TAKING STOCK: NEPC 2024 MARKET THEMES

Asset Allocation, NEPC Research

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At the beginning of each year, we identify the *Market Themes* that we believe will influence the investment landscape over the next 12 months, impacting asset values, sentiment and capital market dynamics.

The *2024 Market Themes* are:

1. **Cost of Capital**
2. **Magnificent 7**
3. **U.S. Fiscal Debt**
4. **Artificial Intelligence**
5. **Geopolitics**

1. COST OF CAPITAL

Businesses and consumers, still ensconced in the bygone era of easy and cheap credit, are yet to realize the full extent of the higher cost of capital ushered in by rising interest rates.

As markets continue to adjust to the new investment regime, many participants have yet to acknowledge the potential likelihood of long-term interest rates staying above 4%, steadfast in their belief that a return to the low inflation levels and easy money of the last decade are inevitable. At NEPC, we believe higher rates and tighter monetary policy are here to stay, and inflation levels will likely prove stickier than expected.

This eventual adjustment to the higher-rate environment and the uptick in the cost of capital will likely lay bare the stark difference between the haves and the have-nots. The haves are the companies and consumers still basking in the security of long-term fixed-rate debt issued at cheaper rates. They have the luxury of time to adjust their capital structures to the higher rates. Many are insulated from the higher cost of capital as they sit atop cash piles, benefiting from a greater interest rate earned on savings. For companies, the cash chests can support capital expenditures without the necessity of encumbering higher-cost debt, while for consumers the additional income from savings can bolster spending and liquidity.

Then, there are businesses, particularly smaller-sized ones, and individuals with floating-rate debt obligations or refinancing needs that will struggle to absorb the rising cost of capital and secure financing as banks tighten their lending standards. As a result, we believe there will be a premium on companies generating consistently free cash flows, robust balance sheets and stable profits that are relatively insulated from debt markets.

2. MAGNIFICENT 7

With their unprecedented size and outsized performance, the so-called Magnificent 7—Apple, Amazon, Microsoft, Alphabet, Meta, Nvidia and Tesla—are hard to miss in investment portfolios.

The Bloomberg Magnificent 7 Index more than doubled in 2023, contributing to a gain of 54% for the Nasdaq 100 Index. These relatively young, large-cap growth stocks of U.S. technology companies account for nearly 30% of the Standard & Poor's 500 Index. Put another way, they make up 10% of an allocation in a global 60/40 portfolio, underscoring the striking concentration risk. Their domination means the success (or lack of) of your portfolio in 2024 is heavily dependent on their performance.

These high-growth companies have mostly cash-heavy balance sheets with relatively low levels of debt, insulating them from the higher cost of capital. In addition, their borrowings come with a low price tag – their debt was issued at much lower rates than the current environment. While their cash-rich and cheap-debt profile works in their favor, their current valuations—markets expect the earnings of these seven companies to grow a whopping 29.2% in 2024 compared to 4.7% for the rest of the S&P 500, according to FactSet—imply a tremendously high hurdle rate.

At NEPC, we recognize concentration in large-cap equities is not new even though these companies may be relatively young (most did not exist 30 years ago); looking back, there was the Nifty Fifty in the 1970s and the dominance of Japanese equities in the 1990s. History has shown that these conditions do not last forever, and we expect mean reversion to kick in even if we cannot predict exactly when that will occur.

3. FISCAL DEBT

Investors have felt the impact in 2023 of the unsustainable growth of U.S. fiscal debt and we expect this to continue into 2024.

Last year was a roller coaster, with rates mostly ticking up higher as the Treasury issued more debt to cover the U.S. deficit. Now, with nearly $2 trillion in net debt that needs to be financed in 2024, the Treasury will be coming to market. Due to the overwhelming supply of debt that needs to be issued and the higher cost of capital, Treasury rates will be pressured to incite demand for U.S. debt. This higher cost of capital is sure to reverberate across fixed-income and the capital markets, affecting yields and debt values.

With a presidential election in November, we expect fiscal deficits and Treasury issuance to be heavily discussed, especially since both parties, each in their own way, are big spenders. On one hand, the higher cost of borrowings may slow the economy and incentivize the Federal Reserve to lower rates this year. On the other hand, the central bank also has to adhere to its mandate of managing inflation. These competing objectives may create volatility in the market, especially when expectations are skewed towards the potential for rate cuts in 2024.

At NEPC, we believe it is always important to have appropriate liquidity and safety in your portfolio. We could see sentiment turn and a spike in volatility, underscoring the need for liquidity and a balanced position in safe-haven fixed income.

4. ARTIFICIAL INTELLIGENCE (AI)

The emerging influence of artificial intelligence in homes, markets and industries points to AI's ambition of driving technological innovation with the potential to boost economic productivity, bolster growth, and drive investment gains.

The intense focus on AI is around its potential to be used as a tool to improve efficiency, potentially replacing labor-intensive and repetitive tasks, especially in the services sectors of the global economy. While some form of AI has been around for many years, what makes it special today is its ease of use and access. AI has democratized technical skills that allow widespread application of machine-learning techniques; in the past, this was only available to a select subset of people with a very technical background. As a result, individual AI adoption rates have been even faster relative to previous technological innovations such as smart phones or the Internet.

Interest in AI extends beyond the technology sector with other industries keen to incorporate new tools into their operations and products. It has also contributed to equity returns in 2023 with its association with the immensely successful Magnificent 7 companies. The macroeconomic impacts of AI could be similar to previous innovations.

When new technologies are adopted, labor productivity accelerates. As a result, real economic growth increases above trend, inflation levels moderate, and unemployment rates fall; during these periods, annualized equity returns are well above average.

At NEPC, we believe markets generally overestimate the short-term benefits of technology while underappreciating the long-term advantages. Nevertheless, 2024 represents a proof statement for AI and its adoption has important implications for corporate fundamentals. Investors are keenly focused on how companies integrate AI into their operating models and the resulting impact on profit margins and revenue. We believe AI is a novel technological advancement and U.S. companies (and their stocks) are best positioned to benefit due to a friendlier regulatory environment and access to key technological inputs.

5. GEOPOLITICS

Two ongoing wars, testy relations between two of the world's largest economies, and an election year unlike any other have escalated geo-politics to the forefront of investors' minds.

As the world moves away from a period of relative geopolitical stability to one with fractures and fragmentation, we are likely to see greater uncertainty. While geopolitics are often considered more of an exogenous factor for markets, this unpredictability can fuel volatility in markets, but typically they have a short-lived impact on investment returns; long-term market dynamics such as growth, inflation and monetary policy tend to drive portfolio gains.

At NEPC, we believe our role is not to predict geopolitical outcomes—be it the trade relations between the United States and China, the wars in Ukraine and Israel, or the results of the super cycle election year with 40 national elections in 2024—but rather to study their potential impact, if any, on growth and inflation through disruptions in economic activity, trade and supply chains.

Looking closer home, we believe the 2024 U.S. presidential election is not a driving force behind long-term market dynamics that form the bedrock of investment portfolios. That said, investors are closely observing the election, generally hopeful for a divided government, which markets have historically favored.

We remind clients that the heightened geopolitical climate shouldn't warrant shifts in portfolio allocations. Our advice: stay focused on long-term core investment objectives and do not deviate from your strategic targets that were a result of thoughtful deliberation and governance initiatives. We also encourage investors to capitalize on portfolio rebalancing opportunities that could arise as a result of short-term volatility.

INVESTMENT IMPLICATIONS

Investors looking to benefit from these potentially market-moving themes should consider adjusting exposure to equities, while embracing quality and value characteristics. We also suggest tilting equity implementation to global equity strategies and recommend greater use of active equity approaches.

We advocate a value-centric mindset for public and private equity. In addition, the premiums offered to take on illiquidity risk remain attractive, and we are focused on identifying opportunities within private markets for clients. Similar to public equities, we think the opportunity for value investing in buyouts has resurfaced. Within private credit, we are starting to see cracks in the capital structure for borrowers with higher leverage. Consequently, we favor higher-quality opportunities and also see emerging potential for regulatory capital relief through banks.

With the normalization of real interest rates, we favor introducing dedicated U.S. TIPS exposure to strategic policy targets. We also remain comfortable holding greater levels of cash and holding appropriate safe-haven fixed-income exposure.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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