VIG
ASSET MANAGEMENT
HUNGARY

INVESTMENT OUTLOOK

FOR 2024

NEW YEAR, **NEW AMBITIONS**

An interview to kick off the new year with Peter Kadocsa, Chairman and CEO of VIG Asset Management Hungary (VIG AM) about the company's 2023 results, its plans for 2024 and exciting innovations in the pipeline.

The VIG AM Outlook is a new publication being published for the first time this year but is planned as a regular report for the following years. Why is it important and useful reading for a wide range of stakeholders?

I think the quality of the 2024 investment outlook makes it useful reading for every leader of the VIG companies, especially in the financial area, as a source to learn about our strategic and tactical way of thinking. Plus, it also holds great value for financial advisors in presenting a storyline for customer meetings with a strong professional foundation.

You have achieved excellent results in 2023. What does this mean in terms of numbers?

We strengthened our team to support the execution of our new strategy, and we also generated great returns for our customers. Most of our funds had double-digit nominal returns and several grew 20% or even 30% last year. More than three-quarters of our assets under management not only had a great nominal return but outperformed the benchmark as well, after fees. We also had a commercially successful year, thanks mainly to our own fund distribution channel and the all-time high inflows from institutional mandates.

What are the pillars of the new strategy?

VIG managed to almost completely buy out its minority shareholder, the Hungarian state, which is a major boost for our regional ambitions. Being part of the VIG family means a great opportunity for an asset management company with a long track record, strong investment know-how and expertise. Having learned global third-party standards in Aegon asset management gives us a great foundation to be a strong pillar of this role in VIG. We have further strengthened our capabilities – team, sales support – to be able to serve more and more VIG countries in line with the Group's new CO3 initiative, which puts more emphasis on communication, collaboration and cooperation between the group companies. We aim to further develop business in all countries while enhancing the profitability of the VIG Group at the same time.

The big success of the year 2023 was the launch of VIG AM's "Rise of the Robots" Fund, which was the first to offer an investment opportunity dedicated to AI in Hungary. What innovations are planned for 2024?

We are in a strong starting position as we already have 35 funds with more than 200 share classes in 5 different currencies (EUR, USD, PLN, CZK, HUF) but we continue to launch new products, in line with the needs of our clients. Some of these solutions are unique in the Hungarian and Eastern European markets. We will launch two "light green" (Art 8) funds with ESG aspects, in addition to strategies not currently available on the market. The SocialTrend equity fund focuses on trends in healthcare, an aging society and changing consumer habits, while the InnovationTrend equity fund – beyond a traditional technology sector focus – is also looking at changes in the communications and consumer service sectors, adding great value to both retail and institutional portfolios. With our "dark green" (Art 9) funds, we will be true pioneers on the Hungarian market: the GreenTrend equity fund targets a riskier asset class, while the GreenBond bond fund is for investors who want to take less risk over the longer term. Both funds meet the highest ESG standards.

What is the Fund Manager's ambition for 2024?

I am proud to say that we are in line with our growth plans declared in 2022, which aimed to triple our AuM by the end of 2025. After one year of preparation for 2024 our biggest ambition is further expansion in the VIG countries. We built a brand-new distribution channel in the Czech Republic together with our colleagues in Bohemika, ČPP, ČPP Servis, Kapitol and Kooperativa. We also started to sell funds via two important networks in Hungary, Money & More and the Union network. Our funds were passported to Montenegro and we set up our funds with Compensa Life so our products can be distributed in Estonia, Latvia and Lithuania. In the upcoming months we plan to boost distribution in our current countries as well as add more VIG countries to the map of VIG Asset Management.

SUMMARY

P4 VIG AM Tactical Allocation Performance 2023

VIG AM Tactical Allocation was launched and presented for the first time in March 2023 – for 2023 as a whole, we have achieved an outstanding outperformance of 101 basis points (bps).

P7 Investment Outlook 2024 – Market Consensus – What can go wrong

Economists and investors are optimistic about a soft landing in the global economy this year, particularly in the US, with expectations of decreasing inflation and lower, but still positive GDP growth in 2024, while in Europe slow growth may persist.

Investors face a significant risk if there is a hard landing or no landing, given that the current market allocation looks optimal mainly for a soft landing scenario. According to the VIG AM Sentiment Indicator, investor optimism is currently at an extreme level, indicating that a market correction may be due in Q1.

P9 Fixed Income Strategy in 2024

The environment for bonds remains constructive. Slowing or muddling activity in the large developed economies is supportive for the asset class. Inflation is also expected to remain in check, reaching central bank targets at the end of this year or next year – but within the policy horizon. In face of high rates governments are prone to spend more to use fiscal expenditures to stimulate demand – therefore, fiscal alcoholism remains a risk.

P12 Equity Strategy in 2024

The baseline scenario (market consensus) is an almost ideal setup for equity markets (i.e. a goldilocks environment for equities), while any upward (overheating economies) or downward movement (recession) on the macroeconomic side poses a risk to markets. The only exceptions could be artificial intelligence-driven productivity growth or if the Fed blows a market balloon ahead of the US election.

P15 Commodity Strategy in 2024

The commodity sector is the only one not pricing in an optimistic scenario, but rather a more severe hard-landing. In other words, better-than-expected economic growth (no-landing) would have a very positive impact on commodities in 2024.

P16 FX strategy

Although a weaker USD is the consensus forecast, this remains a very narrow path as both weaker and stronger US growth could mean a stronger than expected USD.

P21 Expected Returns, Volatilities and Correlations in 2024

The table below summarizes our assumptions for volatilities and correlations for the three-asset portfolio comprising global equities, global bonds, and global commodities.

Correlations	Equity	Bond	Commodity
Equity	1	0.4	0.5
Bond	0.4	1	0.3
Commodity	0.5	0.3	1
Volatility, p.a.	**16.0%**	**5.5%**	**16.0%**

The following is a summary of our return expectations for each economic scenario:

2024	Expected	Expected Returns (USD)			
			MSCI ACWI	Barclays Global Agg	Bloomberg Commodity Index
Scenarios	Probability	Cash	Equity	Bond	Commodity
Soft Landing	60%	3.7%	7.8%	6%	2%
Hard Landing	30%	3.7%	-8.3%	10%	-10%
No Landing	10%	3.7%	9.6%	0%	10%

The optimal allocation of a portfolio will, of course, depend on the economic scenario. Our state-dependent model portfolios are summarized below. We have highlighted the soft landing allocation as our baseline case.

2024	Expected	Portfolio Weights				Expected Portfolio		
Scenarios	Probability	Cash	Equity	Bond	Commodity	**Return**	**Volatility**	**Sharpe**
Soft Landing	60%	15%	35%	35%	15%	**5.7%**	**8.1%**	**0.24**
Hard Landing	30%	20%	10%	60%	10%	**4.9%**	**5.1%**	**0.24**
No Landing	10%	15%	35%	15%	35%	**7.4%**	**10.1%**	**0.37**

1. VIG AM TACTICAL ALLOCATION PERFORMANCE 2023

András Loncsák, CIO

VIG AM Tactical Allocation was launched and presented for the first time in March 2023 at the annual Asset Management Meeting in Bratislava. The monthly allocation summary in 2023 is as follows:

Key
N=Neutral
OW=Overweight
UW=Underweight

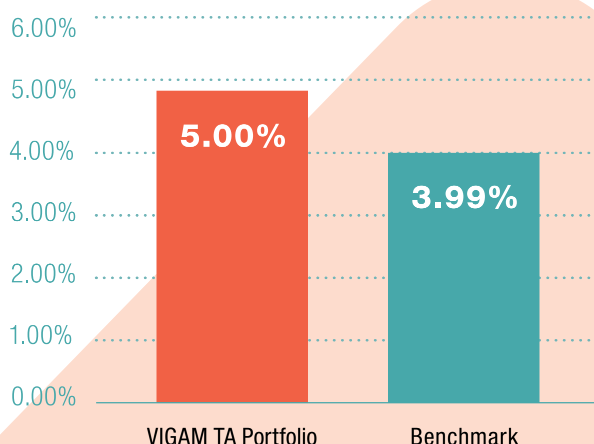
ASSET CLASS	March	April	May	June	July	August	September	October	November	December
Cash (money market)	H OW	OW	OW	OW	OW	S OW	S OW	N	S OW	S OW
Fixed income	N	S OW	S OW	S OW	S OW	S OW	S OW	N	N	N
Core market fixed income	N	S OW	S OW	S OW	OW	OW	OW	OW	OW	OW
EM local currency bonds	N	S OW	S OW	S OW	S OW	S OW	N	S UW	S UW	S UW
EM hard currency bonds	N	S UW	S UW	S UW	S UW	N	N	S UW	UW	S UW
CEE government bonds	N	S OW	S OW	S OW	N	S UW	N	N	N	N
Commodities	UW	UW	UW	UW	UW	S UW	N	N	S UW	S UW
Equities	UW	S UW	S UW	S UW	S UW	S UW	S UW	N	N	N
DM Equities	UW	S UW	S UW	S UW	N	N	N	S OW	N	N
EM Equities	S UW	S UW	S UW	UW	UW	UW	UW	UW	UW	UW
CEE Equities	S UW	S OW	S OW	S OW	S OW	S OW	S OW	N	S OW	S OW

In 2023, there were growth issues worldwide. Europe and China experienced weaker growth, while economic expansion in the US was stronger. As a result, the Fed increased interest rates more than expected. Our Investment Clock indicator (see insert) was in a Recession-like phase throughout the year, with bonds performing the best overall. However, equity markets typically hit their lowest point during this phase. In contrast, in 2023, US equities led by AI-weighted equities outperformed bonds. Nevertheless, equal-weighted equity indices did not perform as well until the positive equity market turnaround in November.

Our monthly Quadrant analysis, which takes into account the Valuation, Fundamental, Sentiment, and Technical indicators for the asset classes, uses the Investment Clock as a starting point to formulate the optimal tactical asset allocation. Unlike the aggregate Global Investment Clock, the US Investment Clock indicator followed a different path due to the AI revolution. This is why the US bond market underperformed while the US equity market outperformed for much of 2023.

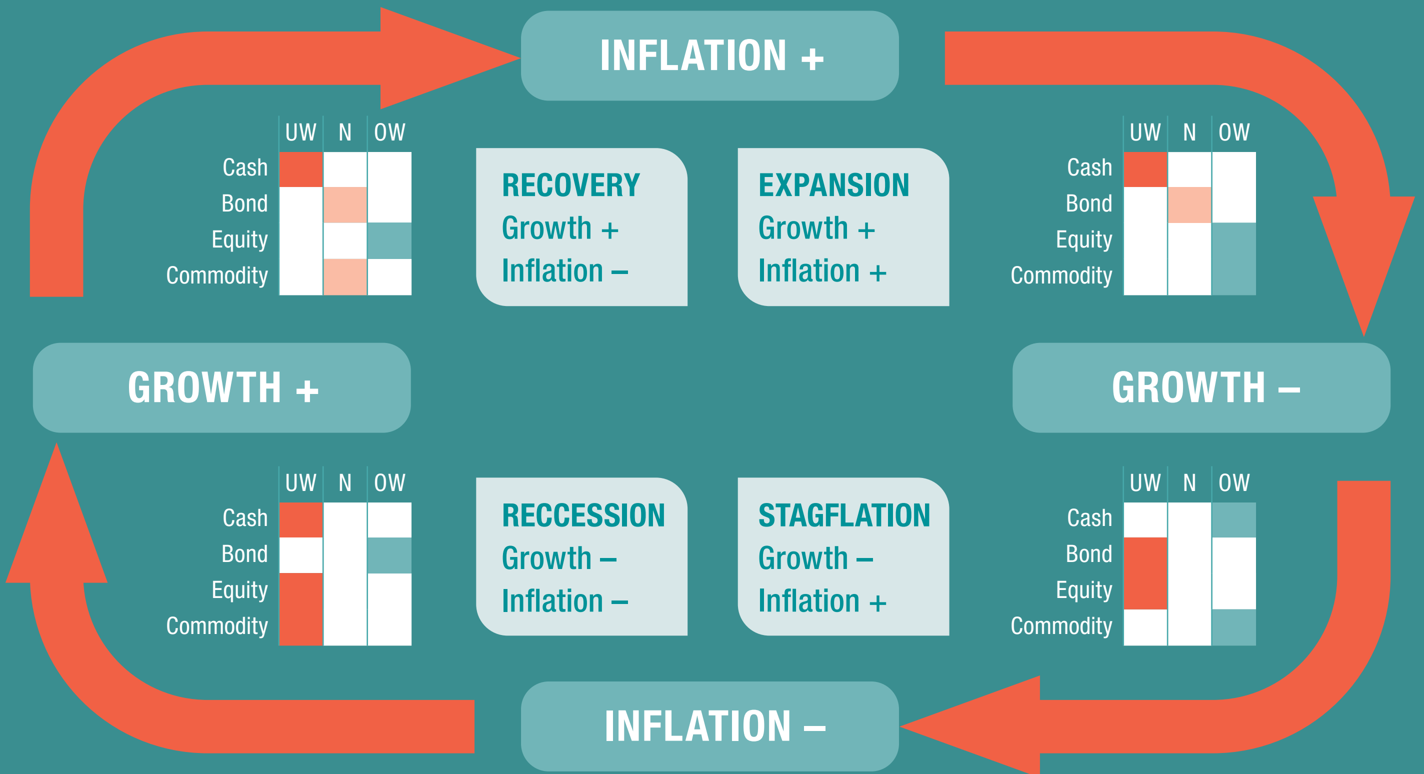
For illustrative purposes, we compare the performance of the monthly tactical allocation since its inception to a benchmark model portfolio. The benchmark portfolio is a 25/25/25/25 cash/bonds/commodities/equities pool, which is expected to outperform a traditional 60/40 bond/equities portfolio over the longer term. This is because we expect real assets to outperform financial assets in the 2020s, in an era of higher inflation and interest rates. **Based on monthly tactical decisions, we have achieved an outperformance of 101 basis points (bps) in 2023.**

Performance since March 2023



WHAT IS AN INVESTMENT CLOCK?

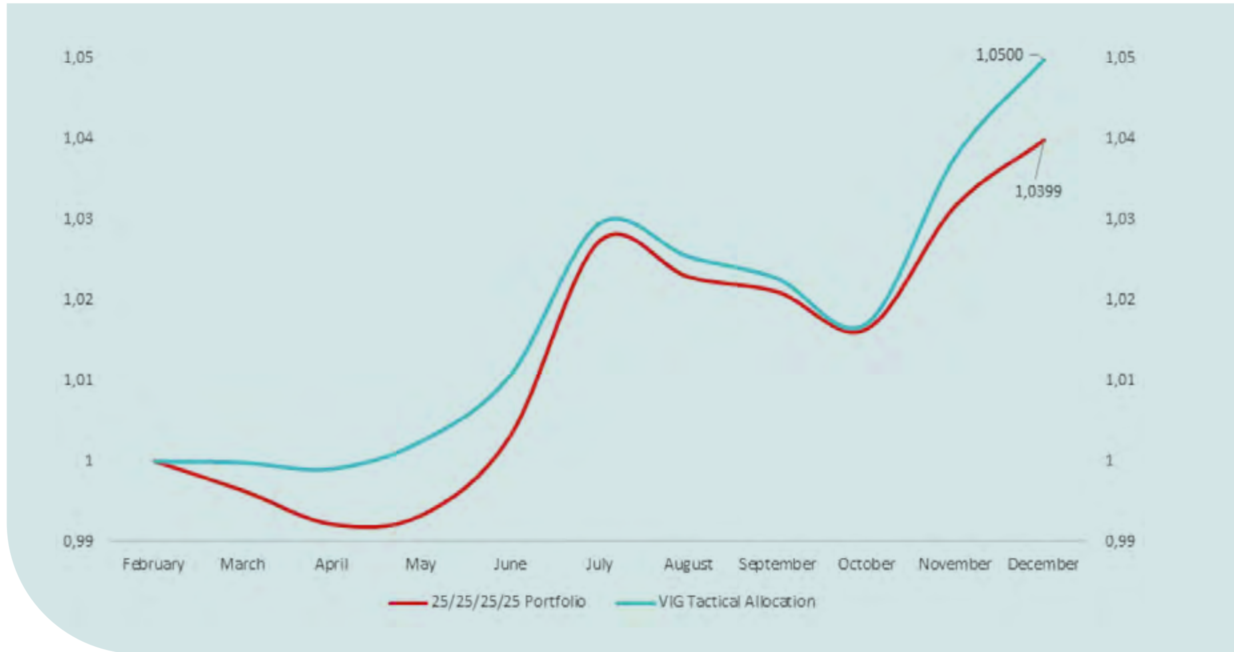
The initial stage of our monthly investment decision-making process involves conducting an Investment Clock analysis. This analysis determines the current phase of the capital market cycle by examining forward-looking indicators in the US, Europe, and China.
It is crucial to determine this position because our backtesting have shown that the stage of the capital market determines the performance of different asset classes. Therefore, we can identify which asset class is preferable at each stage.



PERFORMANCE EVOLUTION

The VIG AM Tactical Allocation Portfolio performed well during the US banking crises in Q1, but the performance of Developed market equities was stronger than expected in Q2 and Q3. Meanwhile, the Core fixed income only began to perform for our portfolio in Q4.

VIG AM Tactical Allocation Portfolio vs 25/25/25/25 Benchmark Portfolio (EUR) March 2023 - Dec 2023



PERFORMANCE BREAKDOWN

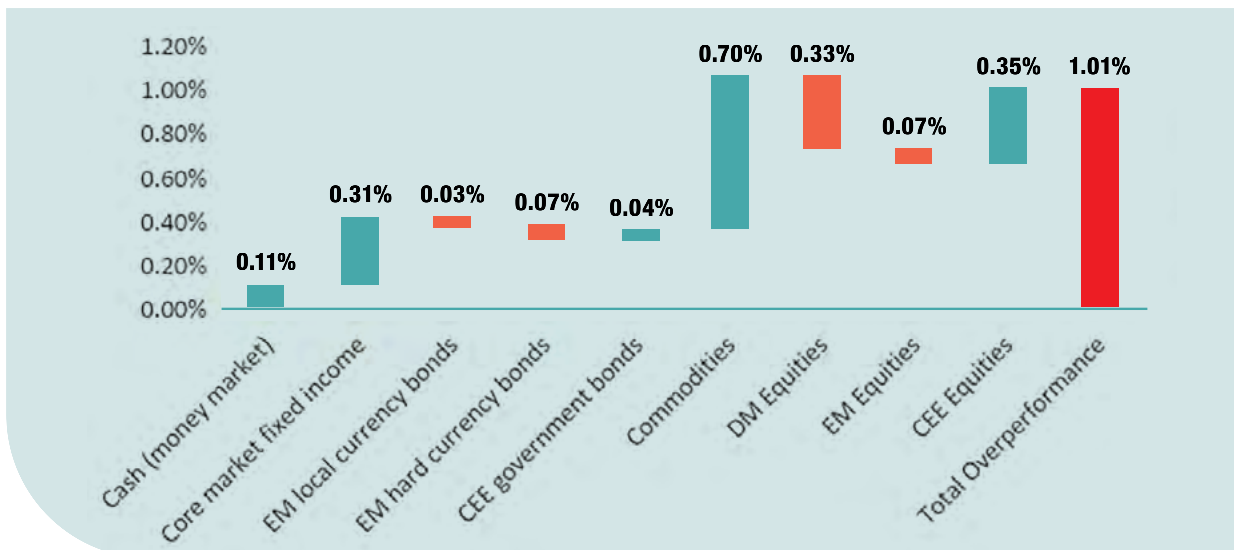
During risk-off periods in March and April, Cash was overweighted to improve relative performance.

In 2023, Core yields provided excellent long-term entry points for fixed income, but our overweight in the core market was a premature call. However, it ultimately contributed significantly starting from November.

Successful technical analysis and timing based on Investment Clock analysis led to the underweighting of Commodities, which worked well since commodity markets are the worst-performing asset class in a recessionary period.

Regarding Equities, the Magnificent 7 shares, which drove 60% of the S&P 500 gains in 2023, had a negative impact on our portfolio as we underestimated their outstanding performance. However, our preference for the CEE equity market paid off well throughout the year.

Overperformance Breakdown of VIG AM Tactical Asset Allocation March 2023 - Dec 2023



2. INVESTMENT OUTLOOK 2024 – OUR MARKET CONSENSUS

WHAT COULD PROSPER AND WHAT COULD GO WRONG IN 2024?

András Loncsák, CIO
Gábor Czachesz, Head of Multi Asset and Quantitative Investment Strategies

SOFT LANDING (OUR ASSUMED PROBABILITY 60%)

A soft landing occurs when interest rates are increased while managing to reduce inflation without causing a drastic rise in unemployment or negative GDP growth. Economists are generally hoping for a soft landing. In the US, inflation is expected to decrease to 2.6% in 2024 from 4.1% yoy in 2023, while real GDP growth is expected to be positive at 1.3% in 2024, down from 2.4% in 2023. In the Eurozone, inflation is forecasted to decrease to 2.5% in 2024 from 5.5% yoy in 2023, while GDP growth is estimated to remain unchanged at 0.5%. **The most likely scenario this year is a soft landing.**

The change in sentiment has been significant since the November 1st FOMC meeting. The market has already priced in approximately 5 rate cuts, and negative news is now being interpreted positively. The prevailing consensus among investors is a soft landing, as reflected in the current investor positioning in the table below. In the event of a soft landing environment, EM Assets may outperform due to investors' current neglect of emerging market bonds and equities. Meanwhile, cash (money market) could experience outflows, resulting in a smaller return outlook compared to fixed income and equities.

Optimal allocation (colors) vs current positioning (x) in a Soft landing

ASSET CLASS	UW	S UW	N	S OW	OW
Cash (money market)					X
Fixed income				X	
Core market fixed income					X
EM local currency bonds		X			
EM hard currency bonds		X			
CEE government bonds			X		
Commodities	X				
Equities				X	
DM Equities					X
EM Equities		X			
CEE Equities		X			

SOFT LANDING IN THE MID-1990S

The monetary policy tightening in the mid-1990s resulted in a soft landing for the economy. The labor market remained strong, and there was no recession during the second half of the 1990s.

We believe that the positive sentiment may continue in January. However, our sentiment indicators suggest that a negative period is inevitable in early Q1. The issue is that stocks are priced for a perfect scenario even though are still many potential risks. Despite the S&P500 being close to a record high, traders appear to be complacent. Any escalation in geopolitical risks could quickly shift market sentiment from greed to fear. Markets believe that the Federal Reserve will make its first interest-rate cuts soon, followed by the ECB in Q2.

HARD LANDING (OUR ASSUMED PROBABILITY 30%)

Increasing interest rates can help to decrease inflation, but it may come at the cost of a recession and high unemployment. In the event of a hard landing, rate cuts would likely benefit long-duration fixed income assets over equities and commodities, with core/developed markets being favoured over emerging markets. This could be very painful for investors who are currently heavily invested in equities.

Optimal allocation in Hard landing

ASSET CLASS	UW	S UW	N	S OW	OW
Cash (money market)		X			
Fixed income					X
Commodities	X				
Equities	X				

HARD LANDING IN THE LATE 1970S AND EARLY 1980S

When we think of a hard landing, we may recall the monetary policy tightening of the late 1970s and early 1980s, which led to economic contractions and high unemployment.

NO LANDING (OUR ASSUMED PROBABILITY 10%)

We believe that the probability of a scenario where there is no landing is currently low. In this scenario, the US economy would continue to be strong while Europe's current slowdown would reverse. Core inflation would remain stable and settle slightly above central bank targets by one or two hundred basis points. The Federal Reserve would not be able to reduce interest rates but would maintain them and emphasize the 'higher for longer' approach. In this scenario, rising real yields would once again become an important driver of the market, leading to the underperformance of bonds. Equities would perform well, as earnings growth compensates for the increase in the discount rate. Robust economic growth in the developed world supports commodity prices.

Optimal allocation in No landing

ASSET CLASS	UW	S UW	N	S OW	OW
Cash (money market)		X			
Fixed income		X			
Commodities				X	
Equities				X	

VIG AM SENTIMENT INDICATOR

According to the VIG AM Sentiment Indicator, investor optimism is currently at an extreme level, and a market correction may be due. A warning signal (red) occurred in November and December 2023, and although it did not work for December, by January the sentiment became even more stretched. In February and July 2023, the warning signal was followed by a 3.6% drop in the S&P500 and a 6.7% d in the MSCI World Index in March, and a 9.9% d in the S&P500 and a 11.1% in the MSCI World Index between August and October. While optimism is high as the year begins, it is not too soon to be concerned that things may change.

3. FIXED INCOME STRATEGY IN 2024

Ádám Bakos, Head of Fixed Income

Following the huge selloff last year until October, we experienced a massive reversal in Q4 with long rates falling more than 100 bps in the US as well as Europe. What are markets pricing now and where do we see the risks? Please find our thoughts for 2024 below.

In terms of economic growth pockets of the global economy already suffered in 2023. China still faces challenges as it deleverages from the huge property boom. Growth rates in European economies were underwhelming after the energy crisis, while the traditional car manufacturing sector remains a structural challenge. The US economy outperformed the rest of the world as excess savings accumulated during the Covid period continued to fuel consumption and drove global yields higher. However, this growth engine is also about to arrive to a cyclical slowdown as savings become depleted and the sharp and quick rise in rates starts to bite with a lag.

Inflation behaved favourably and slowed quicker than expected in 2023 but most of the disinflationary process might be behind us. Goods inflation is back to pre-Covid levels as supply shocks and shipping costs eased while services inflation also seems to have peaked but remains elevated in some sub-sectors.

All in all, at the dawn of the New Year, the environment for bonds remains constructive. Slowing or muddling activity in the large developed economies is supportive for the asset class. Inflation is also expected to remain well-behaved, reaching central bank targets at the end of this year or next year – but within the policy horizon.

Technicals remain mixed. The extreme volatility we have experienced in the last two years should dissipate as inflation volatility declines and uncertainty about central banks' rate path is reduced following the end of rate hikes. This lower volatility might bring new inflows to the market. At the same time, quantitative tightening will continue to be a drag on the market even if the issuance picture looks more favourable than last year.

The market is currently pricing this soft landing scenario where inflation will not be a concern, coupled with an economic contraction that is not dangerously deep or long. This is reflected in the implied rate path: in the US the market expects the Fed to start cutting rates in H1 and to cut by roughly 200 bps in the next two years. In Europe, market-implied pricing suggests the ECB would cut rates by 200 bps over the next 18 months.

But historic data also suggests that a soft landing has a very narrow path. We believe the chances of a deeper downturn are not negligible as rates in the US and Europe are massively in the restrictive territory. If the arriving cyclical downturn proves to be a deeper recession, current market pricing look soft: central banks should act more decisively and cut rates to well below current expectations. Just look at the recent rate cut cycles by the Fed: cumulated rate cuts were larger or the terminal rate was lower than currently priced (admitting that most of these cycles saw a special crisis of their own).

Start of cycle	End of cycle	Peak rate	Low rate	Cumulated cuts	Length of cycle
31.05.1989	30.09.1992	9.8	3.0	6.8	3.3
29.12.2000	30.06.2003	6.5	1.0	5.5	2.5
31.08.2007	31.12.2008	5.3	0.3	5.0	1.3
28.06.2019	31.03.2020	2.5	0.3	2.3	0.8
Average				**6.1**	**1.9**
		Current	**pricing**		
31.03.2024	**31.12.2025**	**5.5**	**3.3**	**2.4**	**1.8**

Despite positive developments in inflation, we also think that a scenario we should not exclude when taking investment decisions is when inflation proves to be stickier than currently expected. Memory of the markets seems to be very short and inflation looks to have ceased to be a primary risk factor for investors. But changing dynamics in the labour market mean service prices can remain stickier while given the heightened geopolitical risks in the world, agricultural and energy prices can spike any time. Also, facing a cyclical slowdown and restrictive monetary policy governments are prone to spend more to use fiscal expenditures to stimulate demand – thus, fiscal alcoholism remains a risk.

In the tables below we compiled the possible outcomes for these scenarios (soft landing, recession, sticky inflation) to illustrate expected returns in each case.

For detailed tables, please see the Appendix.

	BBG consensus	Expected end 2024 10-yr yields (base rate+steepness)	Expected end 2024 10-yr yields (Bund spread)	Expected 1-yr total return (base rate+steepness)	Expected 1-yr total return (Bund spread)
		Soft Landing			
Czechia	3.90%	3-4%	2.5%-3.5%	4%-9.6%	9.6%-15.2%
Hungary	6%	5.5%-6.5%	4.5%-5.5%	1.94%-6.64%	6.64%-11.34%
Poland	5.17%	4.5%-5.5%	4%-5%	1.93%-6.03%	3.98%-8.08%
Romania	6.56%	5.5%-6.5%	5%-6%	4.26%-8.86%	6.56%-11.16%
		Recession			
Czechia	3.90%	2.5%-3.5%	2.5%-3.5%	6.8%-12.4%	6.8%-12.4%
Hungary	6%	5%-6%	5%-6%	4.29%-8.99%	4.29%-8.99%
Poland	5.17%	4%-5%	4%-5%	3.98%-8.08%	3.98%-8.08%
Romania	6.56%	5%-6%	5.5%-6.5%	6.56%-11.16%	4.26%-8.86%
		Sticky inflation			
Czechia	3.90%	4.5%-5.5%	4%-5%	-4.4%-1.2%	-1.6%-4%
Hungary	6%	6.5%-7.5%	6.5%-7.5%	-2.76%-1.94%	-2.76%-1.94%
Poland	5.17%	5.5%-6.5%	5.5%-6.5%	-2.17%-1.93%	-2.17%-1.93%
Romania	6.56%	6.5%-7.5%	7%-8%	-0.34%-4.26%	-2.64%-1.96%

2024 - THE YEAR OF ELECTIONS

More than 4 billion people will head to the voting stations in 2024 and some of the elections across the world will definitely have a meaningful impact on capital markets as well. We collected some of the most interesting contests for you – what to watch in 2024 global politics?

TAIWAN ELECTIONS: on January 13, Taiwanese people will elect a new president and a new legislature. The contest looks quite tight, as the pro-independence candidate's (Lai Ching-te, Western friendly) support has stayed at 35% while the opposition candidate's (Hou You-ih, China friendly) support was 30% in the latest polls. Prepare for some Chinese sabre-rattling in case of a Lai win, while markets might be shaky if the opposition wins, which would mean more uncertainty for the status quo.

REPUBLICAN PRIMARIES IN THE US: Republican Party members start voting state-by-state who they want to elect as the presidential candidate for the November elections. Donald Trump is polling way ahead of each opponent, but the three closest contenders, Nikki Haley, Ron DeSantis and Vivek Ramaswamy have spent a lot of money in Iowa and New Hampshire – where primaries will take place on January 15 and 23, respectively – to boost their chances.
If Mr Trump wins in these states easily, then probably sweeping the candidacy will be a walk in the park for the ex-president. If any of the contenders put in a strong performance in the first two primaries, exceeding expectations, then the race could be more open.

PRESIDENTIAL ELECTIONS IN RUSSIA: Russians head to the polls on March 15-17. Expect no surprises here. Vladimir Putin is ready to be re-elected with no serious opponent allowed to join the race. We can only hope the Russian president does not want to spend his probably last term (he will by 78 by the end of it) with a prolonged war.

EUROPEAN ELECTIONS: there will be nine parliamentary elections, a couple of presidential elections and European Parliament elections in Europe during the course of 2024. The main trend to watch is whether right-wing parties can gain ground, which might result in changes of government in Portugal (10 March 2024) and Austria (September 2024). Also, the European Parliament elections will be more interesting than usual. The far-right is ready to make gains which will influence the EU's policy stance on many current issues (climate, foreign policy, immigration, etc.). UK elections (at the end of 2024) might lead to a Labour government as Tory support is very low after the messy Brexit process. The future nature of the UK-EU relationship will be an important question, with Labour probably supporting a re-strengthening of economic ties. In the Eastern European region, Romanian elections will be interesting to watch, where based recent polls, the current coalition would be unable to form a majority coalition.
US PRESIDENTIAL ELECTIONS: Certainly the most awaited event of the year is the US presidential (and congressional) election on November 5. Most probably it is going to be a rematch between Donald Trump and Joe Biden, despite legal cases against Trump and health issues surrounding Biden. If Trump wins we will have to brace for more market volatility, although we have to admit that markets did not perform poorly during the Trump presidency. A significant change in the geopolitical landscape would be certain and US exceptionalism would probably return as an important market theme.

EMERGING MARKETS: Mexico's leftist president Lopez Obrador will leave office and despite his questionable legacy, his popularity suggests that policy continuity is secured, although any surprise in the June elections would put one of the most popular EM trades under scrutiny. Some of the world's most populous countries will hold elections as well: India and Indonesia will also vote, Indian elections being quite important in terms of international relations. We will also see elections from South Africa through Pakistan to Iran, just to mention a few of the remaining countries of interest.

4. EQUITY STRATEGY IN 2024

György Pálfi, Head of Equities

Equity markets closed a very strong year in 2023 despite the bank failures that occurred in March, recession fears and the highest borrowing costs in decades. The first nine months were all about the rally in AI-related US stocks (now called the Magnificent 7), while later the Federal Reserve signalled that it's likely done raising interest rates, which pushed equity markets within striking distance of all-time high levels.

European equity markets also had a good year thanks to a rally at the end of the year, while regional markets in Central Europe are set for their best year since 2009. Emerging markets were the big laggards of the year, but only because of the slow Chinese market. Excluding China, these markets managed to replicate the good performance of other non-US markets.

CONSENSUS VIEW: GLOBAL EQUITY MARKETS

While the market consensus predicted gloom and doom for 2023, now it is pretty optimistic despite the last year's strong performance. The current consensus is cautiously positive on earnings growth – in line with the soft landing macro scenario –, while the expectation is that the Fed will start lowering borrowing costs by mid-2024. **This means that the baseline scenario (market consensus) is an almost ideal setup for equity markets (i.e. a goldilocks environment for equities), while any upward (overheating economies) or downward movement (recession) on the macroeconomic side poses a risk to markets. The only exceptions could be artificial intelligence-driven productivity growth or if the Fed blows a market balloon ahead of the US election.**

2024 MSCI All country yearly expected return (DDM model)

Soft landing	**7.80%**
No landing	**9.60%**
Hard landing	**-8.30%**

HARD LANDING SCENARIO

One of the key challenges for investors will be assessing the lagged impact of the Fed's rate hike cycle. Although global economies – especially in the US – proved to be very resilient, we cannot rule out a sharp slowdown in the world economy as a lagged effect of the tight monetary policy. As most of the economies are definitely slowing down, another downturn of the EPS cycle would not be a surprise. If the hard landing scenario materializes, it would mean a high single-digit downside for equity markets (according to our DDM model).

EPS growth scenarios in Hard landing

	EPS growth for 2024			
2024 RISK FREE RATE	10% (consensus, Soft Landing)	-5%	-10%	-25%
2.75%	7.8%	-0.3%	-5.8%	-11.2%
3.00%	8.2%	0.0%	-5.5%	-10.9%
3.75%	8.7%	0.5%	-4.9%	-10.4%
4.00%	9.0%	0.8%	-4.7%	-10.2%

Equity return based on dividend discount model: MSCI all country index, ERP: 5%, RFR based on our rate path assumption, EPS growth based on the deviation from consensus.
Blue fields: consensus forecast, white fields: EPS recession

NO LANDING SCENARIO

While the consensus expects lower growth for 2024, almost no analyst predicts another wave of inflation. The current consensus forecast is that inflation will continue to slow at least in the first half of the year but will remain above central banks' targets until the end of the year. Although the market expects that interest rates will likely remain high in the first half of 2024, the FED is seen cutting interest rates gradually in H2. If inflation proves to be more sticky or the US economy remains resilient, real rates will be higher than the consensus expectation, which can be translated to lower equity valuations (P/E compression), just as it happened in 2022. On the other hand, EPS growth could be much higher than current expectations shows (consensus expects 10%). Although assumed market return can be higher due to the higher sensitivity of the model to EPS growth, the expected volatility may also be higher thanks to the higher volatility of the bond markets.

EPS growth scenarios in No landing

	EPS growth for 2024			
2024 RISK FREE RATE	**10% (consensus, Soft Landing)**	**15%**	**20%**	**25%**
3.80%	7.8%	10.5%	13.2%	16.0%
4.25%	7.3%	10.0%	12.7%	15.4%
4.50%	7.0%	9.7%	12.4%	15.1%
4.75%	6.7%	9.4%	12.1%	14.8%

AI: HYPE OR THE START OF THE FOURTH INDUSTRIAL REVOLUTION?

2023 began with a sharp rise in the theme of Artificial Intelligence. The market focused on enablers (Nvidia) and hyperscalers (mega-cap US technology sector). As a result, the "Magnificent 7" S&P 500 stocks – Apple, Microsoft, Amazon, Alphabet, Meta, Tesla and Nvidia – achieved an extraordinary premium to the rest of the index, masking discounts across most of the index. Excluding these seven names, a forward P/E would be 17.8x compared with the full index at 20x. If AI continues to develop and spread at beyond-exponential rates, it could boost productivity significantly in the coming years. AI could lead to a 1.5 percentage point increase in annual global labor productivity growth if it were to achieve widespread adoption over the next decade (ML, GS). According to the historical lesson of innovation-led productivity booms, it can materially alter potential EPS growth over the next decade compared the base case scenario.

REGIONAL OUTLOOK

In the US, despite lower GDP growth, the earnings cycle is seen reaching its bottom in 2023 and earnings may grow by 10% according to the market consensus. After the FED's pivot in November, lagging market segments are joining the Magnificent 7 rally and helping the market to reach levels last seen at the end of 2021. As a result, the market has fully priced in the soft landing scenario: a modest rate hike with low double-digit EPS growth. While we believe that US exceptionalism could persist into 2024, the risk/reward ratio has reached a relatively unfavourable level.

European equities eventually achieved a double-digit rise in 2023 thanks to the year-end rally, although they significantly underperformed the US market. We still see no reason for EU equities to outperform global markets. At 13 times forward P/E, the market has already discounted lower ECB rates, meaning that without an upturn in EPS expectations, the revaluation may end. But while the earnings cycle in the US is expected to bottom out, earnings growth in the EU is unlikely in the base case scenario.

In the soft landing scenario, **EM ex-China** could perform better in 2024. Better relative growth, lower real rates, a weakening USD, tight EM spreads and better commodity markets may support EM performance. In the consensus scenario, our conviction level of underweighting EM countries is lower. In other scenarios (hard or no landing) we still prefer DM markets – as we recommended during the whole year of 2023. Within the EM universe, we prefer LATAM and Central European countries over Asia.

Central European equities gained more than 40% in 2023 in EUR terms. Profits in the region were much better than the consensus expected, keeping market discounts elevated despite the strong performance. We expect CEE markets to remain strong in 2024 as valuation and sentiment continue to support these markets. On the macro side, disinflation and lower rates pave the way for a consumer and economic recovery in the coming year. The profitability of companies in the region has improved significantly in the post-Covid period, with oil & gas being the largest contributor to aggregate profits in 2022 and banking in 2023. In 2024, the positive impact of the Polish election could continue to drive markets, while money finding a place within EM (due to the outflow from China) could also be supportive.

5. COMMODITY STRATEGY IN 2024

Zsolt Kardos, Portfolio Manager

In 2023, the Bloomberg Commodity Index decreased by over 12%, even though gold reached a new high of over USD 2100 and the prices of several foodstuffs, such as orange juice and cocoa, hit multi-decade highs. The main reason for the poor performance was the weak demand for commodities resulting from slowing economic growth. In a favourable scenario of a soft landing in 2024, this would not result in a more severe economic problem. However, in the case of a hard landing, the commodity sector would continue to perform poorly.
What could cause the BCOM Index to shift upward and commodity investments to become profitable again? The index is heavily influenced by energy, particularly oil, as shown in the chart below:

Although there has been an increase in war conflicts, on a historical level we only saw a short-term spike in oil prices, which eventually returned to pre-war levels. However, if there is an escalation in armed conflicts, that could lead to a sustained rise in oil prices in the future. The Biden administration has drawn down half of the US strategic oil reserve from storage to keep fuel prices low in the US. This strategic reserve will need replenishing; the question is when and at what prices. Unless there is a supply-side problem, such as the Ukraine-Russia conflict or the spread of war in the Middle East to other oil-producing countries, the price of oil is likely to rise intermittently. We assume it will be between $65 and $80 in 2024. Therefore, the Bloomberg Commodity Index will only show a moderate increase at most. However, regarding investor positioning, the commodity sector is the only one not pricing in an optimistic scenario, but rather a more severe hard landing. In other words, better-than-expected economic growth (no landing) would have a very positive impact on commodities in 2024.

Bloomberg Commodity Index and Crude Oil WTI price development

6. FX STRATEGY

Gábor Németh, Senior Portfolio Manager

USD OUTLOOK

In 2023, the first half of the year was mostly trendless on FX markets, while most of the second half was characterized by an orderly and powerful dollar bull trend until November. This dollar rally has been built on the exceptionalism of the US economy: US growth proved to be much more upbeat than market participants expected and the FED had to remain hawkish as a consequence. At the same time investors priced in slowing aggregate demand globally, which has weighed more on the economies of Europe and Asia

INFLATION AND GOLD

Gold prices are often used as an indicator of inflation Investors tend to buy and hold gold when they anticipate an increase in inflation. Interest rates also impact the price of gold. Historically, gold prices have risen when interest rates are low, but not when they are high. This is because investors are less likely to keep their money in an asset that does not generate returns. The graph below shows correlation between the yield on the US 10-year bond and the inverse of the gold price. However, when the US 10-year yield approached 5%, the price of gold also increased. This suggests that gold investors believe the US Federal Reserve is halting interest rate hikes prematurely in anticipation of an economic slowdown.

Central banks will move from synchronized hikes in 2022-2023 to synchronized cuts in 2024. For 2024 a soft landing scenario is being priced in by market participants. The consensus forecast for a higher EUR/USD next year is built on a widely expected US slowdown, coupled with easing US inflation, which will enable the Fed to make monetary policy less restrictive. The prerequisite for this scenario is that we avoid a global recession in 2024, moreover the EM-DM growth differential should improve. The end of US exceptionalism also implies relatively improving growth in the rest of the world as well. For the end of 2024, EUR/USD forecasts are around 1.12 currently, while more optimistic outlooks pencil in EUR/USD at 1.2 and beyond.

In the short run the soft landing market narrative is intact. Gradual recoveries in global manufacturing and signs of improvement in China's economy should continue supporting global growth expectations. Major central banks have also turned dovish, US front-end yields have peaked, and major equity indices are close to or even already at new all-time highs and the EUR/USD has behaved quite well in terms of the technical picture. A rather healthy correction took place from 1.1, which drove EUR/USD back towards 1.075 levels, where important moving averages and also Fibonacci levels lie, but the correction stopped there. These collectively serve as near-term USD headwinds and keep the market tactically bullish on EUR/USD, opening the way toward 1.12 or higher. A new market narrative would be needed to challenge this.

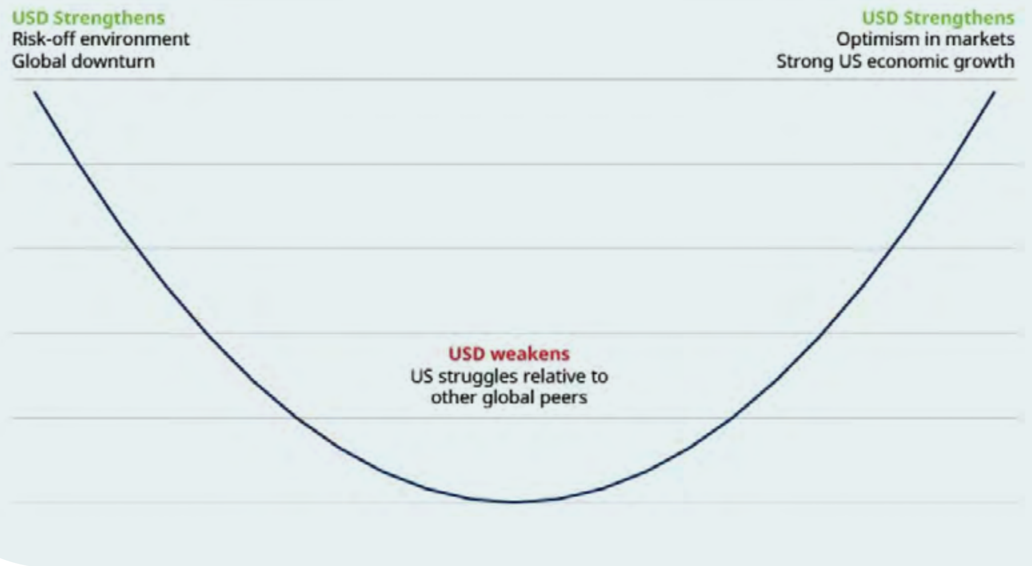
Where could markets be wrong?

In terms of timing, the dollar traditionally performs well at the start of the year and with the Eurozone in recession, many strategists thought the first quarter may be too early to see a decisive turn higher in EUR/USD, and higher levels may become more apparent from the second quarter onwards.
The consensus thesis is that tighter interest rates would finally slow the US economy and the FED would start cutting rates at the turn of Q1-Q2 in 2024. Around the first Fed cut, the US yield curve usually starts a bullish steepening trend, which is the most consistent weak USD regime.
However, many short-to-medium-term fair value models suggest EUR/USD is about fairly valued around 1.075. In other words, there is no extreme undervaluation that has supported EUR/USD at these levels in the past. This really does build the case that any potential EUR/USD rally is likely to be driven by the dollar leg.

What happens if the ECB races head-to-head with the FED?

The most striking headwind to a EUR/USD rally largely stems from weak Eurozone growth and the risk that the ECB chooses to cut rates alongside the Fed. After recent growth data and inflation numbers in the Eurozone surprised to the downside, market expectations have moved towards faster and more sizeable rate cuts by the ECB. Clearly the risk is that growth could be below par in the Eurozone and the ECB eases earlier than the Fed but in similar magnitude. This would limit the expected narrowing in yield differentials at the short end of the curve and result in an absence of a catalyst triggering a EUR/USD rally.

The "dollar smile"



In our view, investors usually play bets and 2024 consensus outlooks early in the year, which means the next few months are likely to provide a weaker USD environment as long as the current market narrative is intact. Meanwhile, on the medium term, many risks are underpriced as next year unfolds, which can support USD.

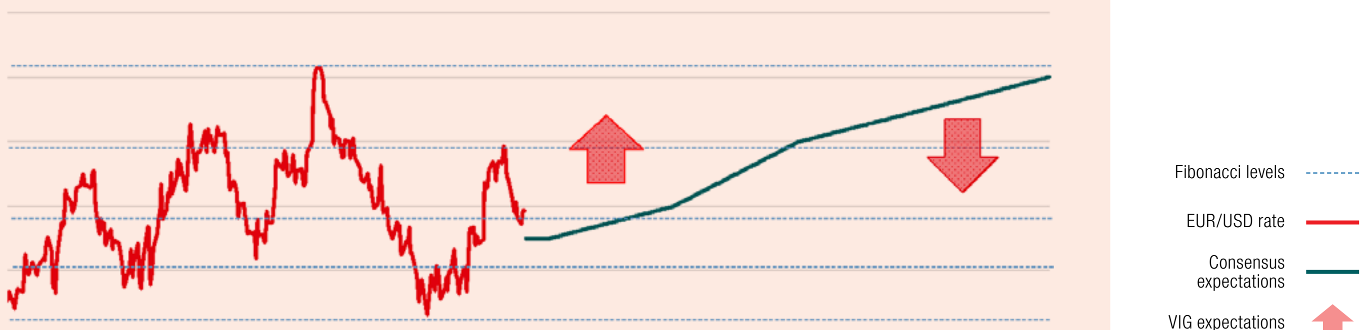
The classic USD smile (see above) provides meaningful insights. When US growth expectations improve versus the rest of the world (US exceptionalism), which was the case in H2 2023, USD outperforms. The Fed remains one of the most dovishly priced G10 central banks for 2024, ignoring the risk for ongoing US outperformance. We should not forget the upcoming US elections in 2024, which means that new fiscal easing and intentions to spur growth in the lead-up to voting cannot be ruled out (but the political gridlock in the Congress makes it more difficult), so US exceptionalism may have another leg next year, against market expectations. Moreover, many strategists think that any swing in favor of a second term for Donald Trump in the opinion polls could be dollar positive – given the experience of a loose fiscal and protectionist policy agenda during his last stay at the White House.

The other side of the USD smile is also important. A more evident slowdown across major developed economies should take shape next year, driving central bank repricing with a potential for e.g. much sooner ECB rate cuts. Rolling recessions in the Eurozone, fiscal constraints in Germany, and potentially widening peripheral spreads amid large net supply should foster an environment susceptible to USD upside and EUR weakness.

Also, a global recession is again USD supportive, as weaker equity prices and risk-off sentiment is negative for EM FX and leads to USD buying as safe haven. Geopolitics may have some word as well.

The current market narrative for soft landing is a narrow path: slowing US growth while improving economic activity in the rest of the world, slowing inflation and loosening labor markets but no recession. Either faster US growth or worse global growth, markets oscillating between US exceptionalism and recession, would be more USD supportive than currently expected.

EUR/USD exchange rate and expectations



EM FX OUTLOOK

In 2024, we think the most important question for EM investors will be the reaction of risk assets to anticipated Fed easing. Recently, US equities' performance mattered more for EM FX than US rates while in case of the last three Fed easing cycles the bond yield vs equity correlation flipped sharply into positive territory and EM assets suffered. If equities remain solid, however, like in the 80s/90s, the stage could be set for a more broad-based rally in EM currencies. To frame it differently, this is all about the hard or soft landing of the global economy. Our EUR/USD expectations should provide the lead for EM FX as well.

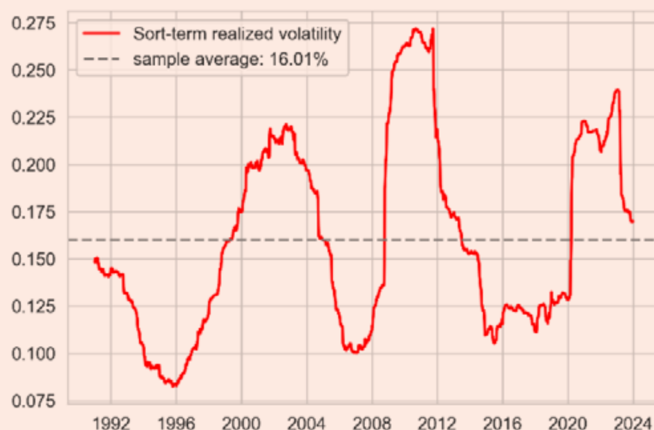
With regard to regional allocation, CEE currencies may be prone to relative underperformance on the basis of expensive valuations, still depressed growth conditions in Europe and especially the scope for many more rate cuts by central banks. Latin America is offering the highest expected real yields and highest carry, which makes it attractive from this point of view, but quite stretched positioning and focus shifting from the fight against inflation towards weak growth might drive investors to look more at Asian currencies, which have better valuation and growth prospects, in a soft landing scenario. The nature of cuts will matter. EM FX with good cutting cycles (where inflation is declining, but growth is superior) should outperform vs. EM FX with bad cutting cycles (inflation declining amid a recession).

However, as long as the current decent narrative is intact investors should stay more hopeful on EM carry, and EM FX with good cutting cycles. US rates volatility will likely move lower at this stage of the Fed cycle, which will also benefit the FX carry trade.

7. EXPECTED VOLATILITIES AND CORRELATIONS IN 2024

Gábor Czachesz, Head of Multi Asset and Quantitative Investment Strategies

From a portfolio construction perspective, the assumptions regarding volatility and correlation are just as crucial as return expectations. To analyse volatility and correlations, it is helpful to start with a long-term historical analysis. The charts below illustrate the realized volatility for major US and international equity, bond and commodity indices. The red line highlights the short-term volatility for each benchmark, calculated using weekly returns and a rolling window of three years. During this timeframe, the realized volatility of the S&P 500 index has surged to peaks of 27% and plummeted to troughs of 8%, averaging out to 16% over the long term.



Source: Bloomberg, VIG Asset Management Hungary

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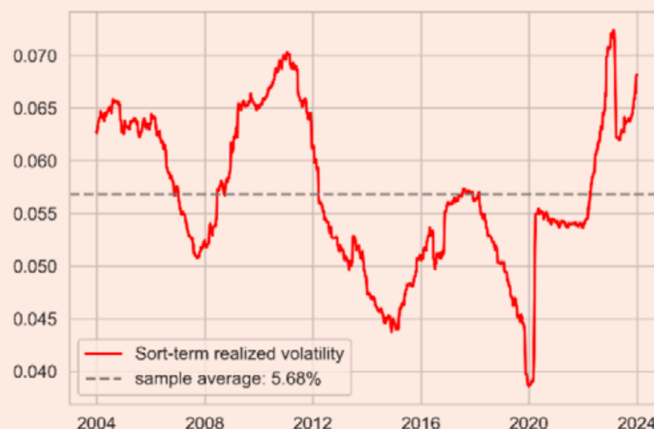


Source: Bloomberg, VIG Asset Management Hungary

When forming our assumptions for 2024, it is important to closely examine recent trends. In 2023, key factors such as the decline in inflation, the risk of recession, and the expected trajectory of monetary policy have all unfolded in a data-dependent and volatile manner. These short-term dynamics have led to increased volatility of fixed income assets, while the implied volatility in the equity market has decreased. This unusual difference in volatility behaviours may be linked to two main factors: the turmoil among regional US banks in the first quarter, which was partially addressed by liquidating long-dated assets to correct balance sheet mismatches. Another important factor was the US Treasury's unexpected announcements regarding sovereign debt issuance. These announcements initially surprised market participants with higher than expected figures in July 2023, followed by an unexpected decrease in November 2023

US Equity and Fixed Income Implied Volatility

Source: Bloomberg, VIG Asset Management Hungary

The correlation matrix is another crucial element in asset allocation. The chart below illustrates the correlation patterns between two significant assets: large-cap US stocks (represented by the S&P500 Total Return Index) and intermediate treasury bonds (represented by the Bloomberg US Treasury Total Return Index). The short-term correlation is calculated using weekly returns and a three-year rolling window, while the long-term correlation compares monthly returns on a 15-year rolling window.

Correlation Between US Equities and Treasuries

Source: Bloomberg, VIG Asset Management Hungary

During the early 1990s, the US economy was emerging from a recession, and the correlation between equities and government bonds was generally positive. This suggests that both asset classes were responding similarly to economic conditions, with equities rising on optimism about economic recovery and bonds benefiting from the Federal Reserve's accommodative monetary policy.

The early 2000s saw a significant shift as the correlation plunged deeper into the negative, especially during the dot-com bust and the subsequent recession. As equities fell sharply, investors sought the safety of government bonds, driving bond prices up and yields down, highlighting the negative correlation as equities and bonds moved in opposite directions.

Moving through the mid-2000s, the correlation began to fluctuate but remained generally negative. The housing market boom and rising commodity prices contributed to a complex investment environment where bonds continued to act as a hedge against equity risk, particularly evident during the financial crisis of 2007-2008.

In the years following the financial crisis, central bank interventions became a significant factor in the relationship between equities and bonds. With interest rates at historical lows and quantitative easing policies in place, the correlation remained negative but less pronounced. Equities gradually recovered, bolstered by low borrowing costs and economic stimulus, while bond yields remained low.

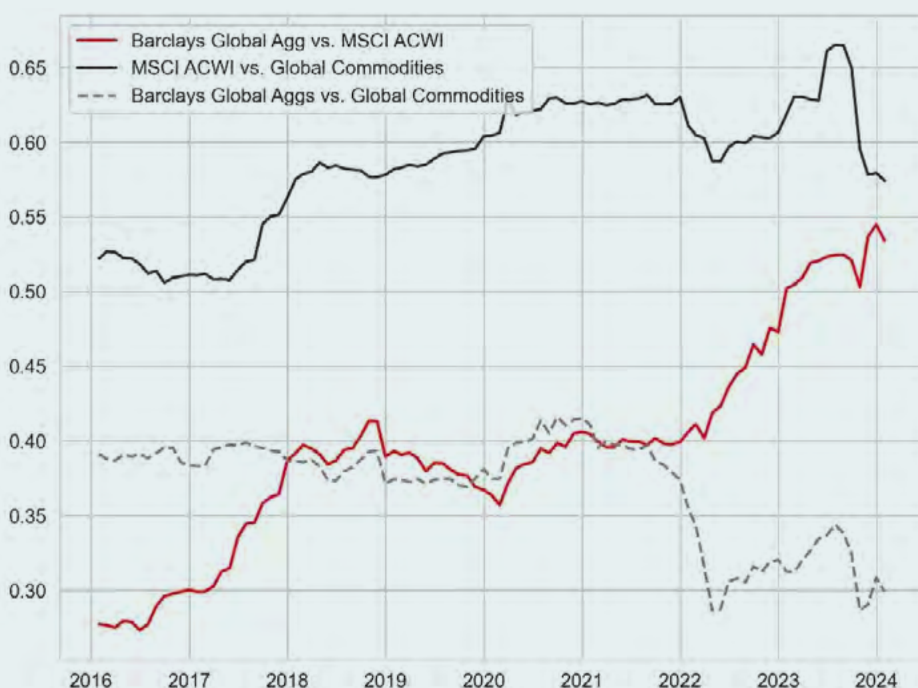
From 2020 onwards, the impact of the COVID-19 pandemic created an environment of heightened volatility. The initial shock of the pandemic saw a flight to quality, with bonds rallying as equities plunged. However, the massive fiscal and monetary stimulus that followed helped equities to recover, and the correlation between the two asset classes fluctuated as investors balanced growth expectations with the reality of an unprecedented economic environment.

Looking forward, we might anticipate a more supportive stance from the Federal Reserve, alongside a soft landing in the US economy. Together, these factors could foster a positive correlation between key asset classes, reminiscent of the 1990s dynamic. However, the growing funding needs of the US Treasury could complicate this outlook by causing increased volatility on fixed income markets. Increased issuance of Treasury securities, coupled with the Federal Reserve's balance sheet contraction, may drive up the term premium. This was evident in the second quarter of 2023 when T-Note yields soared above 5%, prompting a downturn in the equity market. Consequently, a scenario with a rising term premium may also suggest a positive correlation, which is an important consideration for our projections for 2024.

When considering the global investment universe, we can observe slightly different correlation dynamics. Over the last 25 years, the correlation between global bonds and global equities has been increasing, as shown in the chart below, which displays the 15-year rolling correlations between monthly returns. However, it is important to note that the starting point of this trend was already a positive number, which is a significant difference from the pairwise correlation between US Treasuries and US Equities. This likely reflects the unique position of US Treasuries in global investment portfolios, given the US dollar's status as a reserve currency.

The correlation between global equities and global commodities is strongly positive, suggesting limited diversification benefits in this regard. The correlation between global bonds and global commodities has decreased slightly from 0.4 to 0.3, which supports the case for higher weights for the global commodity complex in the optimal portfolio.

Pairwise Correlations between Major Asset Clases



Source: Bloomberg, VIG Asset Management Hungary

SUMMARY TABLES

The table below summarizes our assumptions for volatilities and correlations for the three-asset portfolio comprising global equities, global bonds, and global commodities.

Correlations	Equity	Bond	Commodity
Equity	1	0.4	0.5
Bond	0.4	1	0.3
Commodity	0.5	0.3	1
Volatility, p.a.	**16.0%**	**5.5%**	**16.0%**

Finally, here is a summary of our return expectations in each of the economic scenarios:

2024	Expected	Expected Retrrns (USD)			
Scenarios	Probability	Cash	Equity	Bond	Commodity
			MSCI ACWI	Barclays Global Agg	Bloomberg Commodity Index
Soft Landing	60%	3.7%	7.8%	6.0%	2.0%
Hard Landing	30%	3.7%	-8.3%	10.0%	-10.0%
No Landing	10%	3.7%	9.6%	0.0%	-10.0%

The optimal allocation of a portfolio will, of course, depend on the economic scenario. Our state-dependent model portfolios are summarized below, with our central case of a soft landing allocation highlighted:

2024	Expected	Portfolio Weights				**Expected Portfolio**		
Scenarios	Probability	Cash	Equity	Bond	Commodity	**Return**	**Volatility**	**Sharpe**
Soft Landing	60%	15%	35%	35%	15%	**5.7%**	**8.1%**	**0.24**
Hard Landing	30%	20%	10%	60%	10%	**4.9%**	**5.1%**	**0.24**
No Landing	10%	15%	35%	15%	35%	**7.4%**	**10.1%**	**0.37**

It is worth considering the downside risk in the event of a hard landing or no landing with a portfolio invested for a soft landing. As we can see, a hard landing would be challenging, while our portfolio would perform similarly well even in the event of no landing

2024	Expected	Portfolio Weights				**Expected portfolio**
Scenarios	Probability	Cash	Equity	Bond	Commodity	**Return**
Soft Landing	**60%**	**15%**	**35%**	**35%**	**15%**	**5.7%**
Hard Landing	**30%**	15%	35%	35%	15%	**-0.4%**
No Landing	**10%**	15%	35%	35%	15%	**5.4%**
Weighted avg.						**3.8%**

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