on the consumer side ([rising delinquencies](#)), regional banks ([downgrades](#)), and real estate ([supply constraints](#) and [office valuations](#)), which enjoyed some cushion in 2023 but are expected to cause [default rates](#) to rise beyond 6% in 2024, which potentially could lead into a recession.

6. **Global equity rally:** Predictions for 2023 turned out to be wrong, as the expected recession did not materialize, and global equities rose by 15% YTD, the Nasdaq added 45% (chart 2) and the top seven US technology stocks ([S&P7](#)) rallied by over 85%, reaching extreme PE multiples (Amazon and Tesla at 75, Nvidia at 120). On the other hand, EM technology indices remained flat in 2023 and PE multiples stayed attractive (EMQQ, Alibaba, Tencent, TSMC, Samsung at 16).

7. **Fixed income trap:** Higher for longer has become the result for interest rates as strong growth and strong employment continued. As a result, [fixed income returns](#) now are set for the third negative year in the US and in Europe, although a turning point may have been reached as policy rates peak and real rates turn positive. In [emerging markets](#), interest rates have already started to decline, and emerging market debt mostly recorded positive returns this year.

8. **Bifurcated innovation:** Investors have been excited by innovation in supercomputing, AI technologies, life sciences, satellite / space business, and opportunities in the energy transition. US export controls have led to a [bifurcated race](#) with China, which have hurt trade and capital flows and led to poor performance of Chinese technology stocks. In contrast, the S&P7 firms in [US markets](#) performed extremely well, although valuations appear to become very extended.

9. **Small-cap puzzle:** Historically, [small-cap stocks](#) lead in early market cycles. In emerging markets (esp. in Taiwan, Korea, India, and Mexico) they outperformed all-cap benchmarks by double digits this year (chart 3), while [US small-caps](#) underperformed by double-digits this year, hence contradicting bull market narratives. This cycle discrepancy is further supported by [momentum indicators](#), showing that most emerging markets are progressing into an expansion.

10. Energy volatility: Energy savings in Europe, higher energy supply in the US, and lower energy demand in China have contributed to relative stability in oil prices during 2023, despite the recent turmoil in Israel. However, a [new energy supercycle](#) appears to be starting, which could be accelerated by geopolitical tensions and/or a declining US dollar. Most forecasts for 2024 see [upside risks to oil prices](#), which could adversely affect growth and inflation.

Looking ahead to 2024, the main question is whether a recession has been avoided or just pushed forward into the new year. We look at three possible scenarios for 2024:

A> Baseline Scenario: A soft landing can be accomplished in the US, Europe, and in China, assuming an improvement in geopolitical relations with a resolution of the wars in Ukraine and in Israel. Growth can continue at levels similar to 2023, as projected by current consensus forecasts, and inflation can gradually decline. Earnings, equity market, and fixed income returns can grow into double digits, and reflect a goldilocks situation with slowly declining interest rates.

B> Recession Scenario: A hard landing in China, in Europa, and/or in the US can be caused purely by domestic economic factors. China's real estate crisis alone can cause major economic headaches. Europe's structural problems can lead into recession if another energy crisis hits this winter and/or trade relations deteriorate further. And real estate trouble can trigger a US recession through rising defaults. A mild recession can result even as interest rates decline.

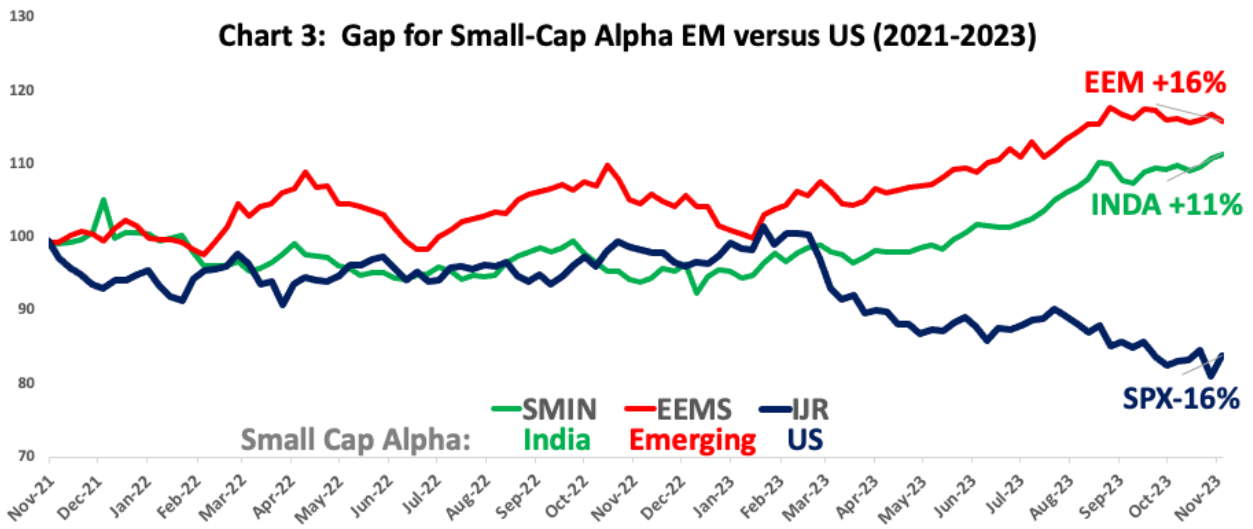
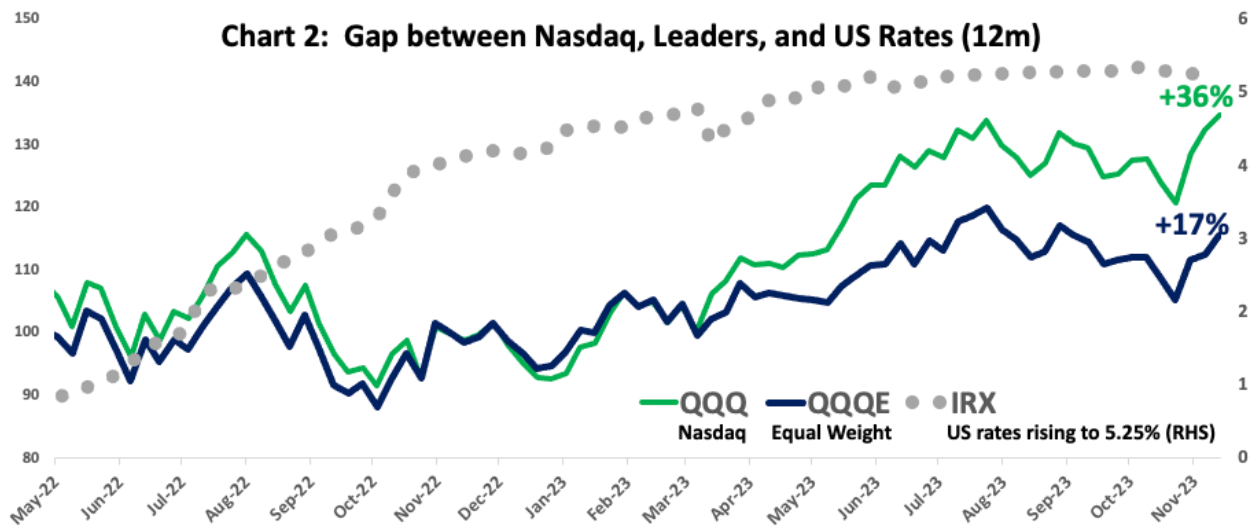
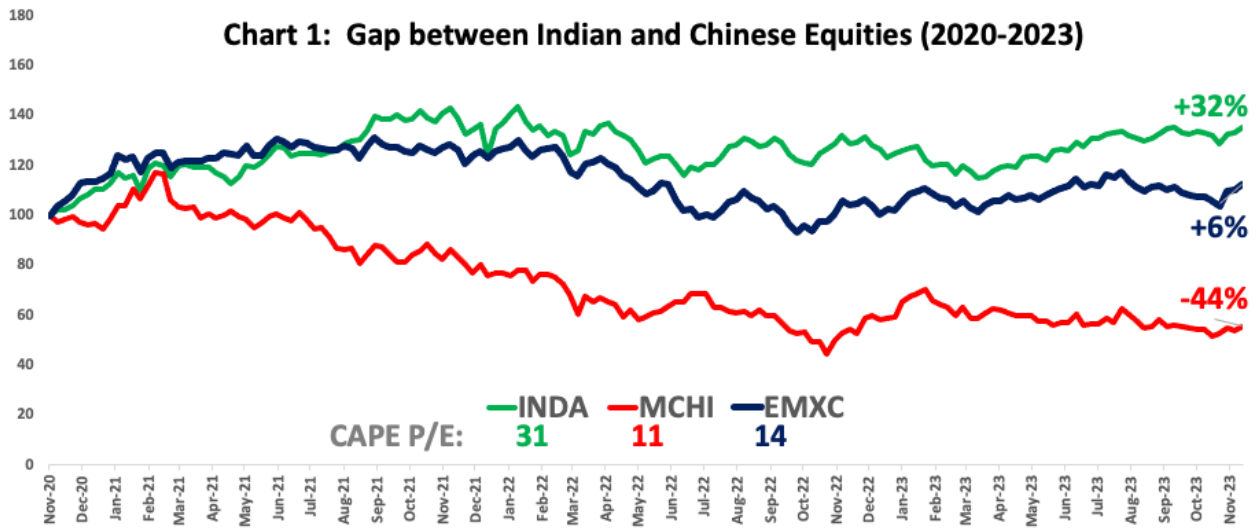
C> Crisis Scenario: Taiwan, North Korea, Russia, the Middle East, and US elections point to five potential geopolitical risks in 2024. Even if US - China relations can avoid any new tension, the Middle East conflict (just one geopolitical flashpoint) can escalate and lead to an energy crisis that can cause a severe global recession, even with strong monetary and fiscal stimulus. Government bonds can then offer a safe harbor and can yield annual \$-returns above 15%.

Our reading is that the crisis scenario C> has a 30% probability for 2024, as geopolitical risks are near multi-decade highs, while US - China relations do remain near multi-decade lows. The domestic recession scenario B> also has a 30% probability for 2024, especially as Europe is facing elevated yet mild recession risks this winter. Hence, there is a combined B> & C> recession risk of 60% as compared to a 40% probability of a goldilocks baseline scenario A>.

Our projections below illustrate some common insights for the year ahead, even as our three distinctly different scenarios cannot be aggregated by probabilities:

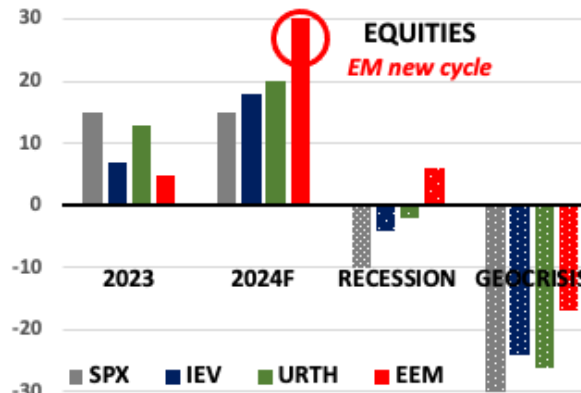
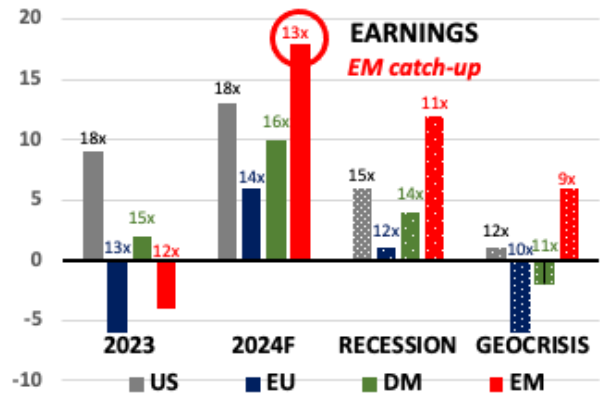
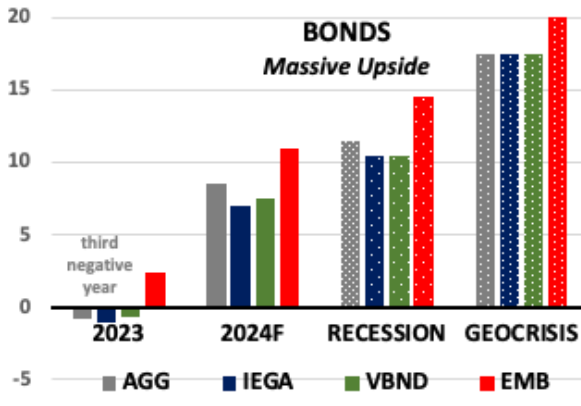
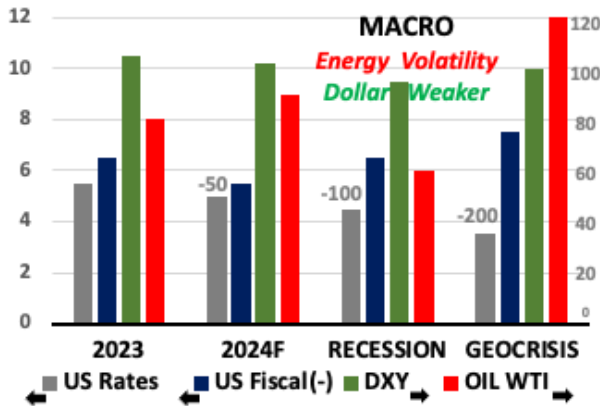
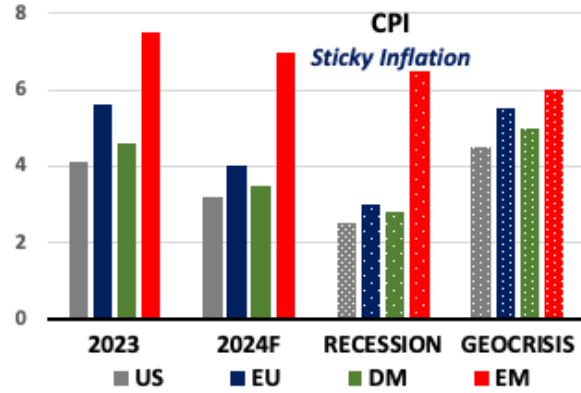
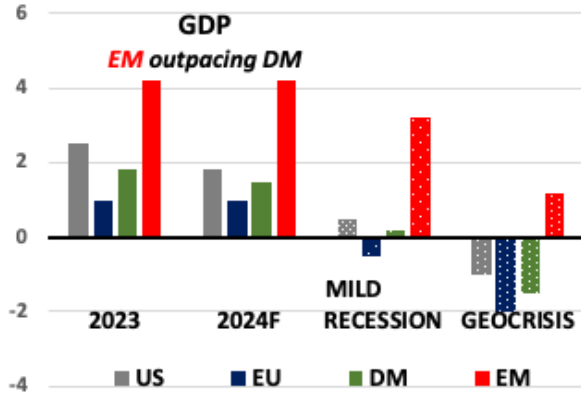
First, emerging markets growth will likely outpace growth of developed markets by 2.5% to 3% as earnings growth resumes, especially in Korea and Taiwan, and Asian currencies strengthen. Second, inflation is likely becoming more sticky with energy prices likely being more volatile, implying only gradually declining interest rates but attractive fixed-income returns globally. Third, a new emerging markets cycle is likely to start in 2024, as revealed by strong small-cap performance, appreciating EM currencies, stable debt dynamics, and stronger equity returns. Finally, if geopolitical risks can be resolved, the upside could be large for 2025.

<http://www.emleaders.com/pdf/eml-2024.pdf>



EM Leaders 2024 Scenarios:

- A> 40%: Baseline 2024F
- B> 30%: Mild Recession
- C> 30%: Geopolitical Crisis



Sources: IMF, World Bank, IIF, Bloomberg, JP Morgan, EM Leaders (2023)