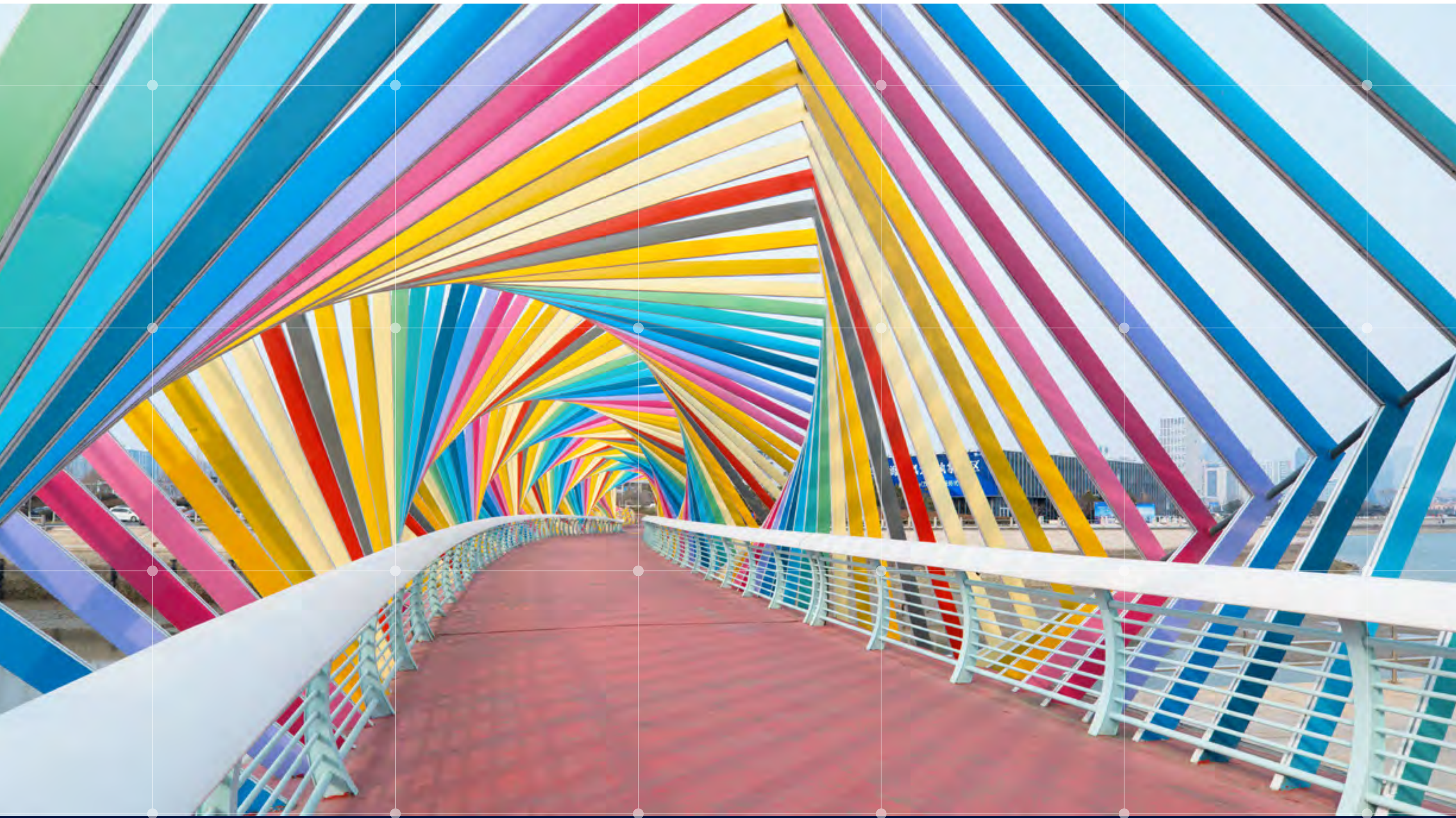
Thornburg



2024 OUTLOOK

GLOBAL FIXED INCOME

GLOBAL EQUITIES

EMERGING MARKETS

MUNICIPAL BONDS

ESG

www.thornburg.com/outlook

Global Fixed Income: Year of the Bond?

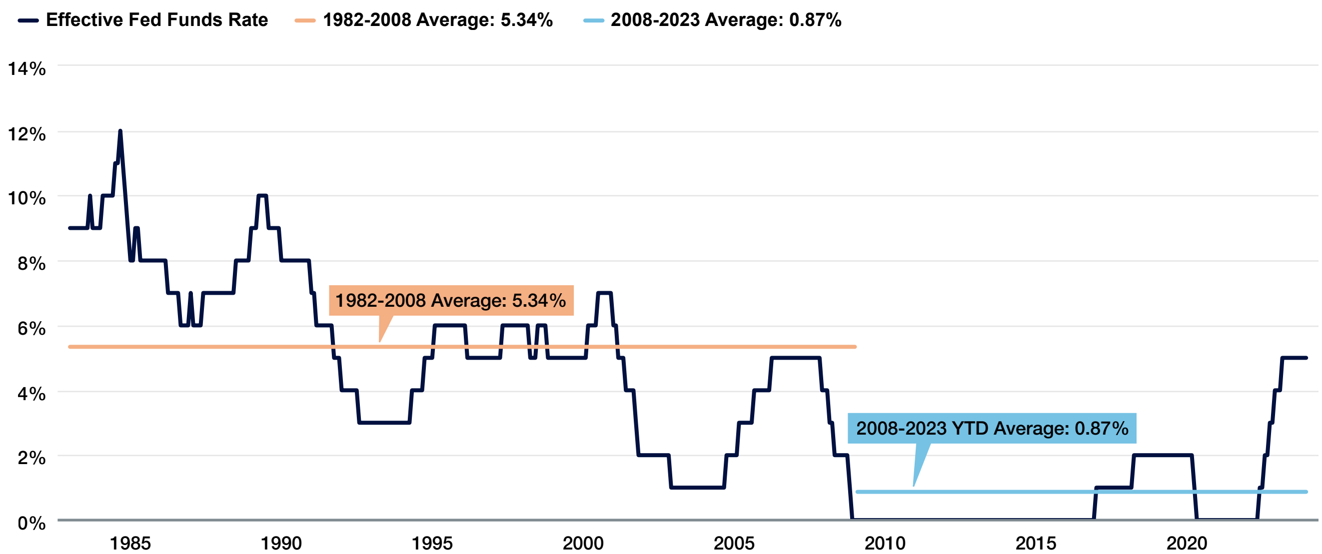
Jeff Klingelhofer, CFA
Co-head of Investments and Managing Director

We think fixed income will return to its more familiar playbook: interesting income and total return potential, and negative or low correlations with risk assets.

Global fixed income markets navigated their way through another volatile year in 2023. But as 2024 gets underway, this is an opportune moment to take advantage of where rates have moved and the setup of fixed income to provide a high source of income, total return and, most notably, an offset to other expensive asset classes.

The past two years of navigating fixed income markets have come down to what we call the end of low-interest rate alchemy, during which previously low rates and cheap cost of capital helped pull demand forward and prop up asset markets. The Fed's zero interest rate policy encouraged many consumers, companies and the federal government to borrow and, in the case of the latter two, notably increase their debt loads as a percentage of GDP. In that previous regime, we also observed positive correlations between fixed income and equity market returns as falling interest rates supported a growth boom that could not sustain itself without virtually free money.

The Cost of Capital Normalizes Again (Somewhat)



Source: Bloomberg Global Aggregate Negative Yielding Debt Index Market Value, Bloomberg

But 2022 and most of 2023 saw a sharp reset, with the Fed focusing squarely on taming inflation and sharply raising the cost of capital. This hawkish Fed policy led to the painful fixed income returns of 2022 but set the stage for a rebound in late 2023 that gave investors optimism about the kind of returns the fixed income asset class can deliver going forward.

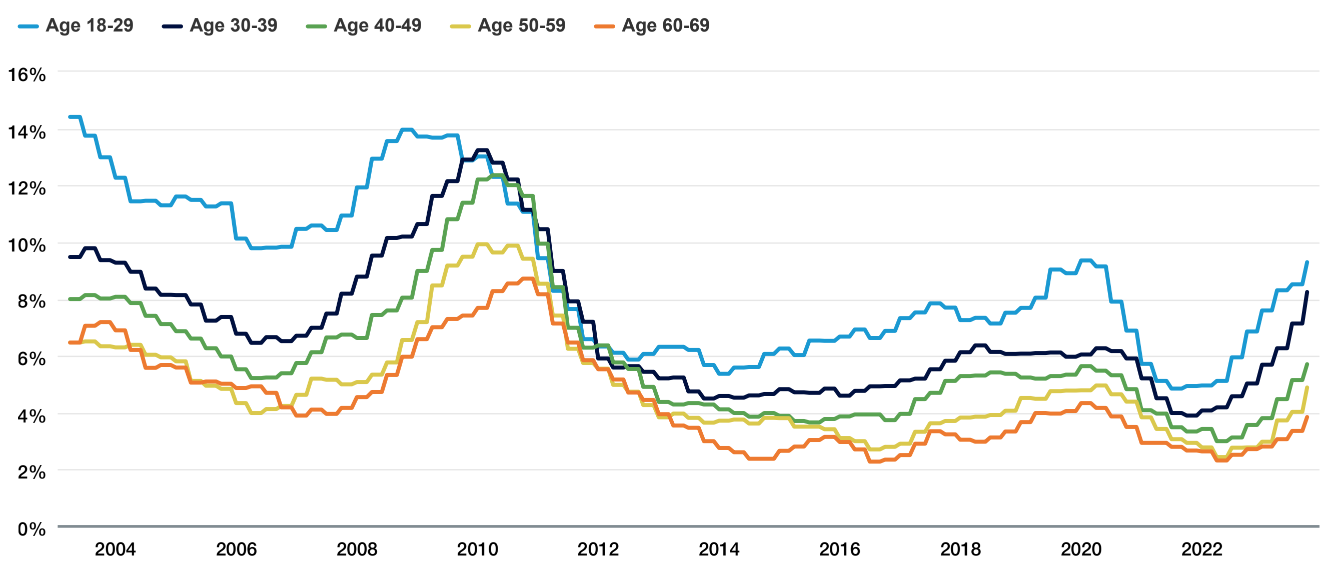
Though trending down, inflation continues to be the Fed's primary challenge, and the main question for 2024 is how much the Fed will turn its attention again to growth risks, and to what extent they deliver cuts to promote maximum employment. Those of us who predicted a recession in 2023 have been eating a bit of humble pie as the U.S. and developed economies in the European Union and Japan have so far defied expectations and continued to expand at a reasonably healthy pace.

That said, I believe the current yield levels and the rally we experienced late in the year signal that painful fixed income returns are behind us. The Fed hiking cycle is essentially over, and the question is how many cuts the Fed will deliver in 2024. While the economy is likely to continue to slow, and inflation returns closer to 'target,' we believe the Fed will deliver cuts but will not be overly aggressive without a significant pullback in economic activity, causing rates to stay higher than the market currently expects. Given this backdrop, in 2024, we expect fixed income to return to its more familiar past playbook: find ways of generating high income levels, all while protecting from the recession tail. If we experience a recession, fixed income can and should act as a ballast and provide negative or low correlations with risk assets. And that is the basis for our 2024 global fixed income outlook.

So, What Is That Negative Macro Event in 2024?

We believe a recession, albeit a modest one, will likely become the adverse macro event that restores normalcy to the fixed income markets this year. We made this same forecast a year ago, but the Fed's aggressive tightening since March 2022 should eventually tip the economy into at least a mild contraction. The aggressive rate hiking of the past two years takes time to work through macroeconomic multiplier effects. Still, we are finally seeing that happen in an increasingly alarming fashion across balance sheets.

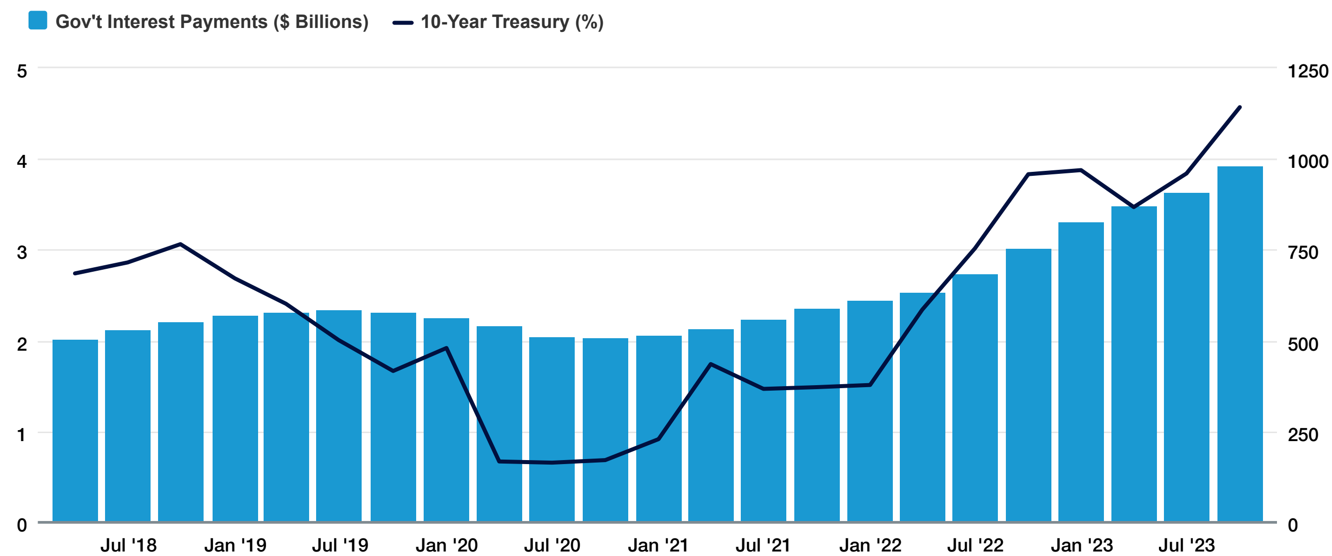
Consumer Credit: Delinquencies Rising from Post-Pandemic Low



Source: Bloomberg. Data represents U.S. Credit Card Quality Index

We typically see delinquencies and defaults on credit cards and auto loans in a recessionary environment. That's happening. Home sales would slow dramatically and decline to multi-year lows. That's happening. Consumer confidence would weaken. That's happening. Interest coverage ratios would decline. That's happening. Companies would require increased returns on investment for capital spending projects to cover the additional borrowing costs. That is also happening. Within government, we see sharp increases in the price of servicing debt. At the state and local government levels, we are beginning to see shortfalls in expected revenue growth that, in some cases, are leading to emerging budget shortfalls in current and future fiscal years.

Rising Rates Matter for the U.S. Government Balance Sheet



Source: Bloomberg, Federal Reserve

All these things are finally happening as we expected a year or more ago. But the impact, regardless of the timing, is the same: the increased likelihood of a recession. The delayed timing aspect is primarily due to the strength of the consumer and labor market. But those strengths are fraying, and as that is likely to continue, a recession in 2024 is quite likely.

The Fed's Reaction Function Will Likely Be to Ease Its Monetary Grip – But Not Aggressively

Our long-anticipated recession is what we expect to force the Fed to cut interest rates and launch a new easing cycle. After December's Fed meeting, markets priced in a series of rate cuts in anticipation of a dovish Fed next year. However, the Fed believes cuts they may deliver in 2024 do not serve as accommodative policy per se but rather to relieve the economy of rate levels it deems in restrictive territory.

We think the current market reflection of about 125 basis points of easing in 2024 is a bit too aggressive, barring a much deeper-than-expected economic contraction. Inflation is still on the mind of the Fed, and the labor market is showing enough resiliency that the Fed does not need to deliver on sharp rate cuts just yet.

It's Still All about Inflation

Inflation was the driver behind the Fed's massive tightening cycle of 2022-2023, and inflation will put the brakes on any aggressive easing cycle in 2024 and into 2025. The Fed has made it clear that its 2% inflation target has not changed, and with core inflation currently running at about twice that level, the central bank has to worry about how long inflation will remain above its target. Unless the expected recession is a genuine shock, we cannot expect the Fed to respond aggressively.

What keeps inflation from slowing to 2% given that it has slowed appreciably from its recent multi-generational peak? It all comes back to the stubbornly strong labor market, wage growth, and the wage pressures already built within the system. Take the United Auto Workers as just one example. Significant wage pressures are now guaranteed for future years, and these wage gains will almost certainly bleed over into other industries and the aggregate economy.

The Fed's approach to monetary policy suggests it will be comfortable waiting for inflation to slow to target and, to address growth risks, cutting rates to lower levels but still in somewhat restrictive territory. Since we don't anticipate an actual shock-to-the-system type of recession in 2024, the Fed's actions should signal to investors that 'this is the business cycle, not an emergency, and this is what we've been trying to accomplish through the normalization of interest rates.'

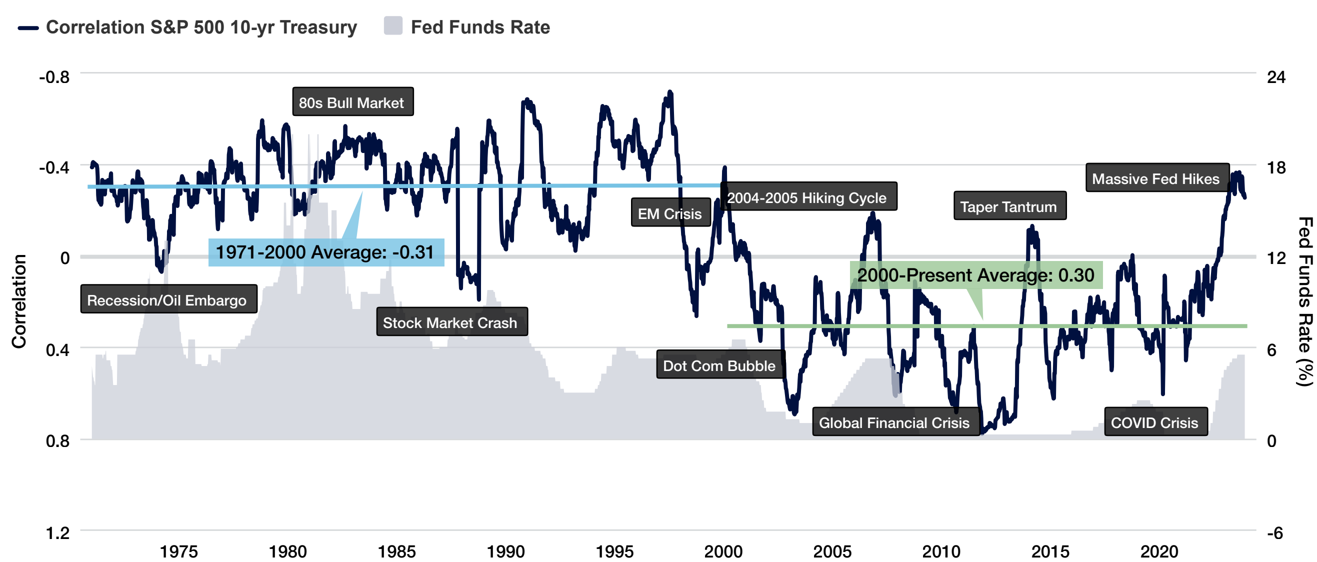
We Expect Negative or Low Correlations with Risk Assets to Reemerge

As mentioned earlier, fixed income is meant to preserve capital and generate income, providing ballast when equity markets are volatile. In other words, fixed income is supposed to do well when equities sell off.

Recall that during the low-rate era, which goes back to about the year 2000 (during the dot com bust when the Fed pushed its funds rate down as low as roughly 1% in 2003), the correlation between fixed income and equities turned positive and stayed there for about 20 years – nearly a generation.

Bonds performed well because interest rates were declining, and the resulting drop in the cost of capital drove equities higher. Investors fondly remember this period because successive Federal Reserve leaders extended the central bank's role beyond its traditional mandates to include suppressing excessive equity market volatility and keeping equity investors happy. It was not until 2022 that the Fed finally rid itself of this perceived obligation. Suddenly, correlations spiked back into negative territory with the current tightening cycle (see the illustration below).

Effective Portfolio Construction Depends on Correlations Expectations



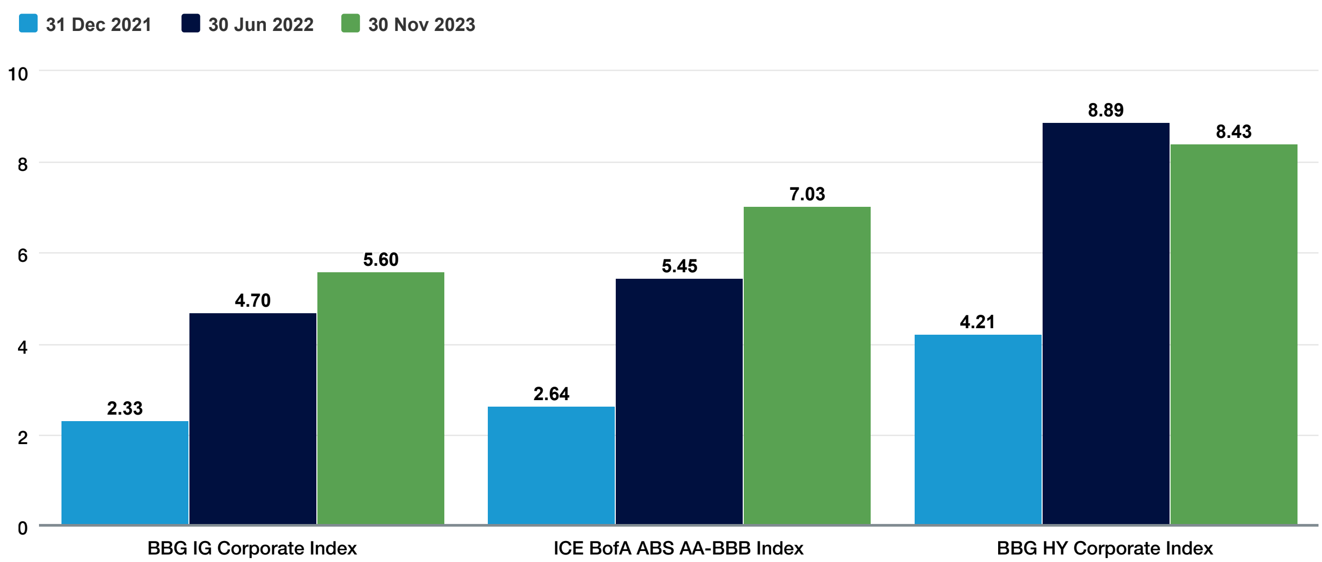
Source: Bloomberg

In other words, with the normalization of interest rates, it's reasonable to expect the recent sharp reversion to negative correlations between fixed income and equity performance to continue even as the economy slips into recession. During the 30 years from 1971 through 2000, the correlation between stocks and bonds was -0.31. That correlation flipped to +0.30 from 2000 through today, even considering that correlations normalized back to about -0.25 in recent months.

Attractive Valuations Still Provide Opportunities in 2024

When we look at valuations heading into 2024, we ask ourselves whether or not we are compensated for risk and an unexpected, perhaps tail, event. As the new year gets underway, we are not. But income generation is the best it's been in 15 years, and focusing on removing potential volatility from portfolios will be the name of the game. These are interesting returns at current yields, even in an unchanged world. In fact, in the case of high yield corporates, they are equity-like returns, which is remarkable, especially since yields in that space were roughly 4% not so long ago.

Higher Yields Provide Optimism for Fixed Income Market in 2024



Source: Bloomberg

Generally, we like less cyclical credits and, therefore, underexposed to a likely recession. Such acyclically oriented sectors include insurance, healthcare and utilities. As mentioned, although overall yields are attractive in the investment-grade and high yield corporate space, valuations in both sectors give us pause to add further exposure.

We continue to monitor weaker consumer trends. Excess savings have come down, and consumption is beginning to soften. In response, our positioning within securitized credit is in higher-rated senior bonds, which tend to behave with less volatility versus more credit-sensitive securities in the mortgage and asset-backed space. Consistent with this view, we find Agency mortgage-backed securities (MBS) attractive, with the potential to outperform should rates fall and mortgage refinancings pick up.

We continue to be cautious regarding continued global risks within international and emerging market fixed income markets. Like U.S.-based credit assets, spreads are fairly tight, so we prefer not to add exposure until spreads widen further. However, there continue to be idiosyncratic opportunities across securities and regions guided by strong balance sheet fundamentals. Further, we find select opportunities in quasi-sovereign names where there is underlying fundamental support from the sovereign itself and an attractive spread and yield to be captured.

Outlook

Macro/Rates

Recession risk appear elevated, which may be driving the Fed's reaction function in balancing growth risks at a time when their focus has been so much on quelling inflation.

U.S. Corporates

Spreads have tightened in both investment-grade and high yield in sympathy with other risk assets. Will need to be selective given our current view on recession and potential spread widening as a result.

Securitized (MBS/ABS/CMBS)

Consumer fundamentals are trending worse, as measured by rising credit card and auto delinquencies. A resilient labor market has been a positive, although the Fed is still looking to dampen demand in the face of above trend inflation.

Emerging Markets

Valuations overall appear stretched, but pockets of value exist. The potential for certain countries to pivot toward cutting cycles, as well as a robust calendar of federal and local elections, will provide both opportunity and risk for the sector.

Positioning

Macro/Rates

Though rates have fallen in recent months, the prospects for easing, and a potentially growth-challenged 2024, keep duration risk reasonably attractive.

U.S. Corporates

Continued focus on defensive, strong cash flow businesses within investment-grade. In high yield, there is good total return potential given the overall level of yields, though spread levels do not compensate investors for growth risks and potential for higher defaults.

Securitized (MBS/ABS/CMBS)

Senior bonds in ABS and non-agency RMBS are well protected and provide good yield. Agency MBS have compelling relative value versus high-grade credit. Investor caution in CMBS allows for select opportunities to buy attractively priced bonds backed by strong properties.

Emerging Markets

EM debt continues to be a place where value can be exploited by individual mis-pricings as opposed to a broadly directional theme. Quasi-sovereigns remain interesting in areas where there is fundamental support yet a sizeable spread to the sovereign.

Time for International and Income?

Ben Kirby, CFA
Co-head of Investments and Managing Director

2023 was the year of the Magnificent Seven. However, we expect increased volatility may lead investors to rebalance toward income and international stocks.

Global equity markets (and risk assets in general) were surprisingly strong in 2023, helped by moderating inflation, resilient economies, lower interest rates, and a pause by major central banks towards the end of the year. The recession so many anticipated at the start of the year never materialized. Risk markets responded well, with the S&P 500 Index up more than 20% by mid-December, the NASDAQ up more than 40%, developed international markets (MSCI EAFE Index) up more than 15%, and emerging markets, dragged down by China, returning only about 7%.

Despite predictions by many market participants, including us, that the relative setup for international equities was favorable entering 2023, the U.S. looks set to turn in outperformance versus the majority of other developed and emerging markets. However, we note that many indicators that led us to last year's prediction remain stretched and that the MSCI EAFE Index has outperformed the S&P 500 since markets began rebounding in October 2022.

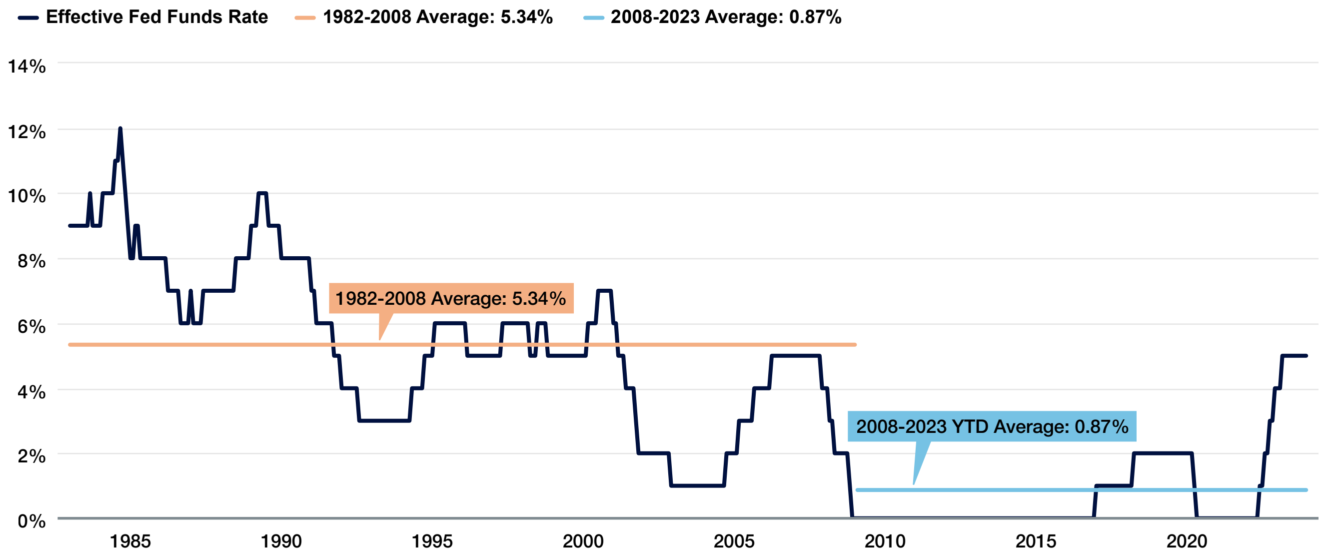
China was the exception to the rule, with major Chinese indicies down double digits as of mid-December. Chinese equities saw one positive quarter in 2023, following its long-delayed re-opening from overly restrictive COVID closures—pressures emanating from the nation's bursting property bubble overwhelmed post-COVID enthusiasm.

The Charge of the Magnificent Seven May Continue in 2024

The primary driver of U.S. index returns in 2023 was the emergence of AI as a significant market driver and the resulting charge of the Magnificent Seven: Apple, Amazon, Alphabet, NVIDIA, Meta, Microsoft, and Tesla. As of mid-December, the Magnificent Seven had contributed about two-thirds of the S&P 500's roughly 25% return, and the S&P's remaining 493 stocks about one-third. As of mid-December, the top 10 stocks in the S&P 500 made up one-third of the index, a new high for the period of U.S. outperformance. The comparable numbers for the MSCI EAFE and ACWI ex USA indices are approximately 15% and 11%, respectively. ChatGPT emerged a little over a year ago, on November 30, 2022. With that announcement and the emergence of other AI platforms, these seven stocks fueled AI mania.

The Magnificent Seven began 2023 with a price-to-earnings ratio of about 20x and are wrapping up the year with a PE in line with their long-term average of about 28x. In other words, these companies began 2023 at a steep discount, which has been closed. Of their year-to-date return, more than half derived from the increase in their PE ratio and the remainder from robust earnings growth anchored in the explosion of interest and adoption of AI.

A Cost of Capital Normalization Has Begun



Source: Bloomberg

U.S. Equities Face a Conundrum with the Fixed Income Market

Heading into a new year, we see a disagreement between the U.S. equity and fixed income markets. As of late 2023, U.S. equities are priced at approximately 20 times earnings, which is 33% more expensive than the historical average of about 15 times earnings. Moreover, the financial markets anticipate earnings growth of about 12% this year. In other words, optimistic equity investors are willing to pay above-average valuations in anticipation of above-average growth.

However, the fixed income market is pricing in about 125 basis points of Fed easing in 2024 in anticipation of slower economic growth and perhaps the delayed recession many thought was possible in 2023. Market expectations for rate cuts were boosted in mid-December due to the dovishness surrounding 2023's final FOMC meeting.

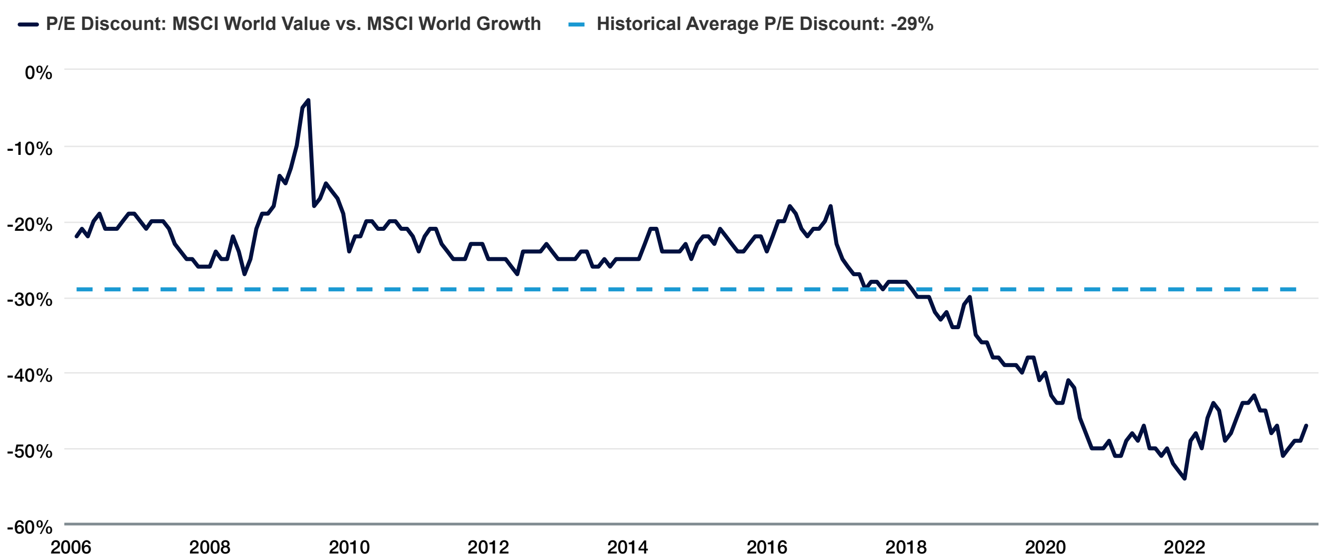
We find it difficult to reconcile these two outcomes: a robust economy supporting solid earnings growth and expensive valuations, but not an easier monetary policy. Or you have a weakening economy and likely recession that supports about 125 bps of Fed rate cuts but not robust earnings growth and historically expensive valuations. You can't have it both ways.

This dichotomy, equity markets calling for growth and fixed income markets for recession, needs to be resolved, and investors may want to seek active equity returns until this situation settles. Given the mixed messaging from markets, we believe that quality and cash flow will be key for equities, and we favor businesses with durable models and the ability to navigate an environment with elevated levels of uncertainty and recession risk. Additionally, we believe active managers may be more agile in adapting to change through the coming year as financial markets rectify this bifurcation of expectations.

With a Higher Cost of Capital, Expect Income to Play an Enhanced Role in Total Return in 2024

As the growth vs. recession situation resolves, and markets continue to digest a more normalized cost of capital (see the illustration above), we expect more modest returns for equity investors and an environment that may favor steadier income-generating stocks. While inexpensive capital of the past decade was a tailwind for companies with less cash flow today, but higher potential growth rates, the rapid rise in rates that began in March 2022 should support more mature companies with consistent cash flow profiles, strong moats and the ability to self-fund future growth. If this plays out as we expect, income will likely play an even more significant role than usual in total equity returns.

Income-Generating Equities Present Attractive Value



Source: Bloomberg

Investors are just emerging from a period of devastating inflation and performance in fixed income, and we believe equity income portfolios that have produced growing income streams are an excellent hedge against stubborn inflationary pressures in the U.S. and overseas. With fixed income markets still struggling in 2023, equity income has emerged as an attractive opportunity for investors, and we believe it offers attractive relative value and the opportunity to deflect any volatility stemming from the standoff between growth and a slowdown or even recession.

International Stocks Beckon with Attractive Valuations and an AI Hook

U.S. equities have outperformed international equities for much of the last 15-plus years. But we know from history that relative performance between U.S. and non-U.S. markets is cyclical.

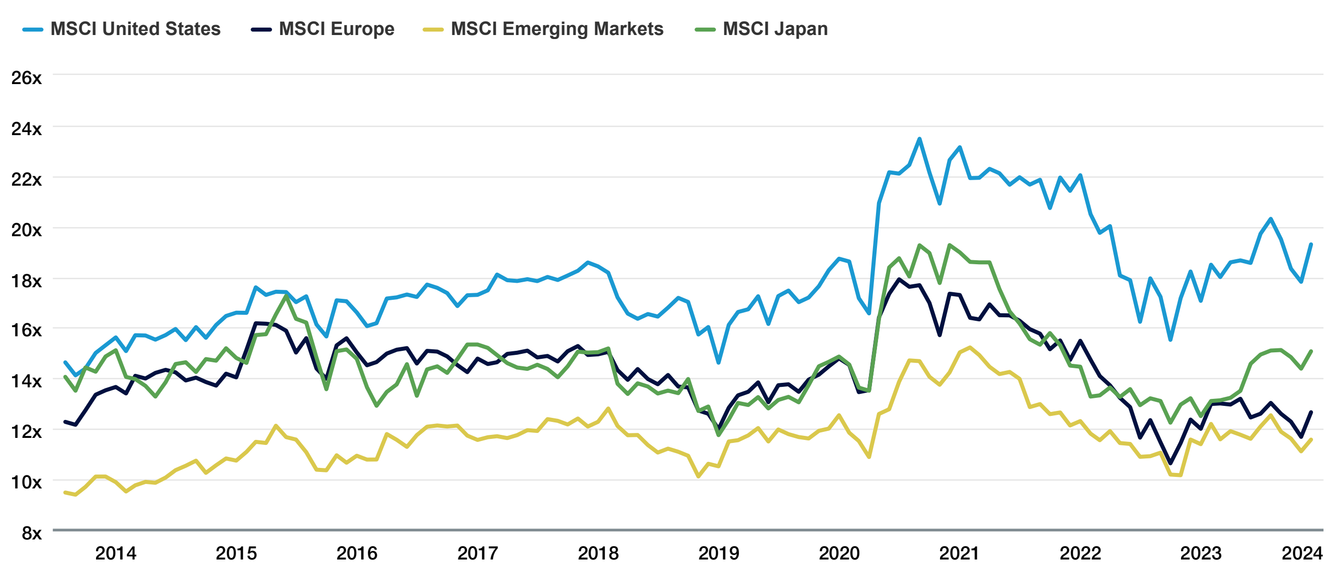
At the end of last year, we noted several factors that in past markets (notably in the early 2000s) had led to a turn in international vs. U.S. performance. While that didn't happen in 2023 due primarily to the catalyst of AI and the performance of the Magnificent Seven, we note that those factors are still present and at stretched levels:

1. Relative Valuations: The MSCI ACWI ex USA Index trades at a 33% 1-year forward P/E discount to the S&P 500, near the widest levels of more than 15 years of U.S. outperformance. While research has shown that although valuation differentials may have a low correlation to short-term returns, they have an increasing impact the longer the holding period.
2. The U.S. Dollar: The dollar is a significant factor in the relative performance of international equities, contributing about 40% of international outperformance in 2002-2007 and half of its underperformance since then. The U.S. Dollar Index (DXY) sits at its highest level since late 2002, around the last time international began to outperform the U.S.
3. Market Concentration and Breadth: As noted above, just seven stocks contributed roughly two-thirds of U.S. performance in 2023, and the top 10 stocks now constitute 32% of the S&P 500. The comparable numbers for the ACWI ex USA Index are about 20% of the total return from the top seven stocks and 11% of the market cap in the top 10 companies.

While we can't time a turn in relative performance, we think it makes a strong case for rebalancing by U.S. investors who hold roughly 14% of their equity portfolio in international companies versus a 38% weight in the MSCI ACWI Index.

While Value has outperformed in international year to date as opposed to the U.S., where growth has outperformed due to AI and the impact of the Magnificent Seven, there is no shortage of interesting Growth and Value investment themes outside the U.S. In AI, many leading "picks and shovels" investments are outside the U.S.—companies such as Taiwan Semiconductor and SK Hynix and semiconductor equipment makers ASML, BE Semiconductor Industries, and Disco. In the booming market for weight loss medications, Ozempic manufacturer Novo Nordisk's headquarters are located in Denmark.

Relative Valuations Support Non-U.S. Assets



Source: Bloomberg

We like these names because we don't have to select the "winners" but focus on the firms providing the tools all players need in the AI revolution. We believe many of the best firms and most attractive valuations are outside the U.S..

Thornburg

Outlook

Macro

Central banks have increased policy rates and signaled upcoming sales of their bond portfolios to arrest inflationary forces, with softer inflation data helping solidify the view that the interest rate peak is near. Geopolitical uncertainty remains elevated.

U.S. Equities

US recession risks remains a key focus. Core inflation is likely to remain elevated resulting in mixed moves in US equities. Earnings will be mixed as we move from (potential) recession to recovery. A widening geopolitical gap between west and non-west seems to be codifying, bringing various market risks.

International Equities

Recession in Europe is believed to be a certainty based on high energy costs. However, consumers and businesses are being subsidized by various government sponsored relief packages. Asia is slowing but China could provide a growth boost.`

Emerging Markets Equities

Despite a lag in recovery versus developed markets and equal exposure to inflation and macroeconomic uncertainty, many long-term structural drivers remain intact.

Positioning

Macro

Although we expect inflationary pressures to ease, expect volatility in equities to continue. focus on idiosyncratic opportunities/ durable companies across sector/geography where the upside outweighs the downside materially. Companies with pricing power, offering essential services and inflation beneficiaries remain interesting.

U.S. Equities

Balance style risks with durable cyclical & defensive sectors. Equity Income names are likely still beneficiaries. Take advantage of sell offs to find high quality names.

International Equities

Look for idiosyncratic opportunities, contagion from Russia-Ukraine conflict should be limited. Equity income and value-oriented companies show substantial promise in this context.

Emerging Markets Equities

Although concerns around index concentration and geopolitical risks may keep EM volatility elevated near term, select emerging markets provide pockets of opportunity not currently reflected in valuations.

Misunderstood and Mispriced

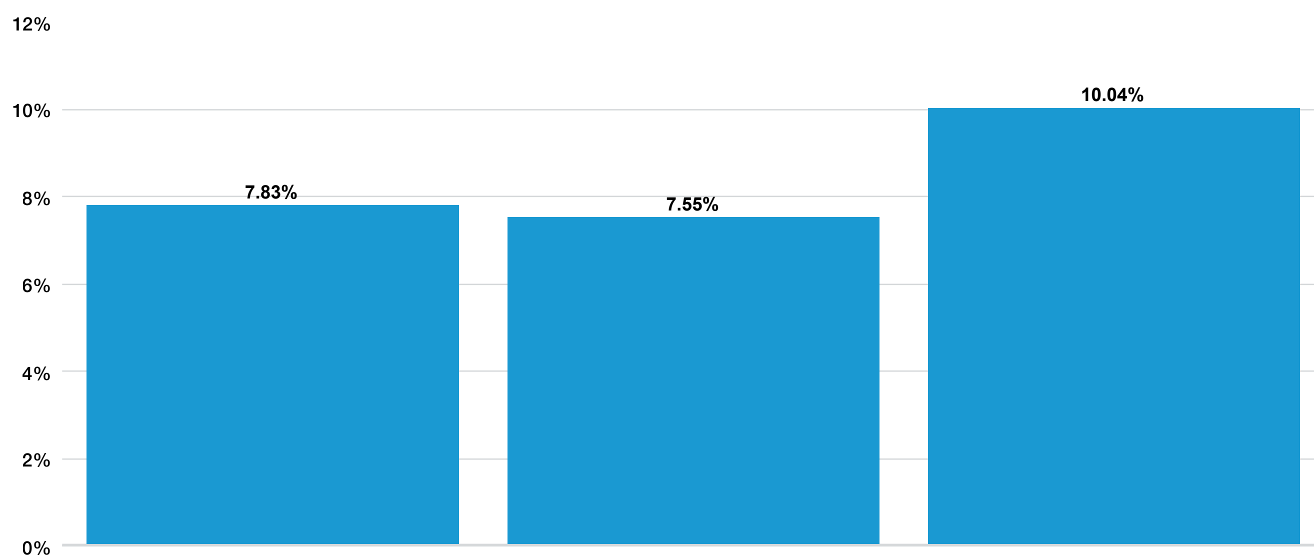

Charles Wilson, PhD and Josh Rubin
Portfolio Managers & Managing Directors

From continuing supply chain realignment to the emergent consumer and more, these factors align for underappreciated and mispriced emerging markets in 2024.

Contrary to recent experience, over the last 25 years, emerging market equity returns have generally outpaced their developed market peers. Since the end of 1998, the S&P 500 has delivered a 7.55% annualized total return, just behind emerging markets at 7.83%. While the NASDAQ has delivered 10.06% annualized return over the entire period, almost half of the total return has come since the COVID pandemic hit. What may come as a surprise is that both the SPX and NASDAQ had significantly lagged EM in cumulative (and annualized) performance before COVID despite the pedestrian returns delivered by Emerging Markets over the last decade. It is worth noting that this was the case despite the period of generally easy money in the U.S. for most of the previous 15 years and the super-charged period of deeply negative real rates since the pandemic. Despite the historically compelling performance, investors remain underweight emerging markets today and have continued to lighten their position in 2023. We think it's time to take a fresh look at your emerging markets allocation.

Emerging Markets' Performance Has Been Compelling

Annual Returns (1999-2023)



Source: Bloomberg

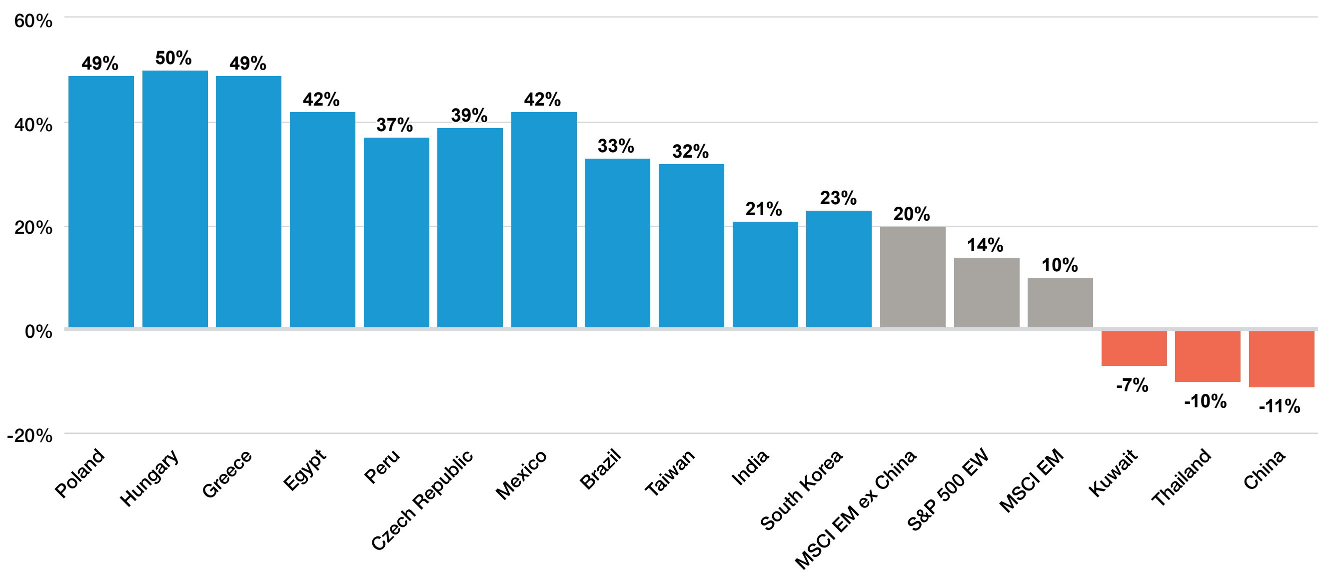
The performance data quoted represents past performance; it does not guarantee future results.

But 2023 was better for many emerging markets than headlines may suggest. For the year, EM delivered a respectable 10.12% total return, ahead of the long-term returns of the NASDAQ, the S&P 500, and EM itself. EM returns fell short of the S&P 500 and developed markets for the year, excluding the U.S., which delivered a 26.26% and 16.22% total return, respectively. But as is most often the case with EM, it's hard to paint the broad and diverse set of markets with a single brush stroke. Several markets within EM significantly outpaced the broad U.S., and ex-U.S. developed market indices, especially if you adjust for the narrow leadership within the U.S. markets by looking at the S&P Equal-Weight Index, which is only up 13.84% for the year.

A cross-section of smaller markets like Poland, Hungary, and Greece and larger markets like Mexico, Brazil, India, South Korea, and Taiwan led emerging markets last year. Half of the 24 markets of EM, representing almost 60% of the index's weight, delivered higher returns than the S&P Equal Weight Index.

The critical headwind for the broader index remained China. After rising sharply at the end of 2022 with the end of zero COVID policy, the Chinese markets reversed course at the start of 2023. They drifted lower over the year due to concerns about the property market and the strength of the broader recovery. If you exclude China from EM, the index would have been up 20% for the year, in line with developed market peers.

A Few Select Markets, Especially China, Accounted For Much of EM's Lagging Performance in 2023 (Percent Change)



Source: Bloomberg

The performance data quoted represents past performance; it does not guarantee future results.

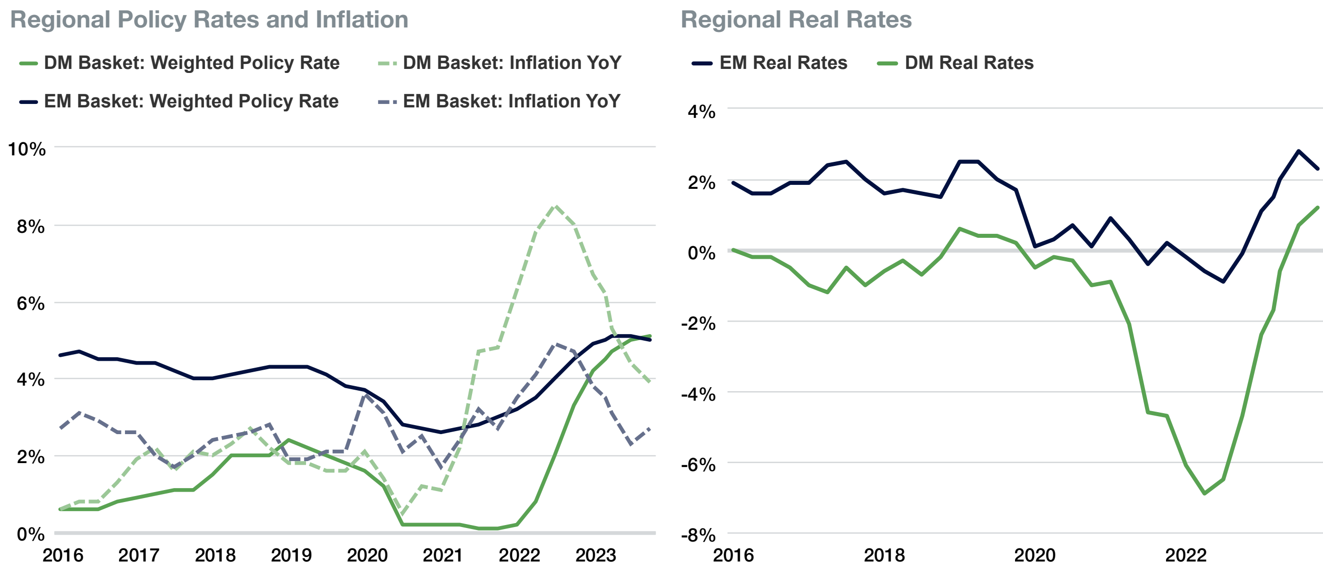
Thornburg

2023 Was Better than Headlines Suggest – What Drove the Strength?

While no single factor contributed to the high performance of specific markets within EM, various factors helped propel the strongest-performing markets.

Disciplined Monetary Policy: Many central banks pursued aggressive monetary policy to tame inflation and stabilize their currencies relative to the dollar. While the increase in interest rates in the U.S. has created pain in some parts of the U.S. economy, this type of rate environment is a more frequent occurrence in EM and, therefore, more manageable for the banking system and consumers of credit. Most EM markets, except those with idiosyncratic issues like Turkey, have seen inflation return to normal.

Emerging Markets Central Banks Are Not behind the Curve on Inflation

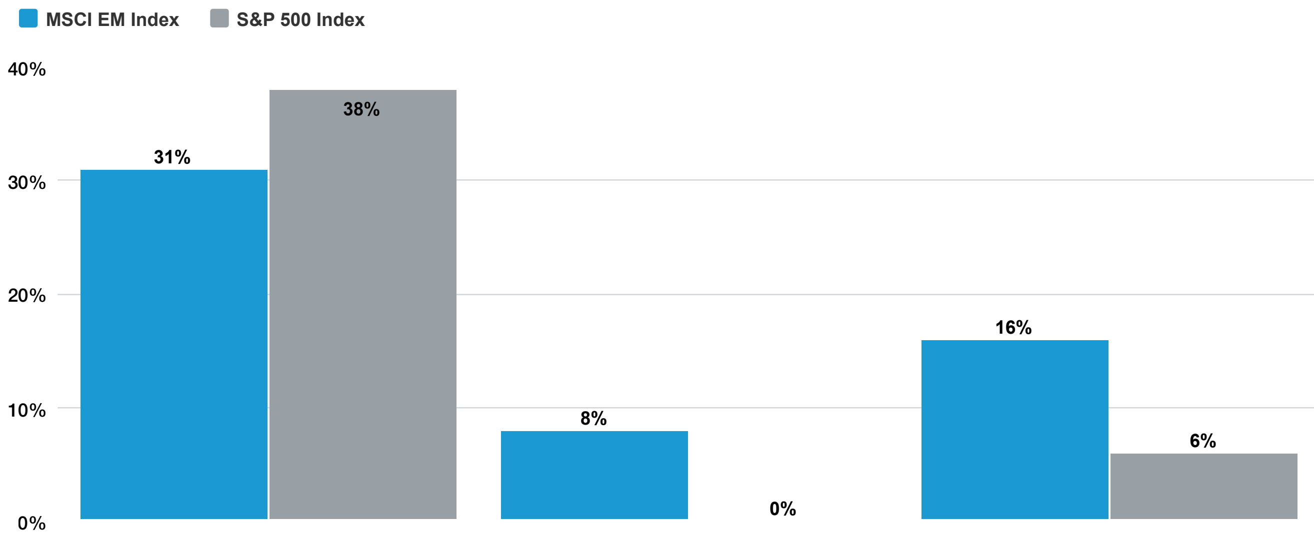


Source: Bloomberg, FactSet, and Thornburg (as of November 29, 2023)

Solid Economic Growth: As EM continues to shake off the COVID hangover, most markets have entered a period where economic growth has been substantial or, in some cases, expected to accelerate as interest rates fall. This period of relative strength is coming when developed market growth has slowed and is expected to slow further in 2024 as high interest rates take their toll on the broader economy. A widening EM growth differential has historically catalyzed EM relative outperformance as equity investors seek better opportunities in other markets.

The Fed Pivot: The mere hint of potential near-term pivot of U.S. monetary policy has been enough to push many markets across EM to year to date and, in some cases, near all-time highs. The last time we had a pivot of this sort was early in 2016 when Janet Yellen decided to step back from a more hawkish stance. Over the next two years, emerging markets delivered a 94% total return. Looking back at the last few peaks in U.S. interest rates, it typically signals EM outperformance in the following 12 to 24 months.

Emerging Markets Have Historically Outperformed 12 Months after the Last Fed Rate Hike



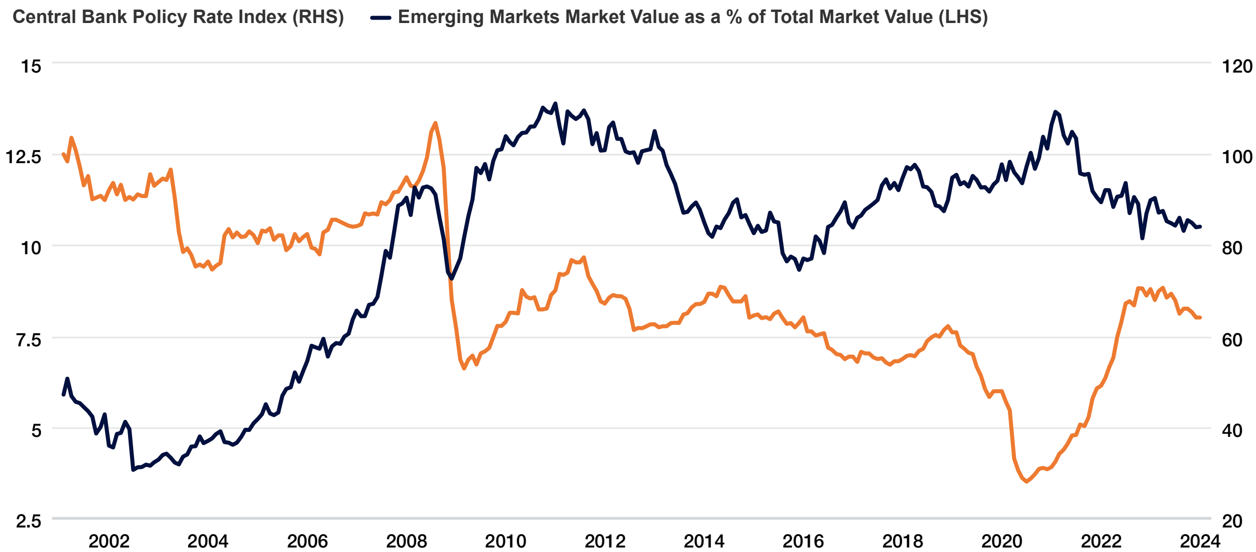
Source: Global X ETFs with information derived from Bloomberg data as of March 31, 2022
Emerging Markets: MSCI Emerging Markets Index; Developed Markets: S&P 500 Index
The performance data quoted represents past performance; it does not guarantee future results.

The AI arms race:: A large part of the technology supply chain resides in North Asia – Taiwan, South Korea, and parts of China. This region produces everything from leading-edge chips to handsets. With every significant company in the world rushing to roll out an AI strategy during 2023, there was considerable unexpected strength of demand for some aspects of technology hardware. This greatly benefited South Korean and Taiwanese suppliers as the broader hardware and memory cycles were bottoming. We believe that the AI technology ramp is still in its infancy. Many end users are still trying to understand the “right” use case for them, which will lead to uneven demand but generally be a favorable tailwind for these sectors and markets.

The Long-Term Case for Emerging Markets Remains Intact

Emerging markets represent almost 60% of global GDP and the bulk of incremental GDP growth but just over 10% of global market capitalization. Over the next decade, the emerging market middle class is set to double and represent more than 50% of the global middle class by 2030. The growth in the middle class is happening across all major emerging markets. It comes when interest rates are declining for cyclical and structural reasons, another tailwind to consumption growth. Looking back at the U.S. as an analog, the period between 1980 and the present was one where middle-class growth was robust, and interest rates were generally on a downward trajectory. During that period, the S&P 500 rose from 100 to over 4700 today. We think many emerging markets will benefit from similar dynamics over the next decade.

Market Capitalization Does Not Reflect the Structural Decline in Rates



Source: Bloomberg

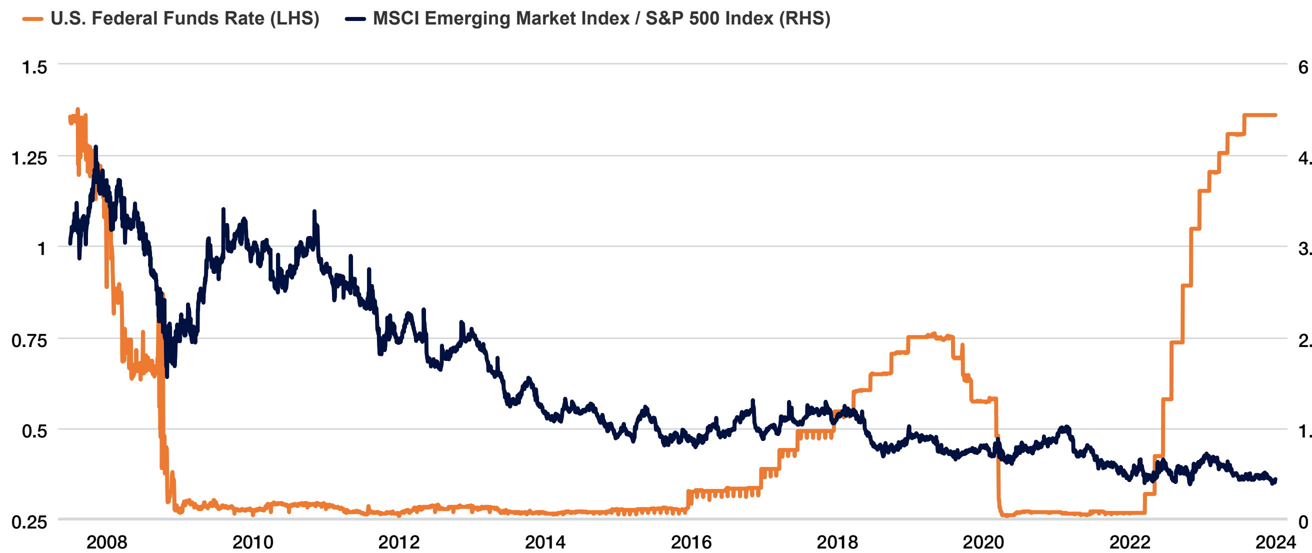
Is this time different?

In short, we think several factors are converging to potentially drive EM outperformance after a long period of sub-par returns. These factors include:

- Low valuations and light positioning signal low expectations
- Stable/accelerating GDP growth while DM slows
- The prospect of U.S. rate cuts
- Stable dollar
- Stretched U.S. valuations after 15 years of low interest rates

While none alone are a catalyst, they collectively provide a fertile backdrop for EM green shoots.

EM Discount to Developed Markets and the Fed Funds Target Rate



Source: Bloomberg

Things to Watch

What If Developed Markets Slow? Many Emerging Markets Will Be Just Fine.

Most forecasters expected a recession in developed markets during 2023. This expectation has shifted to 2024 when many forecasters expect a slowdown or modest contraction in the coming year. In many respects, the idea that if developed markets sneeze, emerging markets catch a cold has become outdated. Global trade and fixed asset investment are no longer the primary driver for EM growth as the EM consumer has stepped into the forefront. We would categorize the impact of a DM slowdown across EM in three different ways.

POSITIVE: More consumer-driven markets will likely benefit from a developed market slowdown. India is the clearest example of a beneficiary of any slowdown in global growth due to its limited exports and a consumer segment sensitive to inflation. The shift China has made toward consumption is surprising to most, as investment has slowed, and exports are no longer a strong tailwind. More than half of Chinese GDP and even more GDP growth comes from consumption today. Both countries will continue to benefit from solid middle-class growth this year and in subsequent years.

NEGATIVE: Markets that rely on exports and global trade to drive their growth will likely face headwinds if key end markets soften. Mexico, for example, will likely slow if the U.S. economy stalls this year due to its close economic ties to the U.S. Other markets facing headwinds due to their export orientation include South Korea and Taiwan. This might be partially offset by a recovery in many technology hardware end markets, which are tied to both markets.

NEUTRAL: Latin American and Middle Eastern economies that benefit from abundant natural resources should see more stable growth driven by ongoing capital spending in commodity production. Most of these markets also benefit from a growing middle class which is shifting the growth driver towards consumption. In addition, several of these markets have suffered from high interest rates and should receive a boost as rates fall during 2024.

China's Erratic Recovery Will Likely Continue to Be, Well, Erratic

China remains the elephant in the room. Beijing's influence in the space ranges from its softening economy to the reaction of global corporations and governments to its policies and reach. We attribute China's weakness last year to several factors.

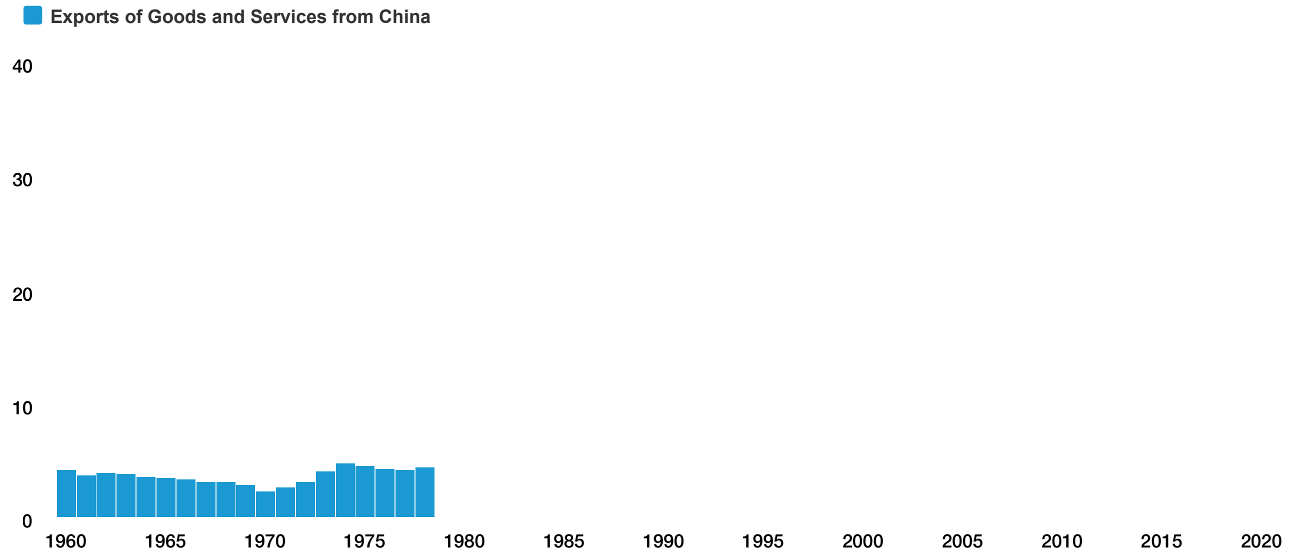
Foremost, the damage to the economy from harsh COVID restrictions was likely worse than anyone expected. Consumers remain very cautious and, as a result, remain slow to get back out and spend. The government, especially local governments, has also been slow to introduce fiscal stimulus programs. Both may be tied back to China's deflating property bubble. Real estate is the primary savings vehicle for Chinese consumers, and property sales make up a significant source of revenue for local government. With property market values uncertain at best, consumers and government stimulus appear frozen. Chinese savings rates remain elevated so consumers can spend. We think it will take longer for China's property market situation to resolve itself so that consumer spending may remain cautious.

Looking ahead to 2024, despite all the challenges discussed above and the subsequent disappointing performance, China remains one of the fastest-growing economies in the world. Even with an overall population poised to decline, the middle class is still increasing and remains an essential driver of the economy. We are seeing attractively valued opportunities across a variety of sectors.

The Long-Term Reshoring Trend Will Continue in 2024, Benefiting Emerging Markets

Last year saw the theme of reshoring away from China to other emerging countries gain much attention among investors. Reshoring is not a new trend. Due to rising wages, supply chains have been moving away from China for nearly a decade. Geopolitical tensions and recent COVID-related policy blunders accelerated the exodus of foreign investment. Foreign direct investment in China turned negative in late 2023, and, as seen in the chart below, net exports have declined for nearly 20 years.

Chinese Exports Have Been in Decline for Nearly 20 Years



Source: World Bank

However, the "winners" of this trend have not and likely will not be developed nations. Instead, supply chain investment is shifting elsewhere, such as in Thailand, Malaysia, India, Mexico, and Indonesia.

But China will remain a powerhouse in the global supply chain, even as firms shift low-end manufacturing to regions closer to their end markets, such as Mexico and Eastern Europe. This is what we refer to as a "China Plus One" shift. That is, firms are looking to China plus a nation closer to their markets for supply chain relief. Moreover, China is becoming a much more sophisticated manufacturer as Beijing develops world champions, adding research and development intensity in various advanced industries ranging from electric vehicles to industrial robotics and automation. This is the next leg of Chinese development as the nation shifts to high-tech exports.

Outlook

China

We expect overall growth to slow but remain relatively robust. Consumers may remain cautious in light of property market challenges.

India

We expect growth to remain strong and perhaps accelerate as inflation moderates. Valuations remain elevated but supported by the medium-term growth outlook and continued strong domestic market inflows.

North Asia

Cyclical and structural factors will lead to recovery across most major technology end-markets. We expect strength in these end-markets to offset headwinds related to slowing DM growth.

Latin America

Falling real rates and faster real wage growth should help domestic growth and consumption across the region. We expect commodity price stability and an uptick in FDI across the region to remain a tailwind. Valuations are highly attractive and do not reflect the solid fundamentals and increasing tailwinds.

MENA

We are hopeful that the Israel-Hamas war will be peacefully resolved soon and that it will not spill over into a broader regional dispute. If so, this leaves room for the ongoing reform process across the region (in particular UAE and Saudi Arabia) to further unlock productivity gains and drive growth. Despite strong fundamentals, valuations remain attractive due to softening oil prices and the outlook for falling U.S. rates (the region often underperforms in a stable/falling USD backdrop).

Positioning

China

We focus on opportunities that are less sensitive to external factors. This can be challenging to find in the current environment and has led us to reduce our exposure to China.

India

We continue to balance valuation and long-term opportunity. We are finding good opportunities across financials, real estate, healthcare, and consumer.

North Asia

We are finding good opportunities to invest in the cyclical recovery and structural growth aspects of the technology supply chain.

Latin America

Despite firm and improving fundamentals, we are finding extremely attractive valuations across the region. We expect currencies to remain supported due to conservative monetary policy and consistent FDI. We have invested in opportunities across financials, real estate, healthcare, consumer, and commodities opportunities.

MENA

Despite short-term headwinds, we think the medium-term fundamentals remain solid and underappreciated by the broader market. We are invested in the region's financials, industrials, and real estate sectors.

2024 Outlook

Municipal Bonds

Will the Tether to Treasuries Unravel?



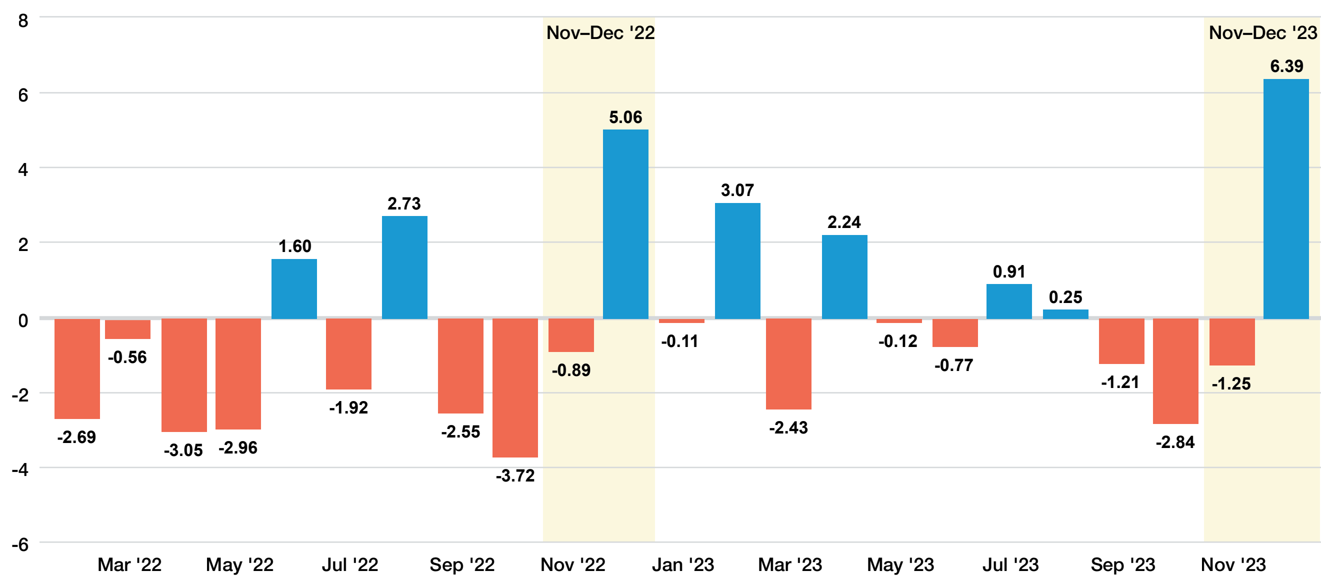
David Ashley, CFA, Eve Lando
and John Bonnell, CFA
Portfolio Managers and
Managing Directors

In 2023, Munis and Treasuries moved in lockstep, and flow dynamics roiled the market. Investors need to be mindful of technical factors amid bountiful yields.

Higher for Longer: Another Tough Year for Bonds

After a challenging 2022, the municipal bond market showed relative stability in the first half of 2023, with outflows slowing down considerably and liquidity recovering to healthier levels. But Muni market sentiment turned volatile in the latter half of the year, triggered by the U.S. Federal Reserve's decision to hike the Fed Funds rate by 25 basis points in July and maintain a steady policy in September.

Municipal Bond Monthly Performance Was Negative until November, Like 2022



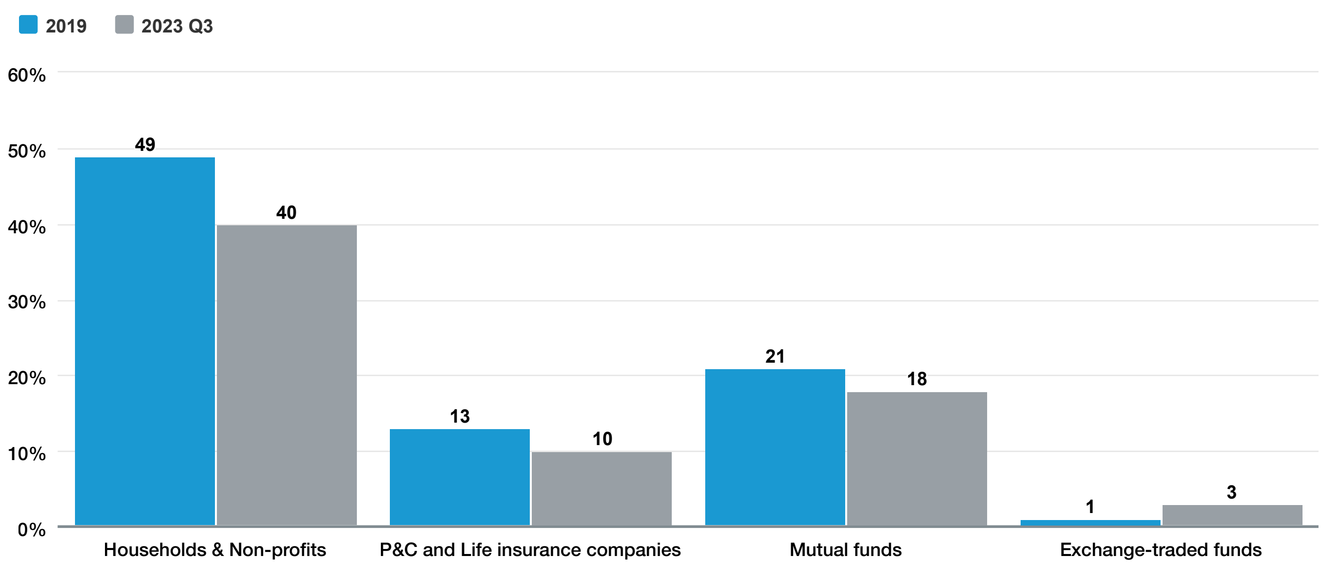
Source: Bloomberg, ICE BoA

There were signs that the U.S. Federal Reserve might be approaching the end of its rate hike cycle in September while indicating its commitment to keep rates higher for longer to continue combating inflation. In response, the market sent Treasury yields surging, and bond prices fell across the board in September, as seen above. Muni bonds joined the rout, with yields soaring on top-rated Muni credits and bond prices diving. But Muni bond performance took off in November as tax-loss selling abated and investors sought to lock in higher yields should Fed policy remain steady or even ease in reaction to a widely anticipated, if much delayed, recession. As a result, 2023 is looking to wrap up as a flat to strong year for Munis, bucking the trend in broader fixed income markets.

Munis Performance Remains Vulnerable to Technical Drivers

Historically, households (i.e., individual investors) owned nearly half of the outstanding debt, and these investors would hold bonds until maturity while consistently reinvesting the coupon and principal amounts. This investor behavior coupled with bond issuers making coupon payments in January and July created seasonal demand for bonds. However, household ownership has declined, as seen below, while managed funds, including Exchange Traded Funds (ETFs), now absorb a larger share of outstanding Munis. ETF assets have tripled since 2019.

Household Ownership of Muni Bonds Is in Decline, Leading To Volatility



Source: Federal Reserve Chart of Accounts

While investors have appreciated the daily trading frequency of mutual funds and ETFs' intraday action, ETFs can amplify market movements given their enhanced liquidity features and ability to trade at a significant discount or premium to their underlying assets. The latter is especially true during times of stress, as was seen during the September panics of 2022 and 2023 when retail investors ramped up selling pressure or redemptions. That, in turn, forced mutual funds and ETFs to sell, exacerbating an already volatile situation and triggering steep declines in bond prices.

Heading into 2024, we believe fund flow dynamics of mutual funds and ETFs will remain among the key drivers of short-term Muni market volatility and performance. On the bright side, the heightened volatility presents unique opportunities for active managers to recognize market overreactions and capitalize on market selloffs. When bond prices fall indiscriminately across the board due to technical, momentum-driven factors, this creates the perfect opportunity for active managers to secure fundamentally sound municipal credits at discounted prices and bountiful yields.

Looking Forward to 2024

We believe current market sentiment is too dependent on the latest economic indicators as investors attempt to predict the Fed's next move. For instance, the recent drop in inflation figures led many to believe the central bank would pause rate hikes, with some even discussing a potential Fed pivot to rate cuts — and that sentiment pushed yields lower. We think these sorts of short-term repricings have not only been historically misguided, leading to being inaccurate, but can also be distracting and counterproductive to providing long-term value for bond investors.

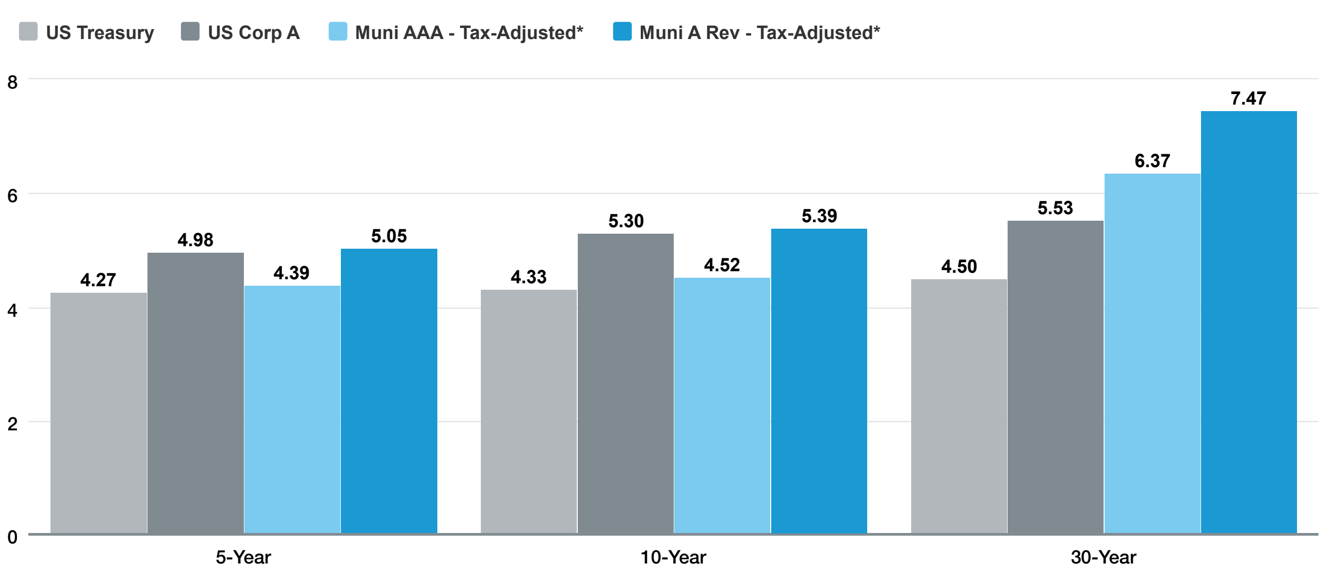
Moreover, bond and equity investors are becoming hypersensitive to daily economic headline news in the current environment, and collective efforts to "read the tea leaves" have adversely impacted the relationship between U.S. Treasuries and Munis. In the past, municipal price movements tended to follow similar patterns to those of Treasuries, with Munis generally lagging Treasuries by a few weeks. But Munis have become so tightly tethered to what is happening in Treasuries that these asset classes now move in lockstep, nearly daily, with minimal differentiation between stronger and weaker credits.

Bountiful Yields in High-Quality Credits

Bond yields have risen to levels not seen in decades, and investors shouldn't miss the opportunity to lock in here and take advantage of the heightened levels of income. Opportunities in Munis are even more compelling when investors consider the tax-exempt benefit, especially in high-tax states.

As seen below, AAA-A rated municipal credits offer much higher yields than similar-quality corporate bonds and government-backed Treasuries across five-, 10- and 30-year periods. It is also worth noting that, over a decade, the tax-adjusted returns of A-rated municipal bonds currently rival those of equities. Essentially, Munis could potentially provide equity-like returns with lower risk than stocks.

Getting Paid Well to Own High-Quality Muni Credits



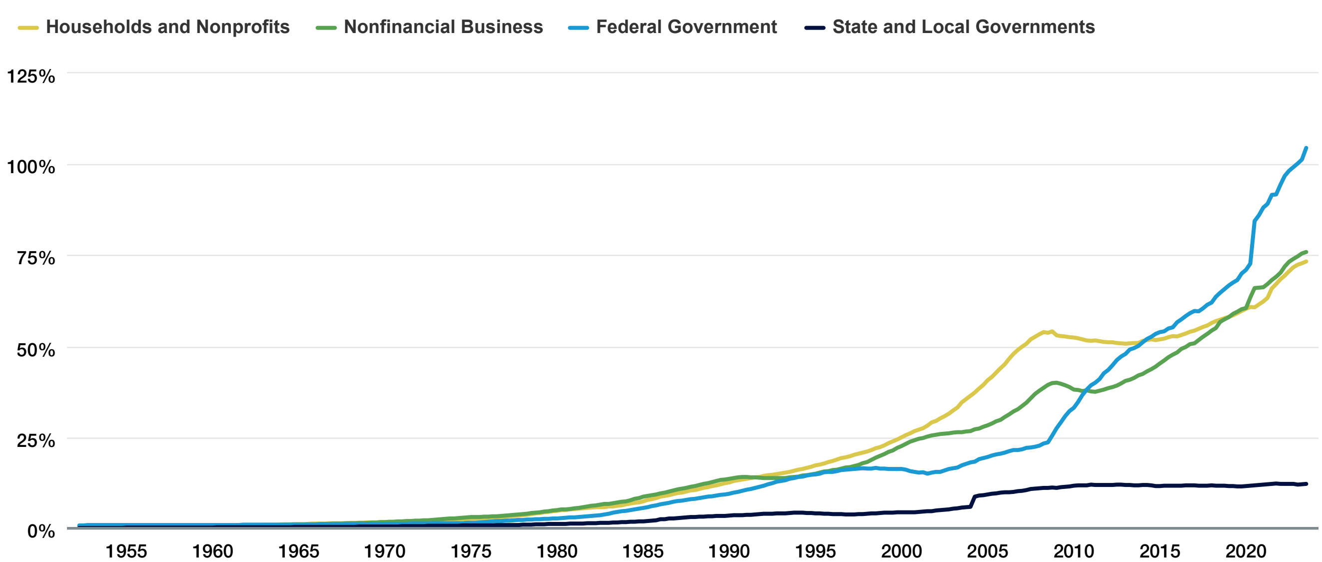
Source: Bloomberg BVAL Yield Curves

Stability and Protection in Municipal Bonds

Municipal bonds are often considered a relatively stable and protective asset class because they tend to be less susceptible to economic headwinds, as most of them are backed by the financial strength of the state or local taxing authorities or specific income streams from various projects. That makes it critical to comprehensively understand the fiscal health and debt profiles of the local government entities issuing Munis.

Contrary to popular belief and unlike the federal deficit challenges, municipalities exhibit remarkably low levels of debt in comparison with other sectors of the economy, underscoring the strength of this sector's financial health. We think Munis are uniquely positioned to be a cornerstone of investors' portfolios due to their strong sector fundamentals, resilience, and long-term stability..

State and Local Governments Carry Less Debt



Source: Federal Reserve Chart of Accounts

Outlook and Positioning

The recent resilience of the U.S. economy surprised many investors who came into 2023 expecting a recession. That strength has led many to reassess and price out near-term recession risks. While there is ample debate about the possibility of a soft landing or whether the current environment is the calm before the storm, we remain attuned to the ever-evolving macro environment while maintaining an unwavering focus on bottom-up credit fundamentals to drive portfolio outcomes.

Turning to 2024, Munis are an enticing investment option given this asset class's attractive tax-equivalent yields and protection. In particular, we believe specific municipal sectors are positioned to perform better than others based on our outlook for each, as summarized below.

Outlook

Rates

The spike in rates, while painful for bond prices, allows investors to once again earn an attractive level of tax-exempt income. The Fed remains committed to more rate hikes in 2023, however, and the inversion in the Treasury curve signals that the market believes the Fed will overshoot, tip the economy into recession and be forced to cut rates sooner than expected.

Spreads

Differentiation across states, sectors and credit quality should re-emerge as investors become more discerning about the bonds they own. A central bank induced recession, along with an end to Federal stimulus dollars, could spark additional spread widening.

Sectors

The municipal market is not immune to inflationary pressures but there are areas that offer some protection. Sectors that finance long-run, hard assets such as education and healthcare, or municipal utilities that operate government monopolies with inelastic demand offer desirable anti-inflationary traits.

Defaults

Municipal defaults will likely remain low but may increase from 2022. Economically sensitive areas will come under pressure if the U.S. enters a recession. Areas such as healthcare, senior living facilities and project finance deals are already feeling inflationary pressures.

Positioning

Rates

The municipal curve has remained very flat inside of 10-years and beyond 20-years with most of the yield pick-up between 10 and 20-years. Despite the flatness of the long-end of the curve, long maturity municipal yields look attractive on a relative basis to Treasuries.

Spreads

Areas that historically offered attractive spread opportunities in the revenue space are areas of focus. However, should heightened price volatility continue, the price paid for a bond will be as important for returns as our credit research to identify specific opportunities.

Sectors

City, state and county G.O. debt is attractive based on the issuer's financial flexibility at this part of the cycle. As are essential service revenue bonds for large metropolitan areas. Pockets of opportunity exist in other sectors that offer attractive relative value and incremental income opportunities.

Defaults

Absolute yield levels no longer require adding credit risk to earn an acceptable level of income. We will look to add credit on market weakness, but selectivity is paramount as is the financial flexibility of an issuer and their ability to control revenue and expenses.

Thornburg

Will High Rates Curb Infrastructure Investment?

Jake Walko
Director of ESG Investing & Global Investment Stewardship

If net zero carbon emissions remains the long-term climate goal, high interest rates require discipline deciding which projects are financed and which are not.

Rates can easily be described as the hero (or villain) of the financial markets over the last two years. However, if we reflect on more long-term secular trends, the increased focus on sustainability and the climate transition is still the buzz of global economies. The implications of both of these themes have had wide-ranging and sometimes divergent impacts on many industries, but at this stage, it's not yet evident who the winners and losers are and how they might change in the future. As we start a new year, we look to offer some of our early observations and long-term prognostications to help our readers gain insights and spark conversations.

How Much Will It Cost to Reach Net Zero By 2050? Estimates Differ

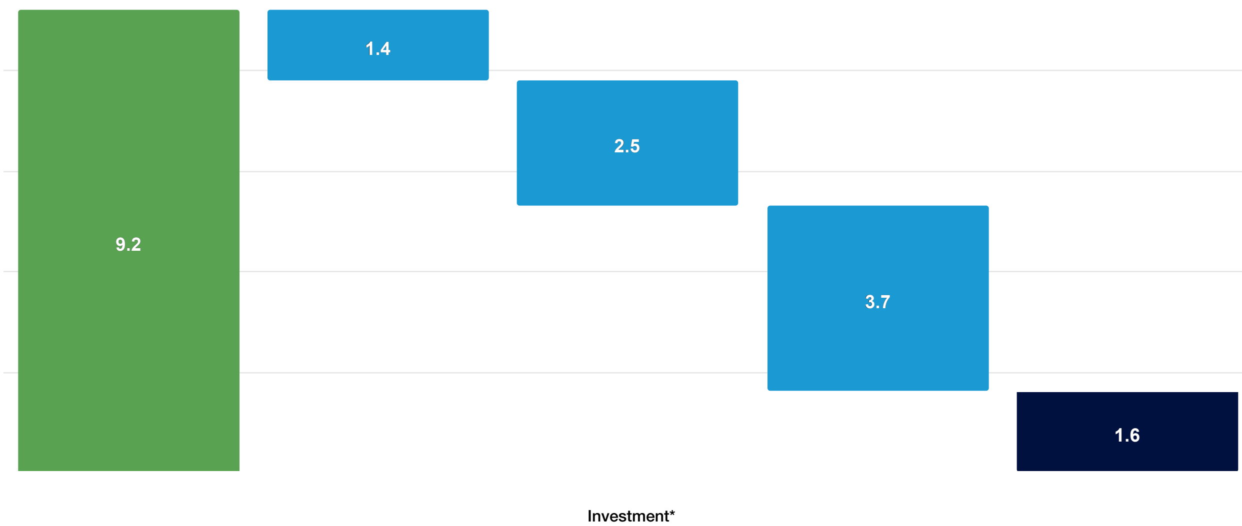
Average annual Investment into 2050 ($trn)	Source	Scenario, scope or estimation method
3.5	Network for Greening the Financial System	Total investment in 1.5'C scenario
4.1	Boston Consulting Group	Total investment, drawn from range of estimates
4.4	International Renewable Energy Agency	Energy investment
3.5–5.1	Bloomberg NEF	Range of investment depending on technology path
4.5	International Energy Agency	Energy related investments
9.2	McKinsey	Broad view investments on demand side

Source: Barclays Research, BNEF, IEA, IRENA, NGFS, BCG, McKinsey

Do Rate Indicators Flag a Pathway for Thoughtful Climate Transition Investment?

The U.S. government recently concluded its Fifth National Climate Assessment with a striking $150B annual price tag for extreme events and projected rising costs. These estimates are imprecise, uncertain, and typically based on extreme tail events. Still, various sources have put the annual capital investment needed to achieve net zero emissions globally at as high as $9.2 trillion a year. More conservative sources sources predict it will take a little more than half of this figure – a still shocking $4.9 trillion annually by 2030. We're not scientists and are not always well-positioned to judge the spectrum between ambivalence and alarmism. However, as investors, we recognize a need and an opportunity to finance the climate transition in any form that moves it along, even if consensus on what perfect looks like is elusive. An investment gap remains between what is required to reach net zero and our current investment trajectory, even after re-directing brown assets–money funding assets that damage our planet and contribute to the climate challenge.

An Investment Gap Still Exists While the World Strives for Net Zero



Source: Barclays Research, IEA (2021), McKinsey (2022), NGFS (2022)

Unlike central government spending in areas such as defense, most funding allocation decisions in the climate debate involve many more participants searching for solutions from the corporate sector that meet their individual needs. This leads to many interested parties, spanning established businesses and entrepreneurial startups. Years of historically low rates and ambition that sometimes bordered on mania in the 'green' space have led to significant spending, ending in several bubbles, false promises, and bottlenecks. While this isn't anything new, we think high rates spurred by inflation will be an essential crucible for determining the path forward.

Misguided government initiatives aren't the only culprit; investors are also to blame. The government may offer broad incentives for companies to head in the right direction, but investors decide which companies are ultimately worth sustaining today and which will tread forward successfully. That said, the world will continue to learn about which technologies led by what incentives may generate actual outcomes. Flows often follow sustainability themes (sometimes dictated by government incentives), followed by some form of pushback and an eventual sharpening of the investment case. The future will not be marked solely by the amount of dollars pumped into climate adaptation and mitigation projects but by how quickly we can improve our knowledge and methods to discern and invest based on the efficacy of the capital deployed into that space. In other words, in a new era of cost of capital, investments in offsetting and adapting to climate change must have a substantially positive return on investment.

Given the massive demands on limited funds, investors must be more scrupulous about the companies and projects they finance. By that, we mean investors must more intently make investment decisions based on an assessment of a company's understanding of customers, suppliers, regulators, and employees—all of whom play integral parts in delivering successful products and services to the places of greatest urgency and successfully making the investment case. We expect the future to favor projects and investments that realistically consider real-world outcomes early on and endure the scrutiny of regulators and investors. In other words, a rising tide will no longer lift all boats.

Indicator 1: Identifying the Places of Greatest Urgency

The reality of higher rates will be a tight squeeze on all government spending. The public is already noting the more significant impacts of climate change, and this strain will increase as dwindling discretionary government spending will make climate adaptation and prevention projects scarcer.

It's tempting to think that new sources of innovation will solve most of these problems. While these blanket solutions may be comforting, they lack realistic expectations for the future. We believe the reality is much more boring, involving many more trucks moving dirt or pouring concrete, than expensive mega-projects or even carbon capture and storage, which is still working towards economic viability. We believe high-quality industrial and materials companies and utilities are indispensable to these endeavors, especially in jurisdictions with significant potential for stimulus and shrinking population centers.

Although high-value urban centers may be a part of the climate transition, most people live in areas where it's hard to discern their vulnerability to the physical impacts of climate change. The costs most people feel won't be as much about catastrophe as it is inconveniences that can have a significant cumulative negative effect over time—think clogged sewers, overheated electrical infrastructure, and commuter disruptions. Moreover, the underinvestment in the infrastructure of emerging economies amplifies the sheer scale of humans affected while making the high rates of future lending that much more problematic for rapid change. Governments may turn to local resources for those small patch-up jobs, but for large-scale infrastructure, there appears to be a shrinking pool of market participants who operate at scale and can field a large undertaking. The companies that realize and capitalize on this issue by optimizing to help the most people will come out on top.

Growth in CapEx Has Slowed over the Past 40 Years

CAGRs	1980-1990	1990-2001	2001-2007	2007-2019
Structures	1.5%	4.4%	-0.6%	1.2%
Intellectual Property	8.7%	7.7%	4.3%	3.5%
Equipment	4.5%	3.3%	3.6%	1.0%
Total	5.6%	5.4%	3.6%	2.5%

Source: BoA Global Research

Indicator 2: Healthy Balance Sheets

As rates stay higher for longer, companies need to be ready, as high indebtedness constrains and limits a company's ability to pivot. Those who want to be competitive bidders on contracts must have a reputation for management quality, a track record of delivering, and the ability to support bids with impressive research and development and human capital capabilities. Healthy balance sheets and disciplined debt management are required to exploit such business opportunities.

Indicator 3: Stealthy Technology

We are also interested in high-margin technology opportunities that will show resilience to lower capital availability and play a part in consulting-style services and pure computing capacity to support infrastructure design-build. Whether upgrading the power grid infrastructure or creating a more resilient physical landscape, most environmental projects require deep analysis of historical data and geospatial components before engaging expert scientific and engineering resources. Most localities don't procure or staff the technology or expertise required to deliver on larger-scale projects in this area, exacerbating a need for consultants. We are beginning to see a shortage of sustainability consulting resources, showcasing the opportunity on the business side.

Indicator 4: A Crumbling Housing Environment in Need of Efficient Construction

Due to the high-rate environment, the construction industry has felt particular supply chain cost pressures. This industry has a significant investment deficit in the housing sector due to the shortage of new buildings as well as aging and quickly deteriorating existing stock, coupled with pressures to solve this quota problem without adding construction emissions. There will be significant demand for contracts that build the most units with the greatest efficiency, both in terms of embedded emissions of the construction process, cost savings, and how sustainable the new housing units themselves will be.

Conclusion

On the surface, it's tempting to oversimplify the problem as one of investment, but this is also about fiscal choices and tradeoffs vis á vis entitlements and government programs, as well as managing issues of scarce industrial materials and skilled labor. That said, we would be remiss if we didn't also acknowledge the many competing regulatory efforts coming into effect. Most of these rules are well-intentioned to incentivize the climate transition or improve the integrity of commercial solutions. While they also place significant compliance costs across all market participants, we prefer those rules to higher prices and the increasing risk of energy disruptions from climate change. We will see if efforts like the EU model of cumbersome climate regulation are the kind of front-loading of cost that positions companies for long-term success. Early indications, however, point to significant voter discontent with rapidly rising prices. Either way, companies that don't monetize opportunities that can pay for those expenses will struggle, and as we see from the 77% or so unspent funds from recent government stimulus, swings in political leadership resulting from voter discontent may add even more planning risk.

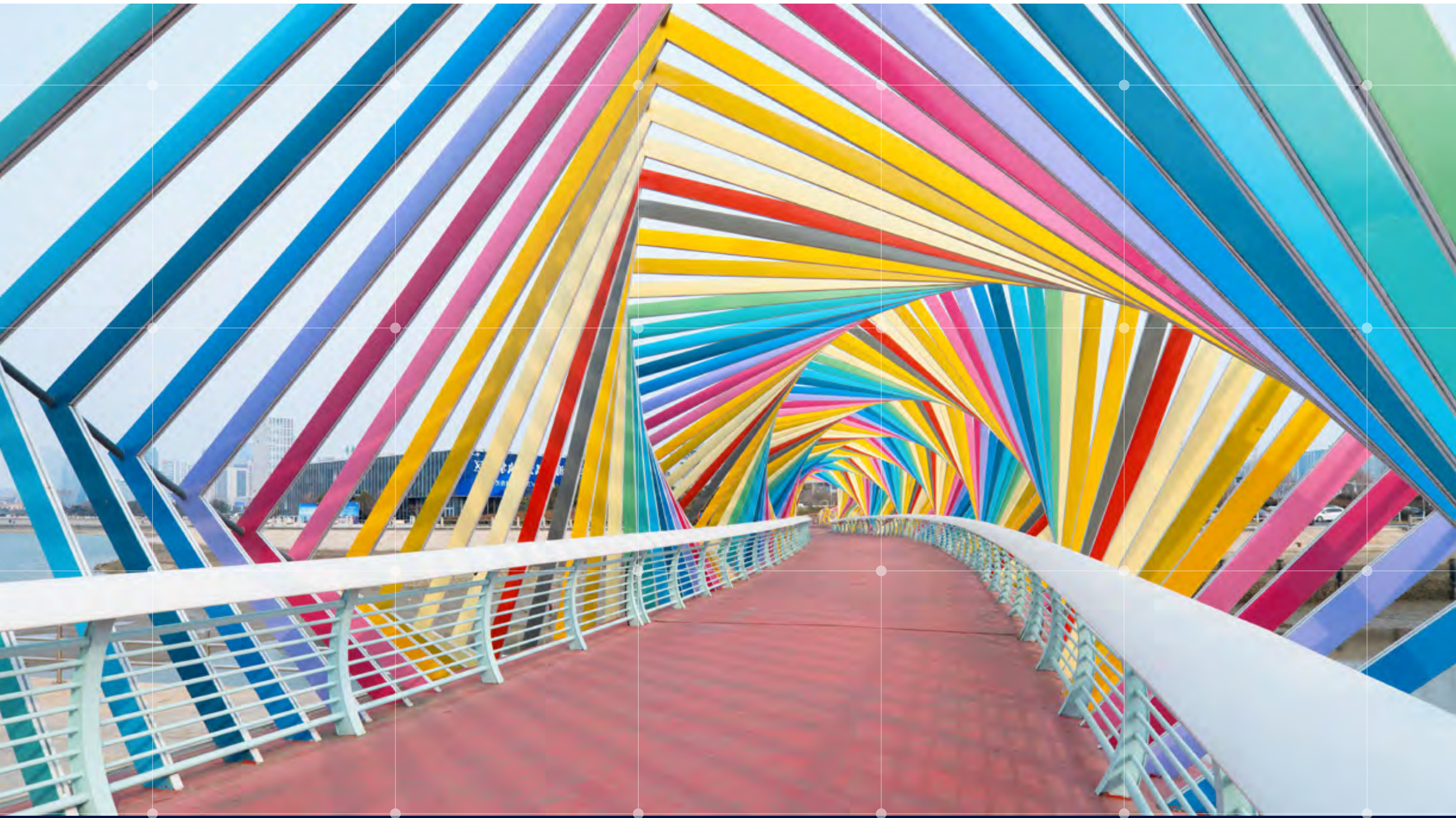
A move towards vigorous evaluations of internal rates of return brings these indicators together and converges at opportunity. Whereas we view much of sustainability efforts today as R&D or simply performative measures, there's an opportunity for it to take on a dimension of business rigor that allows us to meet the challenge of climate change with an eye towards financial opportunity. Simply put, the future of sustainability lies in strong (and realistic) economics.

Important Information

The views expressed are subject to change and do not necessarily reflect the views of Thornburg Investment Management, Inc. This information should not be relied upon as a recommendation or investment advice and is not intended to predict the performance of any investment or market.

This is not a solicitation or offer for any product or service. Nor is it a complete analysis of every material fact concerning any market, industry, or investment. Data has been obtained from sources considered reliable, but Thornburg makes no representations as to the completeness or accuracy of such information and has no obligation to provide updates or changes. Thornburg does not accept any responsibility and cannot be held liable for any person's use of or reliance on the information and opinions contained herein.

Investments carry risks, including possible loss of principal.



09 Jan 2024
TL0703