ARS INVESTMENT PARTNERS

THE OUTLOOK

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The Future Is Not What It Used To Be — *Finding Opportunities Amid Global Disorder*

Executive Summary

Following last year's strong market performance, U.S. investors should see equity markets continue their upward trend, but it will not be a straight line. The outlook for the next 12 months will likely be determined by the impact of domestic and global politics which will affect the prices investors are willing to pay for current and future earnings of businesses. There remains continuing concern for the protection of purchasing power of the U.S. dollar given today's levels of debt and deficits. We believe the current investments in technology, defense, industrials, materials, and healthcare companies will be important beneficiaries of this outlook, serving clients well over the next 12–24 months.

"Markets and policymakers would be well advised to focus on how much the world has changed in the past few years. The inflation roundtrip is neither simple nor complete. The resulting shift in the configuration of the global economy and financial markets will be felt for years."

– Mohammed El Erian, President of Queens College, Cambridge, and advisor to Allianz and Gramercy

Last year's market performance surprised many investors who were too pessimistic about the economy following big market declines in 2022. As shown in Chart 1, a Bloomberg Survey of investors forecast that the S&P 500 would end 2023 around 4000 which was far below where the markets ended the year at 4769.83. Coming into 2023, ARS held the contrarian view that we did not believe that a major recession was a realistic outlook. We believed that inflation had peaked and that the Fed and other central banks would slow or stop interest rate increases, and this would allow the market to find firmer footing. Additionally, we felt that there were many world-class businesses that were not only attractively valued after the 2022 market pullback but would also be the primary beneficiaries of the multi-year capital spending that has been programmed into the economic outlook. Despite our more favorable outlook, the markets exceeded our expectations, particularly given the powerful performance since the last Federal Reserve meeting in December. Therefore, it is no surprise that 2024 began with profit-taking in many of last year's best performing stocks.

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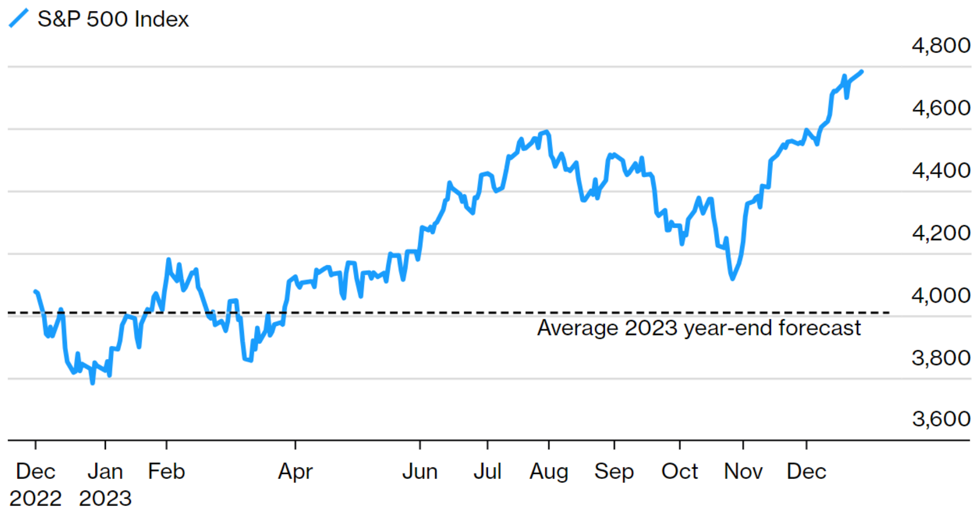
Chart 1. S&P 500 Performance Versus Average 2023 Year-End Forecast

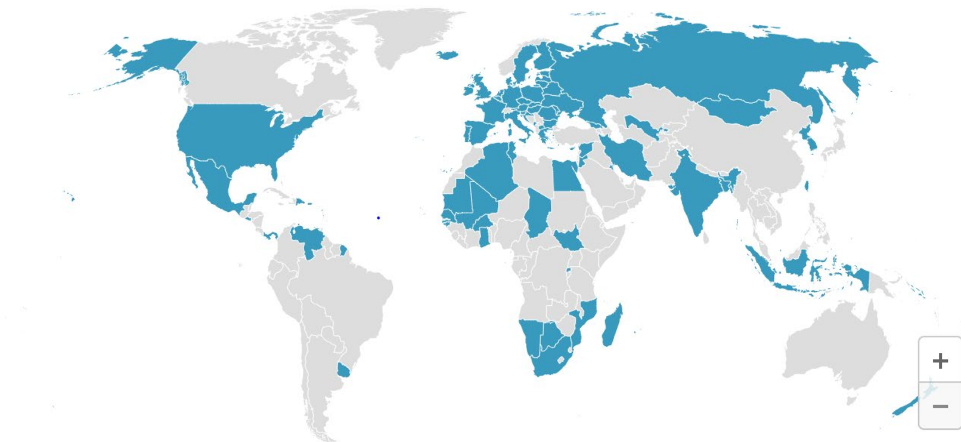


Source: Bloomberg
Note: 2023 year-end forecast as of Dec. 1, 2022

These elections are occurring at a time when the immediate demands of voters far exceed the ability of most governments to deliver on both the short-term and longer-term societal needs given existing debt burdens and rising fiscal deficits.

The outlook for the next 12 months will likely be determined by the impact of domestic and global politics which will affect the prices investors are willing to pay for current and future earnings of businesses. In addition to next year's U.S. presidential election, the outcomes of general elections in more than forty nations must be taken into consideration. Given the already fragile state of world affairs, the results of these elections will have significant implications for domestic and international politics, economics, and societies in the coming period. In most of these countries, these elections are occurring at a time when the immediate demands of voters far exceed the ability of most governments to deliver on both the short-term and longer-term societal needs given existing debt burdens and rising fiscal deficits.

Chart 2. Countries Holding General Elections in 2024



***Correction, October 27, 2023.** This figure has been corrected to include data for Mexico.
Source: Center for American Progress

Further complicating the outlook is our belief that we will need to finance the large U.S. national debt and growing deficits with shorter-term maturities, diverging from the past when it was easier to issue longer-term maturities.

Given the many forces that could impact earnings over the next year, investors should emphasize stock selection over owning the broad market indices.

The most important common theme is the growing demand for and use of high technology to increase productivity, lower costs and raise living standards.

It is against this backdrop that market prognosticators are making predictions for 2024. As negative as most forecasters were coming into last year, the forecasts for 2024 are more positive as inflation has eased and the market anticipates rate cutting from the Fed and other major central banks. We would note that the market must digest some unusual events including the prospect of an escalation in the current conflicts and the need for a divided and ineffective Congress to be able to address significant national security and budgetary issues in the near term. Further complicating the outlook is our belief that we will need to finance the large U.S. national debt and growing deficits with shorter-term maturities, diverging from the past when it was easier to issue longer-term maturities. This puts additional strains on the Congress and the Federal Reserve to get it right.

Given the many forces that could impact earnings over the next year, investors should emphasize stock selection over owning the broad market indices. We continue to favor companies that are among the leading beneficiaries of the reindustrialization of the U.S. economy, those that are driving productivity increases to offset rising living costs, enhancing healthcare outcomes, and those that are critical to national security. The most important common theme is the growing demand for and use of high technology to increase productivity, lower costs and raise living standards. Because we expect corporate earnings will continue to rise overall, the markets could reach new highs in 2024 though investors should anticipate significant volatility.

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The Geopolitical/Political Transformation and the 2024 Elections

"The year 2023 saw the greatest global resurgence of armed conflict since 1945: 2024 will be worse. We are living, if not through a World War, then a world at war, the great post-globalization jostling to divide up the spoils of what was once America's unipolar imperium. This will be as epoch-defining a period as the late Forties were for Britain or 1991 for Russia."

– Aris Roussinos, UnHerd columnist and a former war reporter

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2024 may be remembered as one of the defining years in history as democracies are under siege. In addition to the upcoming Presidential election in the United States, general elections will be held in forty nations around the world. The elections begin in Taiwan in January and are followed by Russia (March), India (April), the UK (May), the EU (June), and the U.S. (November). As shown in Chart 3, some forty nations representing an estimated 41% of the world's Gross Domestic Product (GDP), and 42% of the world's population will hold general elections. Newly elected leaders will need to deal with unpredictable geopolitical risks involving two wars with no clear end in sight, ongoing conflicts between the U.S. and China, and the need to address massive immigration challenges for Europe and the United States which have become major economic, security and political issues.

Chart 3. 2024 Elections by the Numbers

2024 Elections

	Total	Global share
Number of countries	40	21%
Population	3.2 billion	41
GDP	$44.2 trillion	42

Source: Bloomberg Economics based on IMF forecasts
Figures exclude elections for the European Parliament

Global leaders are facing a challenge as the world has shifted from a prolonged period of détente and globalization to global fragmentation and more restrictive terms of trade.

Global leaders are facing a challenge as the world has shifted from a prolonged period of détente and globalization to global fragmentation and more restrictive terms of trade. At the same time, many nations are experiencing worsening demographics, rising debt servicing costs, slowing growth, energy supply concerns, and increasing domestic divisiveness. By failing to make the necessary investments in critical infrastructure, leaders in many nations wasted a decade of near zero interest rates and now have large debt-servicing costs.

It would not be a surprise to see a more nationalistic focus in the West which would play right into the hands of adversaries to take advantage of the distractions caused by domestic issues typical in an election year.

The wars are increasing fears of migration crises as the forced displacement of millions is stoking greater nationalistic sentiment and growing support for far-right parties. The recent election of Geert Wilders as the Dutch Prime Minister may be a sign of things to come in global politics. A far-right candidate, Mr. Wilders ran on a platform of anti-Islam, anti-immigration, anti-climate change, and anti-EU, and he won. While it is too early to call this win a trend, sentiment among voters has been shifting to the right. It would not be a surprise to see a more nationalistic focus in the West which would play right into the hands of adversaries to take advantage of the distractions caused by domestic issues typical in an election year. China, Russia, North Korea, and Iran are not just watching to see if the political dysfunction stemming from these elections creates the opportunity to further take advantage, they are already taking advantage of the perceived weaknesses of the democracies.

As indicated by each candidate's low approval ratings, many voters in the United States are so dismayed by the choice between President Biden and former President Trump that there is talk of a third-party candidate entering the race. While both are clear frontrunners in their parties at this moment, support for each is shaky. As voters head to the polls in 2024, the implications for investors cannot be understated as highlighted in the quote from noted investor Paul Singer of Elliott Investment Management, who said recently, *"the world is now completely dependent on the good sense of leaders to avoid an Armageddon. It is hard to avoid a conclusion that investors are not nearly as worried as they should be."* While we are not as pessimistic as Mr. Singer, we agree in concept with his sentiment as leadership will be the key to better outcomes.

Investment Implications

"I think there's still a risk that the market is probably underestimating that we're not going to quite make as much progress on inflation as people hope and that there's not going to be quite as much room for Fed easing as people hope."
– Larry Summers, American economist, and former Treasury Secretary

As the world continues to adjust to the changing nature of the global economy and the rising risks of an escalation of war, ARS expects a prolonged lower-growth environment. However, specific companies could see an acceleration of growth under these circumstances as we experienced during the pandemic. Another example of this occurred in WWII involving the railroads, which emerged from near bankruptcy to become among the market's best investments during those years. The wars today now involve the competition for technical superiority on air, land, sea and in space.

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We have begun to see signs of a broadening of the stock market from the well-publicized Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) which is important for the stock market to continue to make new highs this year. The two biggest opportunities stem from stimulants in the system that did not exist before — the climate transformation and more advanced technologies including the introduction of generative AI. While both are incredibly important and exciting opportunities over the intermediate to longer terms, ARS anticipates a bumpy ride for investors until the related businesses achieve more rational valuations and higher earnings to support the current hyped-up expectations.

One of the most attractive investment opportunities for this year is one that underperformed last year, and it involves industrial commodities including copper and rare earths.

One of the most attractive investment opportunities for this year is one that underperformed last year, and it involves industrial commodities including copper and rare earths. One area where the battle for technological supremacy is being fought is over rare earth materials that are essential for the clean energy transition and for future advances in military and industrial technologies. In fact, China recently announced that it will be restricting the export of select refining technologies for rare earths which should make the handful of producers in the West even more valuable than they are today. Client portfolios will continue to emphasize leading companies in technology including leading-edge semiconductor/equipment and the cloud, industrials for infrastructure and national security, energy involving both fossil fuels and renewables, materials essential to support the industrial/military complex, and pharma/biotech which are lowering costs, as well as those businesses with strong balance sheets and solid dividends.

In an economy with near-record levels of employment and rising wages, it is difficult to foresee a scenario in which the Fed will reduce interest rates to the level of current expectations.

In the realm of investment management, it's crucial to acknowledge that decisions must often be made with incomplete information, and rarely do we see economists and market strategists having such a wide range of forecasts as we see today. The primary cause is the challenge of determining the course of inflation and interest rates which are two of the three key inputs into securities valuation followed by the outlook for corporate earnings. In fact, much of the market's enthusiasm in the recent period stems from the view that the Fed would aggressively be cutting rates this year beginning in March. ARS agrees with Mr. Summers and believes that the market misinterpreted the Federal Reserve Summary of Economic Policy (SEP) forecast which had shown three cuts in 2024. In an economy with near-record levels of employment and rising wages, it is difficult to foresee a scenario in which the Fed will reduce interest rates and ease monetary policy to the level of current expectations. Consequently, the market is likely ahead of itself.

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There has never been any economic period where good investments could not be found, and we are confident the current investments in technology, defense, industrials, materials, and healthcare companies will be important beneficiaries of this outlook, serving clients well over the next 12–24 months.

In order to offset the continuing structural decline of the purchasing power of the U.S. dollar, investors would be better served owning well-selected equities over bonds. There has never been any economic period where good investments could not be found, and we are confident the current investments in technology, defense, industrials, materials, and healthcare companies will be important beneficiaries of this outlook, serving clients well over the next 12–24 months.

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