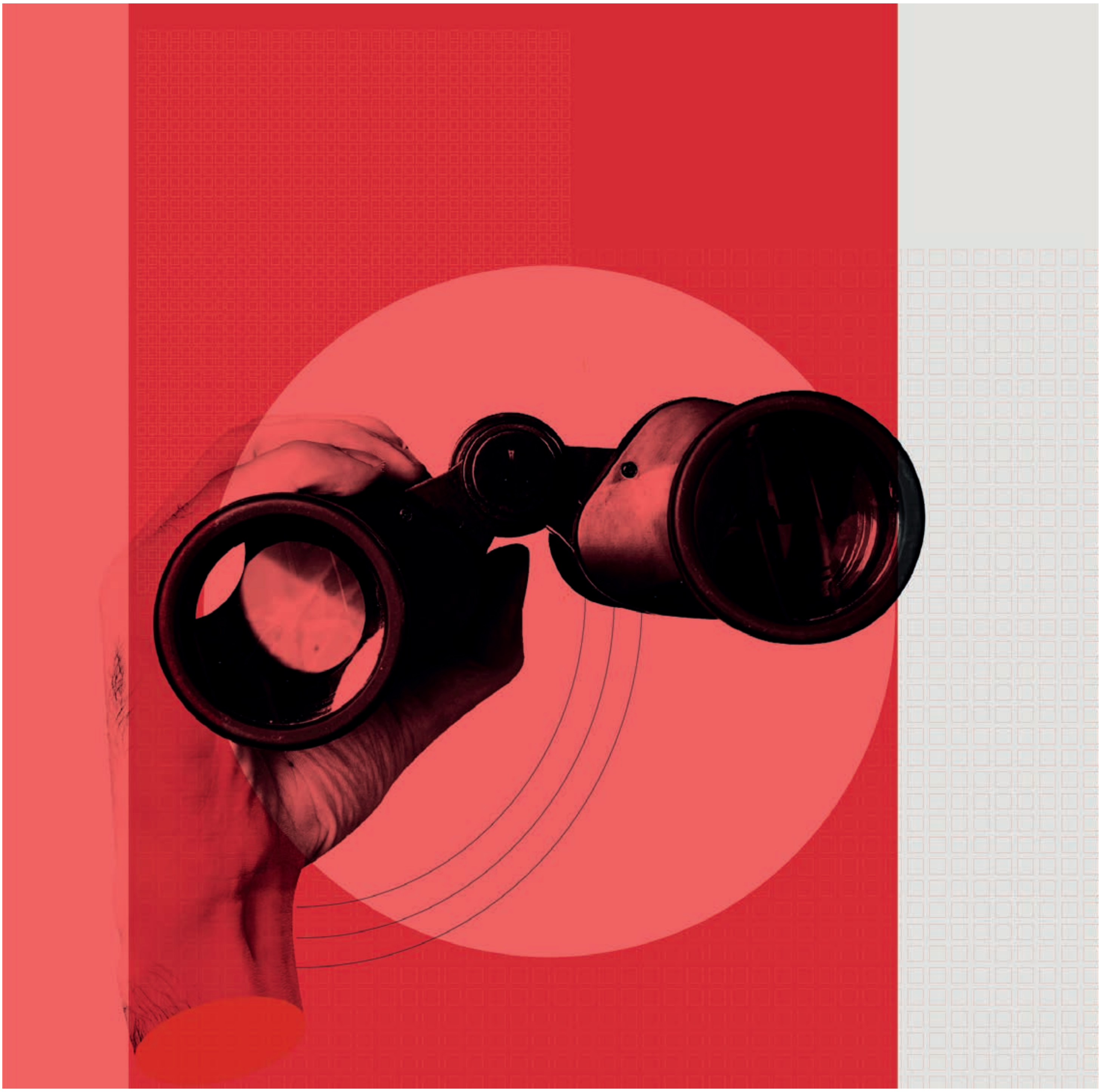
redwheel

Redwheel: 2024 Outlook



Time for balance and selectivity in a world of higher interest rates

Arthur Grigoryants,
Head of Investments, responsible for investment analytics, product management, and ESG

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Despite widespread predictions of a tumultuous year, financial markets in 2023 proved to be more resilient than many anticipated. The year was characterised by a remarkable ability to adapt to unforeseen challenges and avoid the direst forecasts.

Global economic growth, while slower than in previous years, did not plummet as some had feared. The United States and Japan, in particular, demonstrated unexpected resilience in the face of global headwinds. China's re-emergence from its lockdown, while not as dramatic as some had hoped, was nonetheless smoother than expected.

Inflation, which had been a major concern in 2022, surprised many by falling sharply across the globe.

The feared credit defaults and collapse of private assets, which were anticipated due to the excesses of the previous low-interest-rate environment, did not materialise. While the private capital raising environment has undoubtedly become more challenging, there have been no significant signs of a widespread private asset crisis.

Despite these positive developments, the performance of "the Magnificent Seven" technology giants overshadowed many global and US equity managers. These tech titans, with their significant exposure to artificial intelligence (AI) innovation, continued to outperform the broader market.

Central banks, which had been criticised for their handling of the pandemic-induced economic turmoil, successfully navigated a complex monetary policy environment, gradually raising interest rates to more normal levels while maintaining their ability to stimulate the economy if necessary.

While some of the concerns that dominated the headlines in 2023 may still materialise, and underlying systemic tensions remain, the year overall was marked by its ability to avoid the worst-case scenarios.

When the dust settles, two key developments will likely stand out as defining characteristics of 2023.

"While some of the concerns that dominated the headlines in 2023 may still materialise, and underlying systemic tensions remain, the year overall was marked by its ability to avoid the worst-case scenarios."

The rise of AI

The pervasiveness and transformative power of AI took many by surprise, challenging long-held beliefs and disrupting the status quo. Visual processing, language capabilities, and creativity – once considered uniquely human domains – were among the areas where AI made significant strides, unsettling some and raising concerns about existential risks.

As we moved beyond the initial panic and euphoria, it became increasingly clear that AI's technological advancements were rapidly translating into real-world solutions and products. The entrepreneurial spirit of businesses embracing these new technologies and tools was encouraging, signalling the beginning of a wave of innovation that could last for years or even decades.

In financial markets, the immediate impact of AI was evident in the outperformance of tech majors with significant exposure to AI advancements. The next wave of AI's impact will be more nuanced and far-reaching, as AI tools and technologies penetrate various sectors and reshape the competitive landscape of numerous industries.

Sustainability's mainstream acceptance

Somewhat controversially, 2023 will also be remembered as the year when sustainability gained genuine acceptance among mainstream investors. While some might point to the underperformance of ESG, sustainability, and impact-focused strategies, there is a deeper story to be told.

In recent years, the surge of capital into these strategies was often driven by a naive belief that sustainable investing was a sure bet – good for the environment, good for society and good for returns. This reallocation of capital required a test, and the past few years have provided that test.

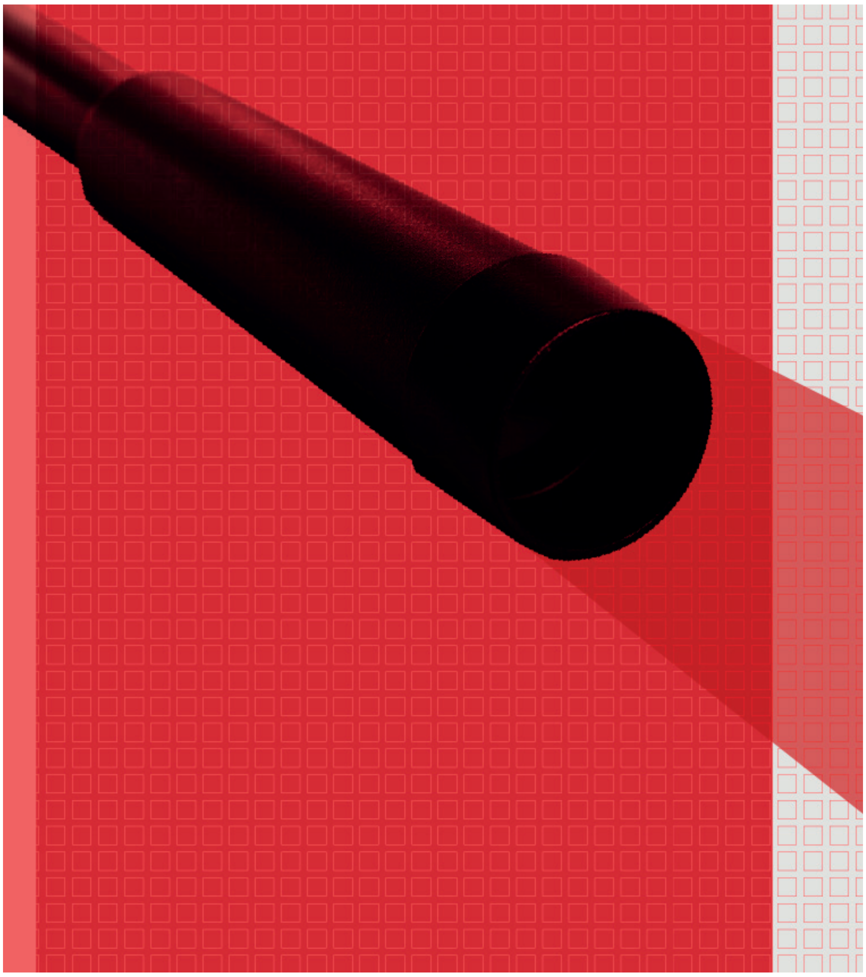
The most compelling evidence of sustainability's structural acceptance in the investment industry is the fund flow dynamic. Despite market fluctuations, flows into sustainable strategies remain robust, indicating that many client groups are committed to aligning their portfolios with products and managers that integrate and emphasise sustainability considerations.

Expectations for 2024 and beyond

As we look towards 2024, it is reasonable to anticipate a continuation of the global geopolitical and macroeconomic concerns that have dominated in recent years. Geopolitical tensions are likely to remain concentrated in three key areas: Gaza / Israel, Russia / Ukraine and China / Taiwan. These conflicts have a proven ability to disrupt market stability and pose unpredictable risks.

On the macroeconomic front, the primary focus will undoubtedly remain on the extent of the economic slowdown in the United States and the severity of the recession in Europe. These concerns extend beyond the realm of pure economics. When combined with rising interest rates and a receding liquidity tide, challenging economic conditions could trigger significant bad loan and leverage issues, potentially impacting a wide range of asset classes.

Adopting a broader perspective, however, the outlook appears less ominous. Long-term investors should find comfort, if not excitement, in the positive impact of advancements in AI and the efficiencies gained in the post-COVID world. These factors, including improved technology, reduced travel, enhanced home-based work capabilities and service arbitrage, are likely to bolster productivity and economic growth in the coming years.



"Long-term investors should find comfort, if not excitement, in the positive impact of advancements in AI and the efficiencies gained in the post-COVID world."

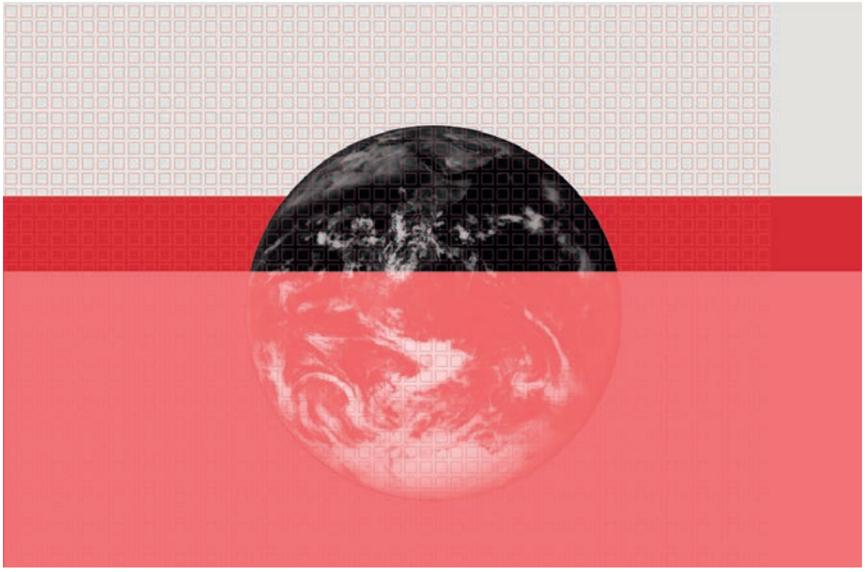
Selective opportunity

While certain segments of the equity market exhibit optimistic valuations, there remain numerous areas and sectors globally that offer attractive investment opportunities for long-term investors and their active managers.

Value stocks in developed markets, as well as broader emerging and frontier markets, present compelling prospects. Additionally, the focus on sustainability-related themes offers an interesting opportunity to further enhance investor returns.

The maturing interest rate cycle is expected to bring positive developments. It will provide investors with both the opportunity to earn decent returns on lower-risk assets and, importantly, introduce a degree of balance to their investment portfolios.

Global Emerging Markets



John Malloy
Portfolio Manager,
Redwheel Global Emerging Markets Strategy

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Closing thoughts on 2023

At the beginning of 2023, the narrative that dominated global markets was clear. Many investors believed that the US would head into a recession while China would see a reopening boom driven by revenge spending. Neither happened and the consensus changed its mind.

Many investors now believe that China is the new Japan and is destined for structural stagflation. On the other hand, the US is an economic phenomenon that is expected to remain resilient throughout the hiking cycle. As a result, the perception was that weak growth in China will spill over to other emerging markets and the commodity complex, while a strong dollar would put additional pressure on Emerging Markets and so on.

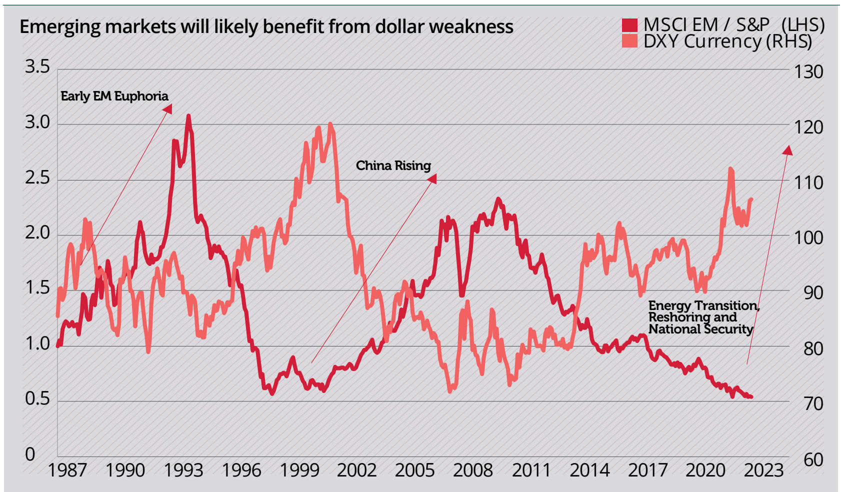
However, we believe the fundamental case for Emerging Markets is still intact and consensus will change its mind once again.

"As we enter 2024, the conditions for an Emerging Market recovery continue to surface."

Looking ahead to 2024

As we enter 2024, the conditions for an Emerging Market recovery continue to surface. In China, the initial signs of an upturn are evident, though the market is waiting for additional policy support.

Rates in the US appear to have peaked, with the US Federal Reserve now signalling rate cuts this year. We expect this to lead to a reversal in the US dollar's strength, which bodes well for Emerging Market performance. Meanwhile, a reducing supply surplus in semiconductors may benefit key technology-exporting markets such as Taiwan and South Korea.



Source: Redwheel, Haver and Bloomberg as at 25 October 2023. Based on the latest Information available. S&P 500 and U.S. Dollar Index (DXY) index is used for performance indicator purposes only and MSCI Emerging Markets Net Total Return index is used to compare/make investment decisions against.

Past performance is not a guide to the future. The price of investments and the income from them may fall as well as rise and investors may not get back the full amount invested. The information shown above is for illustrative purposes only and is not intended to be, and should not be interpreted as, recommendations or advice. The forecasts and estimates are based upon subjective assumptions about circumstances and events that may not yet have taken place and may never do so.

The real GDP growth differential between Emerging and Developed Markets continues to accelerate throughout 2023. Commodity demand, which is beneficial to many Emerging Market countries, should be driven by numerous factors such as reshoring, defence spending and the energy transition. We believe capex growth is likely to trend higher as investor priorities shift towards spending on defence and reshoring, which will drive demand for materials.

Net-zero targets and sustainable energy product growth around the world are drivers of the energy transition. This should drive demand for green metals that are powering the energy transition such as copper.

Emerging Market central banks raised rates well before their developed markets counterparts, remaining ahead of the curve. Going into next year, this leaves room for increased rate cuts.

Valuations in India, which has been a key performer for Emerging Markets, are now stretched and we may see a correction in 2024.

So, in summary, we have a couple of reform stories – Turkey and Argentina. We have a couple of your classic reshoring stories - Mexico, Vietnam. And, of course, on the commodity side, we have Indonesia, Chile, Peru and parts of the Middle East looking very strong.

What portfolio builders should be thinking about
A key part of the attractiveness of the next generation investment universe is the sheer lack of interest from global investors. There's very little money invested! As we know, Emerging Markets have had a difficult decade. But if people aren't investing in countries like China, Korea, Taiwan, then they certainly aren't going to look at the next generation of Emerging Markets, which are a notch or two down from a size perspective, such as Indonesia, Thailand, the Philippines. Meanwhile, many parts of Africa have been bereft of investor interest for nearly a decade. Ultimately, this is why we can build a portfolio that is so incredibly attractively valued, at about six times forward earnings with about 20% earnings growth[1]. So, there's potential for a huge amount of growth at a reasonable price.

I think another important aspect of the future is really, what role does the next generation of Emerging Markets play in the world? The vast majority of the world's commodities and resources are likely to come from the next generation. The vast majority of the world's workforce are likely to come from the next generation. And yet valuations remain very compelling. We saw a very dramatic rerating of Emerging Markets between 2002 and 2007, starting from a very similar valuation base to what we see now. The saying suggests that history doesn't repeat, but it often rhymes. If history rhymes here, there's a strong chance we could begin to see significant inflows into Emerging Market strategies, which would obviously be beneficial for the next generation too.

[1] Source: Bloomberg as at 31 December 2023.

Next Generation Emerging Markets

James Johnstone
Portfolio Manager,
Redwheel Next Generation Emerging Markets Equity Strategy

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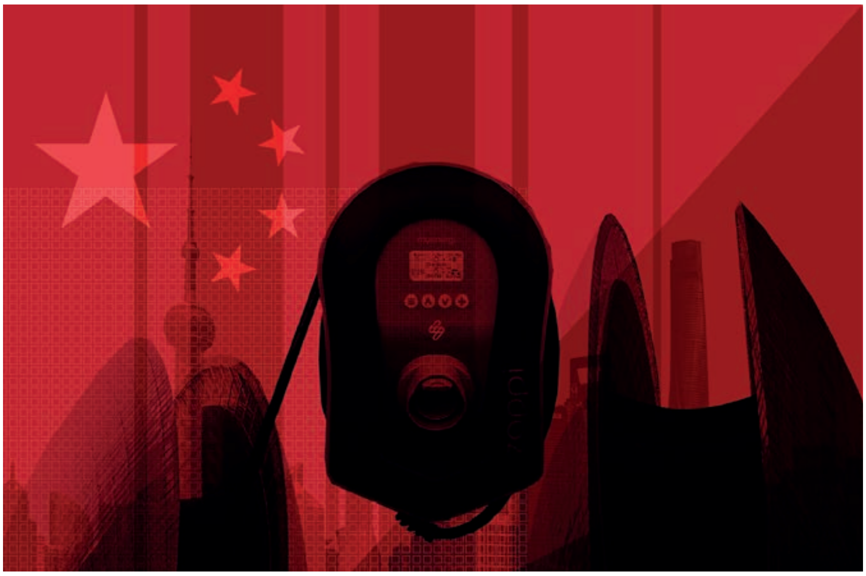

Looking ahead to 2024

We would anticipate 2024 being a pretty good year for Emerging Markets generally, after what has been challenging period over the last decade or more. There are certain caveats to that confidence but, if the Fed has peaked in terms of its interest rate tightening cycle, if China continues to put stimulus into the market and continues to reform its real estate market, then we would anticipate there to be good global tailwinds for Emerging Markets.

Those actions from the Fed should mean that the dollar has peaked. That should put global liquidity back into markets, as money flows out of the dollar to the benefit of the rest of the world, Emerging Markets included. This should prove to be a very good tailwind for Emerging Market economies and stock markets.

In turn, that should benefit one of the three key themes that feature in the Next Generation portfolio, which is reshoring. We continue to see dollars flowing towards industrial assets in countries such as Vietnam, Mexico and India.

Meanwhile, the second theme of commodities can also perform better as spot prices recover. Spot prices are the clearing mechanism for today's supply and today's demand, but for some time, our thesis here has revolved around the supply-demand imbalance of certain commodities which should see steadily rising demand as the world decarbonises. There simply isn't enough supply of things like copper, aluminium and lithium to meet this growing demand. So, we would anticipate that, as demand rises and supply remains constrained, we see higher spot prices, which should lead to the start of what we see as a fairly strong commodity cycle in the years ahead.

Our third theme is travel and tourism where the outlook also looks positive. There could be a bit of pressure from developed market tourists, depending on happens to the US and European economies, but we continue to expect very strong emerging market to emerging market tourism flows.

Strategy positioning

We currently have strong positioning across the three themes outlined above, as you might expect. We have a good exposure to Mexico which continues to look cheap. Mexico is now the largest importer of manufactured goods into the US, having overtaken China last year. We should continue to see inward investment into Mexico as reshoring continues.

Again, the commodity theme feeds through into Middle Eastern countries such as Saudi Arabia and UAE. We've seen a lot of capital being attracted to the UAE as a hub city, and that's attracting capital, attracting employment and driving the residential real estate market, which has been a strong part of the strategy for the last couple of years.

Elsewhere, we have strong exposure to a range of South American economies, such as Chile and Peru. Very excitingly, Argentina has a new president with a mandate for change. This plays across our themes because Argentina has much of what the world wants and needs. It has lithium, copper, beef, wine and it has a fantastic tourism sector. It's an incredibly strong and interesting country right now, so that is well-represented in the portfolio too.

China Equity

Colin Liang
Portfolio Manager,
Redwheel China Equity Strategy

China in 2024

The Chinese economy was expected to rebound quickly in 2023 and resume its role as the engine of global growth. Instead, it stalled to the point where it was being called a "drag" on global output. After a clear pivot from Covid lockdowns, the Chinese economy was faced with a challenging property sector, struggling employment market and plunging exports which obstructed a highly anticipated recovery. This led to China's economic growth being the slowest in a decade. The Chinese equity market therefore went from a risk-on scenario to risk-off during the year, with a <20% fall in MSCI China index.

The table below details what happened in 2023 and our outlook for 2024.

	What happened in 2023?	2024 outlook
Geopolitical tensions	The balloon incident in February disrupted the intentions of US and China to stabilise ties. Biden-Xi's meeting in November signals a mini-detente. Narratives only regarding China's involvement in Russian-Ukraine war, or invasion of Taiwan. Overall limited impacts from sanctions and retaliations.	A benign geopolitical setting into 2024, as China softens its aggression in foreign affairs. Harsh rhetoric is expected to continue on China during US election campaign. Status quo of Taiwan-China relationship after Taiwan election. DPP continues to rule but with a divided parliament.
Policy & regulations	Pro-growth economic policies yet restrained stimulus magnitude. No major negative sector regulations, anti-graft campaign in healthcare were lifted shortly after enacted. Loosening monetary policy, PBOC cut RRR twice by 50 bps in total.[1]	Likely 5% GDP growth target in 2024. Expect accommodative fiscal policies while the deficit target could be raised again in 2024.
Property	Property sales declined by 8%, dragged down by a fall in area sold and flat housing pricing in 2023.[2] Housing completions remain as a key focal point. Loosening property policies since Politburo at end July. Government lends financing support for eligible developers.	Property-related investment should pick up as the government relies on fixed asset investment to restore growth. Property sales have started to bottom out in 2024 after the worst inventory destocking cycle. Project new starts should follow suit.

[1] Source: PBOC as at 31 December 2023
[2] Source: NBS as at 31 December 2023

"Active exposure in China is extremely light, with historically low valuations, we view China equities as offering meaningful upside with limited downside."

	What happened in 2023?	2024 outlook
Consumption	Uneven consumption recovery post Covid, i.e. robust low end and luxury but sluggish mid end. EVs, education and travel did well, but F&B, apparel did poorly. Weak consumer confidence but over the worst. Household saving rate increased to ~35% and has remained elevated.[3] Negative wealth effect restricts spending propensity.	Household income outlook to improve given government's efforts to stabilize the economy. Mid-end consumption growth will converge to those of high end and low end. Prices start to stabilise in 2024 with healthier inventory.
Earnings growth	Corporates had c. 9% earnings growth in 2023.[4] Segments with fast growth were EVs and travel-related business.	Expect low teen earnings growth for corporates against 5% GDP growth target. High growth opportunities e.g. EVs, Semiconductors.
Index valuation	MSCI China current trades at 10x forward PE ratio, a 35% discount to the MSCI Emerging market index.[5] China's equity risk premium is over 6%, one STD below historical average.[6]	MSCI China valuation at troughs given growth is stabilising on supportive policies. Positive catalysts are needed to start rerating, such as benign geopolitics and more domestic stimuli.

We are optimistic that China can achieve 5% GDP growth in 2024 on the back of continuous supporting measures. We believe Chinese corporates' earnings should see growth accelerate to mid-teens from c.9% in the past year. The growth will be contributed by a stabilisation in economic growth, completion of the destocking cycle and continuous cost-down efforts by corporates. Index FY24 price to earning ratio is below 9x, a 35% discount to the MSCI Emerging market index. It is the widest discount between the two indices in two decades. China's equity risk premium has recently climbed to over 6%, reflecting attractive valuations. Active exposure in China is extremely light, with historically low valuations, we view China equities as offering meaningful upside with limited downside. It does require some catalysts to unlock its upside potential, events such as a more benign geopolitical backdrop, further stimulus policies on the property sector and more fiscal expansion from the central government could aid the momentum.

[3] Source: NBS as at 31 December 2023
[4] Source: Bloomberg as at 31 December 2023
[5] Source: Bloomberg as at 31 December 2023
[6] Source: Bloomberg as at 31 December 2023

International Equity

Eloise Veillet
Portfolio Manager,
Redwheel International Equity Strategy

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Closing thoughts on 2023

International equity markets in 2023 made moderate gains in an environment dominated by globally stubborn inflation and continued central bank tightening.

Resilient GDP growth supported equity markets – most notably in Japan, returning to growth after a generation of stagnation – while fears over a deep European recession were averted, with relief from lower gas prices.

2023 was also notable for an acceleration in the adoption of generative AI, GLP-1 obesity treatments and a continued resurgence of defence spending. Exposure to our existing themes of Tech Enablers & AI, Reshoring & Defence and Aging Demographics & Health contributed to positive performance.

Exposure to companies with strong pricing power through the cycle proved to be beneficial during the current inflationary environment. We view this as a key differentiator for companies' relative abilities to maintain profit margins as we head into a disinflationary setting.

"Globally, we view inflation and interest rates as having peaked and a soft landing as the most likely economic scenario."

Looking ahead to 2024

Into 2024, we see many factors pointing to a more positive market backdrop for international equities. Globally, we view inflation and interest rates as having peaked and a soft landing as the most likely economic scenario. In contrast to the US, where valuations are elevated, equity market valuations across major international markets are only at or below their twenty-year averages.

Emerging Markets should benefit from a more dovish Federal Reserve and a weaker dollar. Many Emerging Market central banks are in a position to cut rates. We see room for the Chinese economy to re-accelerate supported by policy actions, in contrast to the moderation of growth we expect in the US.

Europe should also benefit from China's recovery, for example driving a recovery in German exports. We view European consumption and manufacturing as already having bottomed.

We remain upbeat on the structural transformation in Japan. The recent inflation cycle and sharp recovery created a unique opportunity for the Bank of Japan to lift long-term expectations and set inflation back on a sustainable path to the 2% target. Initiatives from the Tokyo Stock Exchange focused on boosting returns and corporate governance reforms provide additional investment opportunities.

Geopolitical tensions and uncertainty will likely persist in a year in which around 45% of the world's population will have a national election[1]. We view this as supportive for our exposure to Commodities as well as Reshoring & Defence themes.

Strategy positioning

With volatility in fossil fuel prices and availability, the energy transition continues to gain momentum with clean energy investments estimated to have risen to $1.7trn in 2023[2]. We view this as a multi-decade tailwind. We are invested in key beneficiaries across the value chain and in both developed and emerging markets ranging from green metals and commodities, power grid providers and electrification enablers.

45%

of the world's population will vote in 2024

[1] Source: Barclays, November 2023.
[2] Source: International Energy Agency, May 2023.

Value & Income

UK Value & Income

Ian Lance
Portfolio Manager,
Redwheel UK Value & Income Strategy

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Closing thoughts on 2023

At the start of 2023, few would have predicted that the outcome of central banks aggressively raising interest rates and shrinking their balance sheets would have been yet another melt-up in US technology shares. Yet that is exactly what happened with the Nasdaq Composite Index soaring by over 40% by year-end[1].

Whilst it has been well documented that the majority of these gains came from the seven large US technology companies (now dubbed "the Magnificent Seven"), this reaction to aggressive monetary tightening was unusual and seems to have been driven by two factors. Firstly, steadily declining inflation data led many to believe that interest rates had peaked, and a central bank pivot was rapidly priced into equities. Secondly, markets reacted to strong results from Nvidia by pricing significant future AI growth into the valuations of many of the technology companies.

"As a value strategy, we are obviously positioned in the cheapest areas of the market, but the level of undervaluation is very stark with some stocks in our portfolio trading on mid-single-digit price-to-earnings ratios and dividend yields of 7-9%."

[1] Source: Bloomberg in capital return terms in US dollars over 12 months to 31 December 2023. Past performance is not a guide to the future.
[2] Source: Bloomberg as at 31 December 2023.

Looking ahead to 2024

We still believe that 2022 marked the start of a normalisation in inflation and interest rates after more than a decade of exceptional policy that saw both zero percent interest rates and quantitative easing.

The only way for governments to inflate away their enormous debt loads is to follow a policy of financial repression in which interest rates stay below inflation rates. This will lead to a regime change in which the stocks that performed well in the last decade do badly in the next decade and vice versa. This suggests that returns from expensive growth stocks will be hit as they de-rate, whilst value stocks should be poised to do better.

Strategy positioning

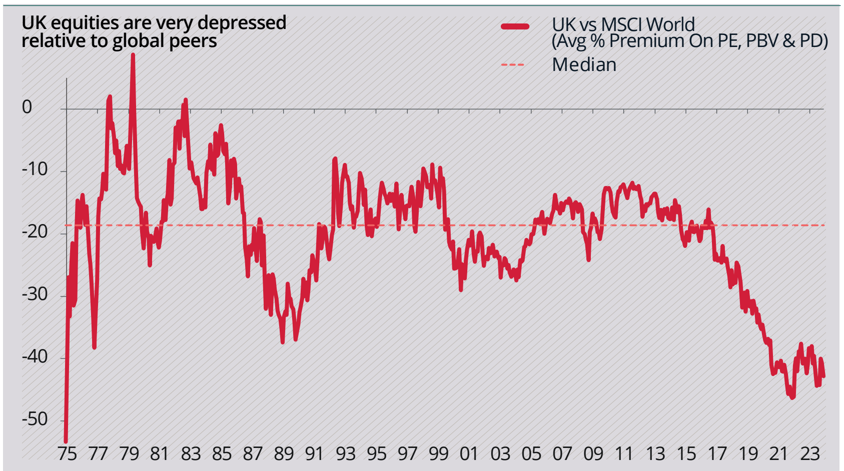
As a value strategy, we are obviously positioned in what we believe are the cheapest areas of the market, but the level of undervaluation is very stark with some stocks in our portfolio trading on mid-single-digit price-to-earnings ratios and dividend yields of 7-9%[2]. These valuations are most commonly found in sectors such as energy, materials, financials and cyclicals in general.

Contrarian views

Consensus positioning amongst fund managers seems to be in mega cap, technology and quality growth stocks in general. As we have no exposure to these areas, I would consider that a contrarian position. Conversely, we are exposed to some of the stocks dubbed "uninvestable" by some in the market, such as energy companies and banks.

What portfolio builders should be thinking about?

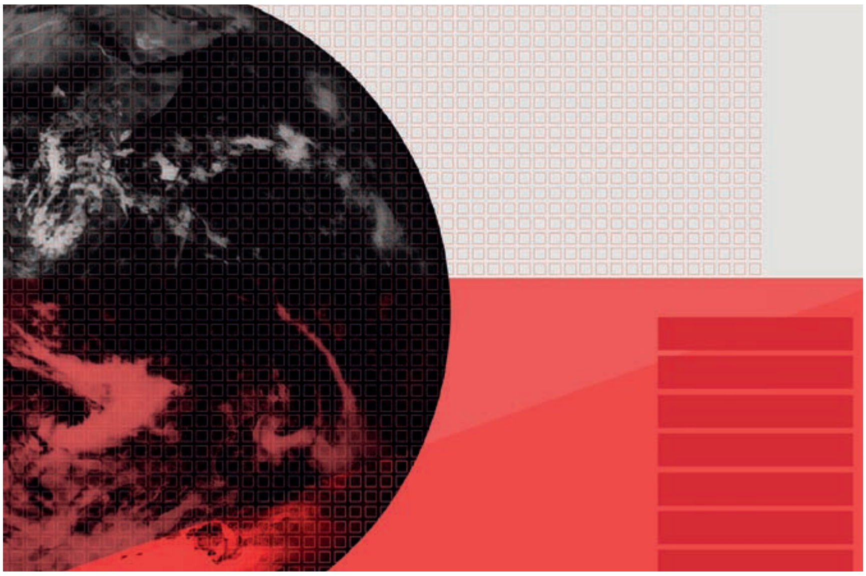
From the perspective of valuations, which are a principle factor in driving future long-term returns, we believe it would make sense to use this year's rally in US technology stocks to re-balance from US equities (which look very expensive compared to history) and into other geographies such as UK, Japan and Emerging Markets, and from growth to value.



Source: Morgan Stanley to 31 October 2023. Past performance is not a guide to the future.

Global Equity Income

Nick Clay
Portfolio Manager,
Redwheel Global Equity Income Strategy



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Closing thoughts on 2023

Bond yields rose further across the whole curve in developed economies and Japan. And, as the year progressed, inflation started to fall meaningfully from the recent highs. This coincided with economies starting to slow – although the US remained more robust, Europe saw a faster decline in growth. This was due to two factors. First, the ongoing impact of war in the Ukraine. And second Europe's closer ties to China, which struggled to accelerate its economic growth following opening-up from Covid lockdowns.

China is struggling because the excesses in the property markets have come home to roost, and the default cycle which is unfolding is weighing heavily on the economy and confidence.

Then, there was war again, this time in the Middle East between Israel and Hamas in Gaza. So far, it remains contained and thus oil prices have not responded.

Japan finally finds inflation (due to being a large energy importer) at last for now. This has broken the need for anchoring rates to zero in Japan and yield curve control has raised its limits in response.

Throughout the year signs of pressure began to emerge – Some US regional banks and Credit Suisse went under, consumers showed signs of struggling as delinquencies rose on auto loans and credit cards, and houses prices start declining – yet employment is holding up so far.

Government debt, however, continued to rise – another $1trn was added to the US deficit. Concerns rise about whether governments can afford high interest rates.

And all of this meant markets couldn't be happier – well, seven stocks at least...

The now branded "Magnificent Seven" rose over 70%[1], leaving all else in their wake. These stocks were touted to take over the world mainly because of... step up AI... which, it is claimed by many, will be the saviour of all our problems.

"Like the market, we expect 2024 will be the year of the rate pivot. However, unlike the market, we believe that unintended consequences are inevitable. We believe we will see recession or inflation – or a combination of both."

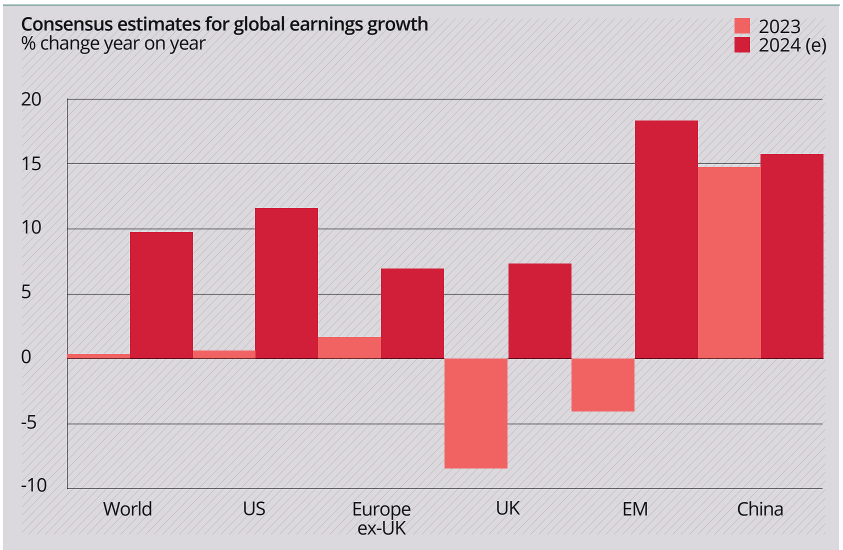
Looking ahead to 2024

The consensus is that the "Goldilocks scenario" is all but a given now. The market expects that inflation will likely fall to below 2% and remain there, employment will remain robust, thus rates can fall again, and no landing is required.

This represents economic nirvana – everything we previously knew about economics has been rewritten, and MMT (Modern Monetary Theory) has become reality – forever. We believe this is naïve and optimistic at best (although, of course, there are no guarantees in this profession...).

Like the market, we expect 2024 will be the year of the rate pivot. However, unlike the market, we believe that unintended consequences are inevitable. We believe we will see recession or inflation – or a combination of both.

If we do see recession – and many indicators are pointing to one or suggest that it has already begun – then corporate earnings will likely fall. This will be a surprise to the market which is forecasting earnings to rise meaningfully in 2024[2]. This will likely prompt volatility, and defensive characteristics may be in high demand.



Source: Bloomberg, MSCI, J.P. Morgan Asset Management as of 30 September 2023. Past performance is not a guide to the future.

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[1] Source: Bloomberg to 30 November 2023.
[2] Source: Bloomberg as at 31 December 2023

Contrarian views

As contrarians, clearly, we see a different outlook to the consensus. We believe that interest rates will come down (at the first signs of weakness) because this is most governments' preference. Most governments cannot afford higher rates for longer because they have too much debt. They don't want inflation to tumble because that is how they default on their debt – they would rather inflate it away. Meanwhile, several governments have major elections coming up and do not want to go to the people in a recession.

The market seems solely focused upon rates coming down and has been conditioned, Pavlovian style, to buy quality growth stocks.

However, central banks relenting too soon increases the probability that inflation does not return to its box. Instead, it returns, a la the 1970's, in waves. This could lead to volatility in many asset classes, particularly equities and bonds. It undermines real returns greatly.

History suggests that such conditions require certain attributes to be able to manage client monies effectively.

Companies will need pricing power to grow nominal cash flow. In turn this should allow for dividends to grow in line with or ahead of inflation – as they did in the 1970s.

We believe the return of volatility means it will no longer be about getting rich quick and trying to have the best upside capture numbers. Instead exhibiting lower volatility will matter, as downside avoidance will become a more important attribute.

And finally, we believe valuation will matter again. Within cycles of boom and bust, it is far harder for companies to deliver consistently on expectations and thus excessive valuations become a meaningfully unhelpful risk characteristic.

In our view, this will be a time for discipline. A time to be differentiated from what is now a very concentrated herd of investors. A time when one's total return will, again, be driven by the compounding of income and not capital growth.

"Within cycles of boom and bust, it is far harder for companies to deliver consistently on expectations and thus excessive valuations become a meaningfully unhelpful risk characteristic."

Biodiversity

Amanda O'Toole
Portfolio Manager,
Redwheel Biodiversity Strategy

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Closing thoughts on 2023

2023 was a year of awakening. As individuals, corporates, asset owners and investors, we are deepening our understanding of the importance of biodiversity and natural ecosystems to our wellbeing and economies. Policymakers have committed us to the Kunming-Montreal Global Biodiversity Framework and 2030 Global Targets. More granular measures are emerging to incentivise and mandate better practice, for instance, the EU's legislation on deforestation.

"We expect to see a sharp focus on the critical issues surrounding water. As a result of climate change and human activity, there is greater freshwater scarcity, flooding and water pollution."

Looking ahead to 2024

A number of new data providers are launching. Taskforce on Nature-related Financial Disclosures (TNFD) reporting should mean better information for consumers and investors, allowing us to differentiate the good from the bad.

Meanwhile, issue-specific legislation is coming. This will reinforce the case for change – both physical and transition risk will encourage adoption of best practice. Whilst the transition is challenging for asset owners and operators, it is a source of demand growth for enabling technologies.

We expect to see a sharp focus on the critical issues surrounding water. As a result of climate change and human activity, there is greater freshwater scarcity, flooding and water pollution. The cost of extreme flooding will continue to rise and, for businesses with exposure, this physical risk must be reflected in investment decisions, making water management systems increasingly economic.

Accountability for excessive withdrawal, inefficiency and pollution are rising up the agenda through legislation and the threat of litigation. Corporates will continue to step up their investment in smart water tech and remediation solutions to address the growing transition risk. We expect a particular focus on specific contaminants such as heavy metals and poly and perfluoroalkyl substances (PFAS) or "forever" chemicals.

There are areas where regulation is accelerating change. For instance, the EU's new Deforestation Legislation mandates global value chain due diligence for seven soft commodities (including coffee, cocoa, soya and wood) and their derivatives. By the end of 2024, products which are not "deforestation free" or that are not compliant with local social and environmental legalisation, cannot be sold in the EU. This will highlight a need for enhanced supply chain visibility, which is expected to benefit satellite technologies which can offer geospatial insights to assist in mapping and monitoring of the value chain. More sustainable substitutes for commodities should also benefit, creating a growth opportunity for materials such as recycled pulp and paper, along with the biotech and precision agriculture tools which increase agricultural productivity.

This comes against a backdrop of appealing valuation – companies which benefit from these opportunities enjoy a multi-decade potential growth opportunity, underpinned by increasingly solid drivers and yet stock performance has been challenged by the rotation toward value. Well-managed companies with leading technologies and a strong market position should fare well through 2024 and beyond.

Strategy positioning

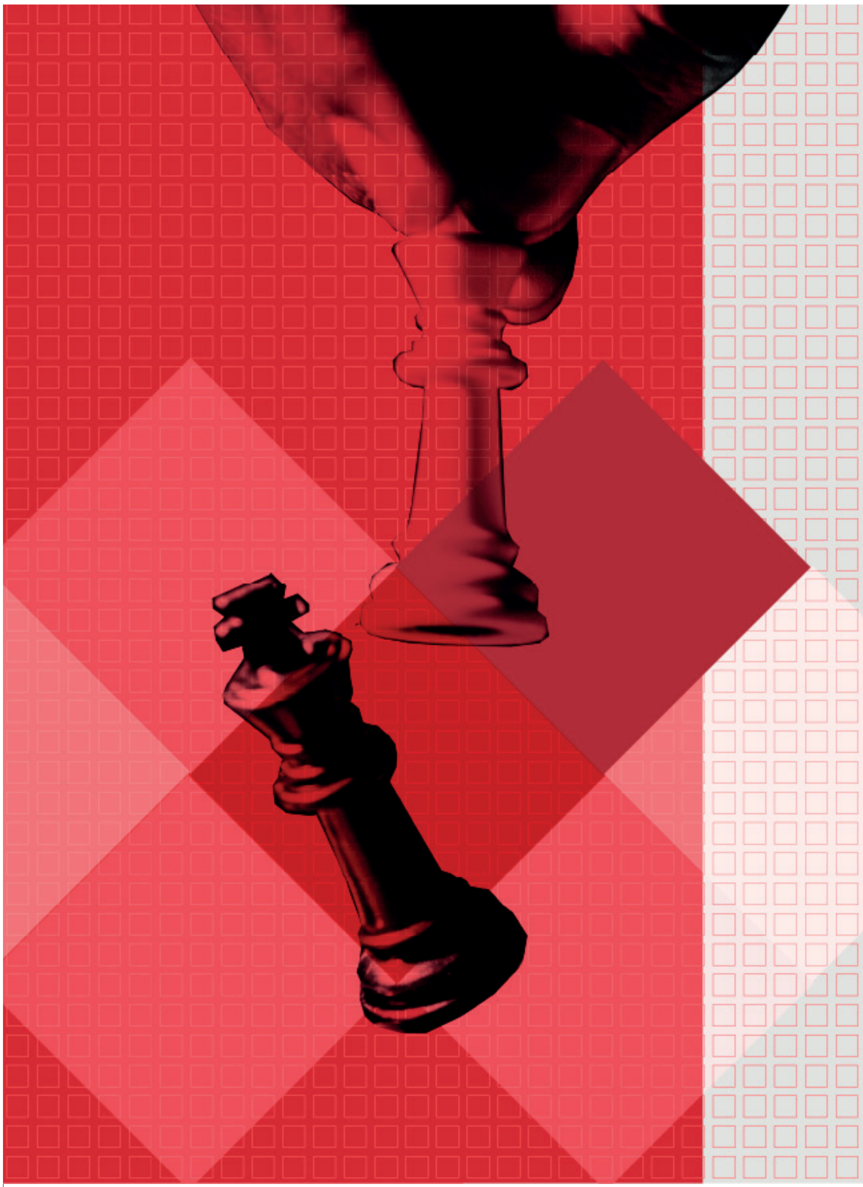
The Redwheel Biodiversity strategy is positioned to capture the best of these opportunities through holdings in the leading suppliers of technologies which enable their clients to meet legislative and customer expectations effectively and in a cost-efficient manner. These are the businesses that we believe are best equipped to scale-up to meet the multi-decade growth opportunity that lies ahead.

"Well-managed companies with leading technologies and a strong market position should fare well through 2024 and beyond."

What should portfolio builders be thinking about right now?

The ability to generate financial returns through investment in strategies aligned with a more sustainable future depends upon the careful construction of an investable universe which is both consistent with the direction of policy and consumer expectations and populated with a diverse range of investable companies. Stock selection within such a universe is critical to the delivery of the financial objective.

By focusing on the products and services which enable the shift towards a biodiversity positive future, a strategy is aligned with a potential multi-decade growth opportunity which will expand in step with natural capital risk mitigation. The winners in these areas have the ability to support a transition, whilst offering portfolio diversification and generating financial returns for shareholders.



UK Climate Engagement

John Teahan
Portfolio Manager,
Redwheel UK Climate Engagement Strategy

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Closing thoughts on 2023

Across Europe, politics weighed on energy transition progress in 2023. Poland, Hungary and Italy objected to a pledge to increase the bloc's emissions reduction target. Meanwhile, Sweden slashed biofuel targets and said it would cut funding for climate and environmental measures in 2024, while introducing tax cuts on petrol and diesel.

In the UK, the Prime Minister also watered down green policies, with the ban on the purchase of new petrol and diesel cars delayed from 2030 to 2035. Germany has also been lobbying for a weakening of climate rules to boost its auto industry.

Looking ahead to 2024

The coming year will likely continue to be challenging, as 2023 was, for the energy transition. Political risk, higher interest rates and inflation were headwinds in 2023 and remain so for 2024. The transition does not have a linear pathway... it will be turbulent, and we will see progress and regression along the way.

In 2024, Europe will see nine parliamentary elections and European Parliament elections in June. However, the biggest political event of the year will be the US presidential election in November, with Donald Trump threatening to reverse much of President Biden's Inflation Reduction Act (IRA). There is also the likelihood of a UK general election and we have seen that climate and environmental issues are going to be part of the campaign.

Politics matter greatly to the climate transition. The election of Biden has led to a huge boost to low carbon energy in the US and the election of Lula da Silva has transformed Brazil's approach to climate change.

Meanwhile, inflation and high interest rates have put pressure on renewable projects, with governments slow to raise electricity prices to reflect the changed macro environment.

We also have a number of company-specific climate transition plans up for renewal and these will be put to shareholders at the respective AGMs. Shell's plan could potentially be the most contentious, and shareholders will be looking closely at whether it adjusts its emission reduction targets.

Offsetting the negatives, there are many positives. Investors will be looking to see if the US IRA incentives begin to have a material impact on low carbon energy and industries in the low carbon supply chain.

There are also signs of a strengthening of US / Chinese cooperation on climate issues, specifically on methane reduction targets, which is incredibly important to mitigate global warming in the short term. As mentioned, Brazil has become a much more positive player, and we expect to hear more from them.

"The transition does not have a linear pathway... it will be turbulent, and we will see progress and regression along the way."

Life Changing Treatments

Peter Hughes
Portfolio Manager,
Redwheel Life Changing Treatments Strategy

WATCH FULL VIDEO

"Healthcare stock valuations look to be generally in line with the long-term average, but current expectations are that healthcare growth will outpace the broader equity market, which suggests the risk / reward dynamics could be quite attractive at present."

We see new Alzheimer's and obesity drugs ramping up sales this year. The uptake of these is important for investor sentiment, so we should get a look at whether patients are adopting and staying on these drugs as expected.

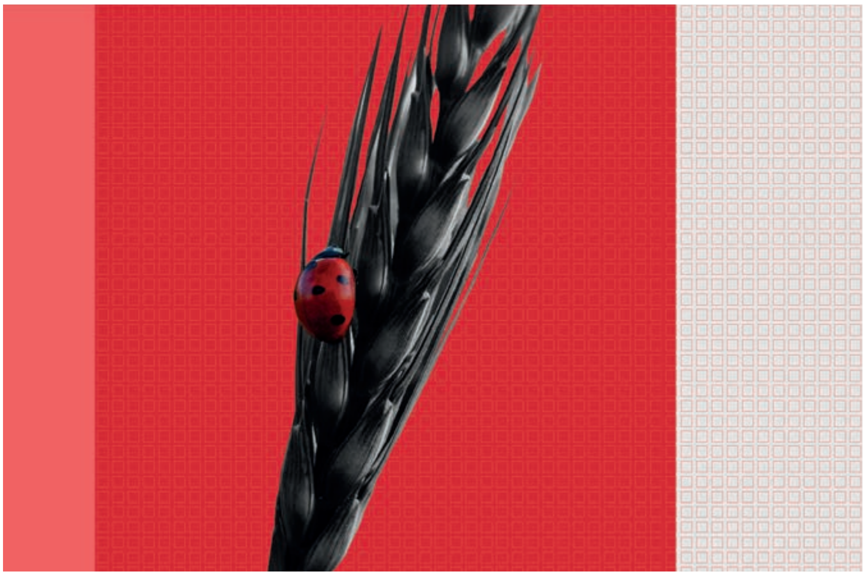
The impressive benefits from new weight loss drugs became clearer in 2023, but we haven't seen what some investors expected, which was that some stocks would lose out because of these new obesity treatments. This had been anticipated, particularly for businesses with products treating conditions that have a higher prevalence in obese patients, such as wearable devices for diabetes and heart valve replacements. We believe this is a large market and patients have very varied needs. Therefore, many solutions can – and should – be available to them.

A more challenging economic outlook could influence investor perceptions of healthcare. Investors often see healthcare as more defensive in a downturn, particularly large pharma. Weaker economic growth could lead to a short-term increase in healthcare demand, particularly in US, if patients perceive a higher risk of losing their jobs and therefore their employer-funded healthcare benefits. It could also negatively impact affordability and access to care in low- and middle-income countries.

On valuation, healthcare stock valuations look to be generally in line with the long-term average, but with healthcare expected to experience long-term increases in demand due to factors including ageing populations, climate change and rising prevalence of chronic diseases, the risk / reward dynamics could be quite attractive at present.

Although healthcare growth may be faster elsewhere, the US remains the largest market for healthcare. The looming US election could increase volatility, therefore, particularly if healthcare policy becomes a key topic of debate.

Sustainability



Stephanie Kelly
Head of Greenwheel – Redwheel's Sustainability Research Team

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Sustainability challenges like climate change, biodiversity and human rights are far from immune from political risk. Indeed, elections in 2024 could make or break the outlook for retaining any hope for fulfilling the goals of the Paris Agreement, arresting biodiversity loss, and how human rights are upheld or contravened. All of these have powerful implications for investors in sustainable thematics, not to mention the broader investor landscape.

Top of the billing is the United States Presidential and Legislative elections in November next year. The Trump campaign is already signalling that climate incentives in the Inflation Reduction Act (IRA) will be a key point of dispute in the election campaign and that they will seek to dismantle elements of it if he wins. Casting uncertainty over the future of the green incentives in this way risks stalling what has been an impressive response from US producers since the IRA was passed.

Closer to home, the UK elections should be core to the path for Net Zero action in a country that has been among the most impressive decarbonisers over recent decades. While climate action doesn't face the same politicisation in the UK as across the pond, both Labour and The Conservatives face a difficult balancing act with building climate policy without creating the perception that voters or key groups like farmers will suffer after an already difficult cost of living crisis. It will take innovation and a focus on the just transition to navigate this successfully but thus far neither party has given clear detail on how they will go about this.

"The UK elections will be core to the path for Net Zero action in a country that has been among the most impressive decarbonisers over recent decades."

In the EU, parliamentary elections will take place and a new commission will be appointed. The EU has been a leader on a range of innovative sustainability directives over the past couple of years. The new parliament is unlikely to derail this progress. However, the challenge in the EU is always getting agreement across the 27 member states and the balance of power as well as the influence of the new EU Commissioner will be key to making further progress.

European Equities

Jimmy Tillotson & Petteri Soininen
Portfolio Managers,
Redwheel European Focus Strategy

WATCH FULL VIDEO

Looking ahead to 2024

We are excited about the outlook for 2024, particularly from the perspective of European equity valuations. This looks to be a rich environment in which to put money to work. Europe appears cheap, both in absolute terms and also relative to history and other regional markets such as the US. Within Europe, small and mid-cap companies look particularly attractive in valuation terms.

Strategy positioning

The Redwheel European Focus strategy is one of the longest-standing constructive activist investment strategies in Europe. For more than 15 years, we have deployed an active ownership strategy in all our portfolio companies, seeking to create value, independent of economic and market cycles.

Our aim is to make our companies better. We identify companies that possess the attributes of great businesses and great investments and invest in them when those characteristics are not being appropriately valued.

Being a constructive activist in the European context allows us to focus on companies across the entire market cap spectrum. However, we have found that the small and medium-sized company space offers the greatest potential. Companies in this segment typically exhibit positive growth characteristics but are less well-known, which represents an opportunity to find businesses that are neglected, misunderstood or as yet undiscovered. These companies, especially the ones we tend to look at, typically have international revenue bases, generate decent returns on capital, and have strong balance sheets.

We work with these companies to improve their quality profile and make them better understood in the markets, over a three-to-five-year time period.

What portfolio builders should be thinking about

We would encourage asset allocators to take a second look at Europe and the small and mid-cap space in particular. We believe the underlying dynamics and fundamentals of companies in this market niche are extremely attractive and hold their own against most other companies globally.

"This looks to be a really rich environment in which to put money to work."

Japan Active Engagement

Nicola Takada Wood
Portfolio Manager,
Redwheel Japan Active Engagement Strategy

WATCH FULL VIDEO

"It takes time, energy, and patience for the entire corporate culture of a very large economy to be turned around. But the process is so far advanced now, there is no turning back."

Looking ahead to 2024

Although the latter part of 2023 was largely influenced by the apparent arrival of the Fed pivot and hopes for an unexpectedly soft landing for the US economy, considerable uncertainty remains around Fed policy. Geopolitical uncertainties are clearly also on the rise and, by contrast, Japan stands out as distinctly stable from an economic and social perspective.

Many Japanese companies have strong, secular growth prospects, and are global leaders in their niche fields. There are others that are benefiting from the global 'onshoring' theme, with businesses seeking better trade relations with other countries as they reduce dependency on China. The weak yen has also been benefiting exporters, while inflation, which of course remains a major problem for many of the world's leading economies, is looking more benign in Japan.

Overall, the outlook is upbeat for Japan, from both an economic perspective and in terms of equity market potential.

Strategy positioning

Over the last two decades of deflation and demographic challenges, global investor interest in Japan has waned, resulting in reduced analyst coverage of the small to mid-cap space. The team believes that this area of the market will benefit the most from the "once in a generation" corporate governance reform Japan is experiencing, and has created hidden opportunities that we believe can be identified and captured.

Our strategy, first and foremost, is an engagement strategy – indeed, having commenced in 2005, it is one of the longest-running active engagement strategies in Japan. Our initial focus was on higher quality companies in sectors such as healthcare and technology, but recent corporate governance reforms have improved the opportunities for successful engagement in many other sectors, allowing us to diversify into other areas like financials and chemicals. As a result, our strategy has more balance than ever before.

What portfolio builders should be thinking about

The impact of corporate governance reforms is evident across various sectors and should not be underestimated. Progress was initially slow but momentum has been building and we believe 2023 represented a watershed moment for overseas investors to recognise Japan's transformation.

It takes time, energy, and patience for the entire corporate culture of a very large economy, with more than 4,000 listed companies, to be turned around. But the process is so far advanced now, with the regulator, the Tokyo Stock Exchange and all the major state pension funds on board, there is, we believe, no turning back.

As we progress further down this path of value creation through corporate governance reforms, we believe more and more investors will recognise and appreciate the quiet revolution in corporate governance reform that has been building force for over a decade. 2023 was a major breakthrough year in this regard, but we are confident the momentum will continue into 2024 and beyond.

Convertible Bonds

Davide Basile
Portfolio Manager,
Redwheel Convertible Bonds Strategy

WATCH FULL VIDEO

"We believe it's important to find a period of history that is more closely aligned to current conditions than the most recent chapter can offer."

Looking ahead to 2024

The convertible bonds asset class transformed itself in 2023 in the sense that coupons are now a relevant element in our investment universe. Historically, at least over the last few years, our asset class has generally been issuing at zero coupon, so the introduction of higher interest rates over the last eighteen months has dramatically changed the level of issuance that has been forthcoming, and the income attached to this new issuance has been attractive. This favours a balanced investment approach, with a focus on total return being delivered through both potential capital appreciation and income.

I think the higher rate environment comes with a number of different forward-looking aspects. One is the volatility environment, which we believe will remain elevated. This should be positive for our asset class, because convertibles tend to perform well in periods of higher volatility, especially in relation to equity.

Meanwhile, the asset class is also trading quite cheaply in relation to option value, which suggests the outlook is attractive from a valuation perspective too. The dynamics for the active new issuance calendar are strong. Again, convertibles tend to perform better when active issuance is present.

Strategy positioning

Across the strategy, we are looking to increase duration, for two main reasons. Firstly, the new deals that are coming to the market not only have a higher coupon, but they are also being issued with a longer life. So, participation in these new issues is naturally resulting in a slightly longer duration.

Secondly, it is our view that the interest rate cycle has peaked, at least in the short term. This also suggests that a slightly longer duration is sensible and will prove to be a good place to be.

What portfolio builders should be thinking about

Although we believe that rates have peaked in the near term, we do not expect them to decrease meaningfully any time soon. This should be an environment in which rates are higher and remain more elevated. In some respects, for investment professionals that have been in the market for a long time, this feels like more of a normalised environment. Normalcy has become a little bit skewed by the elongated cycle of low rates that we've had for more than a decade.

That's why, if you look at the past 10 to 15 years, it's not sufficient enough context. This is perhaps the biggest challenge facing portfolio builders today. We believe it's more important to find a period of history that is more closely aligned to current conditions than the most recent chapter can offer. The last ten years is no longer enough. You really do need to look further back to find a period that looks similar to what we face now.

Key Information

No investment strategy or risk management technique can guarantee returns or eliminate risks in any market environment. Past performance is not a guide to future results. The prices of investments and income from them may fall as well as rise and an investor's investment is subject to potential loss, in whole or in part. Forecasts and estimates are based upon subjective assumptions about circumstances and events that may not yet have taken place and may never do so. The statements and opinions expressed in this article are those of the author as of the date of publication, and do not necessarily represent the view of Redwheel. This article does not constitute investment advice and the information shown is for illustrative purposes only.

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