The Federated Hermes 2024 Outlook

Our investment experts on the nine themes that will matter next year

Federated Hermes Limited

www.hermes-investment.com
For professional investors only

Foreword

In my foreword to our annual outlook last year, I reflected on 2022 as a year of "events, dear boy, events" (with thanks to Harold MacMillan). I hoped that 2023 would bring a bit more order and certainty, but that didn't unfold. Instead, added to the Ukraine war, which sadly appears to be moving towards something more long-term, we had further geopolitical disturbance in October with events in the Middle East.

Meanwhile, markets spent most of the year reacting to central banks and their continued interest rate hikes as they moved to contain inflation. Another factor which made markets unpredictable and volatile.

So what's in store next year?

Geopolitics will, once again, play a central role. In 2024, for the first time, more than half the world's population will vote in an election, according to The Economist. A lot will hang on the result of the US election and if, as current polls suggest, President Trump is returned to office it won't be without global consequences. Perhaps the rapprochement between China and US will stall and support for Ukraine will wane. President Biden's Inflation Reduction Act could be watered down. Each will have their impact on global markets.

Interest rates will be a focal point again, with mounting evidence that they have reached their peak, but markets are bracing themselves for an extended period at a 'flat top'. The Fed will be looking to avoid a US recession and guide the economy to a soft landing. Expectations for a "constructive" year in the US remain, among our equity teams.

At the time of writing, world leaders are gathering in the UAE for COP28. The societal and economic transition to net zero will have differing impacts, depending on where people live and a large focus of this year's conference will be how to make this transition fair. My hope is that COP is a springboard for action in 2024 and not only supports poorer countries, but also developed nations who need to transition in a way that will sustain people and communities and avoid economic destruction.

As we await action that will determine the course of our planet's survival, it is perhaps another MacMillan saying that we should reflect on: "History is apt to judge harshly those who sacrifice tomorrow for today."

Saker Nusseibeh, CBE
CEO, Federated Hermes Limited

United States presidential election

Phil Orlando
Chief Equity Market Strategist, Federated Hermes Inc.

U.S. investors vote with their feet. Over the course of the last century, there has been a strong positive correlation between the performance of the equity markets and the economy and the results of presidential elections in the United States.

Looking back over the last 24 four-year presidential election cycles, the performance of the S&P 500 in the three months leading into the early-November election matters significantly for presidential candidates. If the stock market is negative on a price-only basis in those three months, the incumbent has lost his bid for re-election 90% of the time. But if the stock market is positive on a price-only basis in those three months, the incumbent has won the election 86% of the time.

If the U.S. economy is in recession during the two years prior to the election, the incumbent president has lost his bid for re-election every time. But if the economy is growing in the two years before the election, the incumbent has won the election every time.

President Biden's current polling numbers are very poor, with expectations for a sharp deceleration in economic growth over the next three quarters. As a result, the stock market could be choppy in the August-September-October period in 2024, which historically has been a precursor to a change in White House leadership.

Against that historical backdrop, we are expecting a constructive year overall for the stock market in 2024. We think the S&P 500 will end 2023 at about 4,600 and are expecting an 8-9% increase to 5,000 by the end of 2024. More specifically, we think the very narrow rally in technology stocks that dominated the first half of 2023 will broaden over the course of 2024, with U.S. large-cap value, small-cap growth and international stocks doing well. We also expect Treasuries to perform well in the fixed-income market and for cash to continue to be a real asset class.

But the new year could also be volatile. The first half could be strong, if the Federal Reserve has paused its interest-rate hiking cycle, as stocks typically rip on Fed pauses. But the late summer and early fall run-up to the November presidential election could be choppy. Post-election, we expect a powerful, end-of-year, sigh-of-relief rally.

Mark Sherlock
Head of of U.S. Equities

As we look into 2024, uncertainties remain, not least fiscal and monetary policies, but also around the upcoming Presidential election. However, we remain constructive on U.S. Equities and in particular U.S. Small and Mid-Cap (SMID) equities.

When approaching our outlook for 2024, keep in mind that U.S. equities have typically gained in the fourth year of presidential terms. Since President Hoover's last year in office in 1932, the S&P 500 has gained an average of 6.2% in an election year. Whilst the Russell 2500 Index doesn't have data as far back as the Hoover administration, U.S. SMID has beaten the return of U.S. large caps in every election year. Elections give clarity to investors and the period after an election has historically been positive for U.S. equities. Since the inception of the Russell 2500 Index, it has outperformed the S&P 500 Index in three of the last five first years post-election.

Whilst we don't claim to have a crystal ball that can predict the outcome of the 2024 election, the strong tailwinds that are supportive of U.S. SMID companies for the next 5-10 years will still be in situ regardless of who is sitting in the White House. The Inflation Reduction Act and infrastructure spending has largely been authorised and will boost new investments. Onshoring, which has seen unprecedented infrastructure spend from the Biden administration, is also on the agenda for the Republican nominees and arguably was kick-started by the Trump administration.

Recession expectations have been pared back in recent months as both the U.S. labour market and broader economy have been resilient to the Federal Reserve's aggressive tightening policy. The softer inflation data supports the case that interest rates have peaked and provides scope for cuts next year if we see an economic slowdown. A robust domestic economy with structural tailwinds should be supportive for U.S. SMID given that it trades demonstrably cheaper than large cap vs its longer-term average.

Assuming interest rates remain higher-for-longer, selection within U.S. equities will be significant. Companies that have over levered due to the low interest rate environment of the past decade are already starting to feel the pain of a margin squeeze, which will be exacerbated by higher-for-longer rates. The tighter monetary policy will be supportive of "quality" companies; those with strong balance sheets, robust marketing positions and pricing power.

United Kingdom general election

Chris Taylor
CEO, Real Estate

The UK real estate market has had to contend with a confluence of multiple challenges that have adversely affected investor sentiment and radically altered occupational demand; heightened geopolitical tensions, Covid, Brexit and a swift normalisation of interest rates. This has not only led to a rapid repricing of real estate markets, but accentuated the existing longer term structural trends affecting occupational demand leading to an increasing awareness of the environmental and societal risks associated with real asset investment.

Political certainty is vital to provide investors with the confidence needed to invest in major new projects, which can deliver both relevant and resilient real estate outcomes. Confidence in planning policies at a national and local level and major infrastructure schemes such as HS2 will be key to how we seek to continue creating value through development projects in placemaking and Build to Rent (BtR) activities. Securing long term patient capital from global investors to fund these new projects is critically dependent upon their confidence in the UK and its political stability; last Autumn's Budget turmoil caused damage to these investors' confidence in the UK as an attractive destination for long term investment in real assets.

Whichever government succeeds in winning the forthcoming election will hopefully grasp the importance that the built environment can play as a conduit for not only enhanced productivity, but also delivering tangible societal and environmental benefits to our economy as a whole. Our placemaking schemes in major UK city centres and BtR programme represent outstanding examples of the longer-term value to be released with a compelling partnership between public and private sectors, which thrives upon political certainty and clarity for longer term town planning and infrastructure strategies. The result of the forthcoming election will be key to delivering these outcomes in the built environment and the enhancement of the UK's productivity and societal and environmental wellbeing.

Just transition

Leon Kamhi
Head of Responsibility

My great hope for the COP28 summit is to see actionable commitments, from governments, industry leaders and financial institutions, to invest in a just transition. If the ever-increasing action gaps remain, economic losses from global warming will balloon, making the inevitable transition more painful. As we look ahead to 2024, it is clear that the next 12 months will be critical to delivering success.

However, investments will not be enough. The consumers and citizens of the world must join our journey. Yet without access to affordable food and energy and the availability of income-generating and interesting jobs, they will simply not share our goals.

This 'just transition' will take different forms. The first form will be country to country. Those in the Global South will look to the Global North for support to fund the required investments. We expect this to be evidenced through an increasing use of the Loss and Damage Fund and more Just Energy Transition Partnerships. There will need to be multilateral agreements on how to compensate poorer countries for as yet untapped fossil fuel reserves.

Secondly, food and energy supplies form a significant part of the lives of the poorest in our societies. Therefore, policymakers will need to consider how to make these commodities affordable through progressive subsidies, possibly financed by taxation of those emitting carbon. Providing education so consumers can make informed choices on food waste, their use of energy and other consumer behaviours will also be vital if we are going to achieve a just transition.

Thirdly, companies whose activities will inevitably change thanks to the just transition will need to retrain their employees. Paying the living wage and offering living hours will also be important. Specific industries could benefit from the just transition in other ways. For example, retail banks can offer residential mortgages that cover the cost of solar panels, heat pumps or insulation.

Finally, the investment industry, through meaningful stewardship, should encourage its investees to support the just transition. The industry should continue to make direct investments in primary markets which have a positive social or environmental impact. Be that in reforestation, regenerative agriculture, education or the like.

Without a 'just' transition there will be no transition.

Higher for longer

Deborah Cunningham
Chief Investment Officer for Global Liquidity, Federated Hermes Inc.

After years of ultra-low interest rates, the Federal Reserve's aggressive rate-hiking campaign has been a nirvana for money market investors. Many have found that spreading their clients' cash across multiple liquidity vehicles – including money market funds – and time horizons, such as apportioning non-operating cash to higher yielding products, to be a sound strategy. But as inflation continues to fall and the remarkably strong labor market cools, is the blissful environment over as we move to 2024?

We don't think so. Throughout the tightening cycle, U.S. monetary policymakers have made clear they will not repeat the past mistakes when they assumed inflation had rolled over, only to have it reverse course. When the U.S. Labor Department reported lower-than-expected consumer price index (CPI) data for October, the markets responded with gleeful rallies. But the Fed likely viewed it warily, lest it be just another "head fake," as Fed Chair Jerome Powell colorfully described inflation's behavior over the last two years.

Even if inflation truly is falling, it is not where the Fed wants it. CPI and the personal consumption expenditures index (PCE), the Fed's preferred measure, still sit above the central bank's 2% target. If the Federal Open Market Committee meeting opts to hold rates in the 5.25-5.50% range at its December meeting, which we expect, the game is not over.

We think the Fed has entered a 'higher for longer' period that will likely extend to at least the second half of 2024. It behoves policymakers to let the lagging impact of monetary policy be fully felt before easing. Plus, Powell would like nothing more than to guide the economy to a soft landing. He has never given up hope that the U.S. could avoid a recession, and his legacy would be boosted if he can pull it off.

This scenario should keep cash managers on cloud nine, even as some investors extend duration to other asset classes. Most liquidity products should continue to mirror the target range with attractive yields. And when the Fed finally starts to reverse course, the broad sector likely will attract asset flows if yields decline slower than other cash options, as has been the case in previous periods of easing.

Fraser Lundie
Head of Fixed Income – Public Markets

The evidence is mounting up that interest rates have reached their peak. Central Banks are now hellbent on maintaining a 'higher for longer' narrative that they hope will regain lost credibility, having underestimated the scale of the tightening job that has been required. Images of Cape Town's Tabletop Mountain as sighted by Huw Pill of the Bank of England are designed to prepare the market for a long, flat top, ensuring complacency does not allow a re-emergence of problematic inflation. This will likely remain a push-and-pull, cat-and-mouse game in 2024.

The economy has been surprisingly resilient, but cash buffers built up through the pandemic are now winding down, locked-in low rates are rolling off and whilst yields may be lowered by Central Bank cuts, it remains much more uncertain whether spreads at the lower end of the spectrum will be able to come in too. It's hard to see help coming in the form of top line growth with consumers tightening their belts, facing higher loan payments, greater rewards for saving, and the ill feeling of house prices continuing to adjust downwards. To add further complication, structural economic trends may cause some inflation to be stickier than we would like – climate transition, an aging population and the related greying of the developed market workforce, as well as increased defence spending, all point to lofty fiscal spend. Governments will have their hands full balancing public debts that are rising rapidly with a higher proportion of spending on interest payments. A false step will see the bond market punish fiscal profligacy – as former prime minister, Liz Truss, found out to her cost last year. But cutting public services or raising taxes can be politically toxic, particularly in election years. And it's not just voter confidence that is required – markets are going to be asked to digest a lot of Sovereign new issuance at a time when Central Banks are also attempting to unwind bloated balance sheets.

Hidden pockets of leverage will continue to emerge, although the flip side to this is that higher interest rates may return some discipline to markets – a reminder that you can pay a dividend, but you must pay a coupon. The new regime of higher rates will feel strange and uncomfortable, but really it was the prior time of ultra-low rates and QE infinity that was the abnormality.

Patrick Marshall
Head of Private Credit

After nearly two decades in a low interest rate environment in both the UK and in Europe, the direct lending market is adjusting to a period of higher-for-longer.

Transaction flow is expected to remain subdued in 2024. As we have seen in 2023, low enterprise valuations, exacerbated by higher interest rates, will force private equity investors to hold onto assets for longer in order to make their target returns. This will lead to increased focus on the financing of buy and build strategies, adopted by private equity to grow the value of their existing assets by bolting on small acquisitions to portfolio companies. Furthermore, with a higher cost of debt, focus will be on cost rather than flexibility in loan terms. This should benefit the bank lenders over the unitranche lenders, who have higher return targets. This means that senior secured lending will continue to gain market share over unitranche products in the European loan market.

The sustained higher interest rate environment will benefit investors who have backed conservative direct lending funds. As loans are floating rate assets, investors will benefit from the rise in base rates on loans. However, companies burdened with high levels of financial leverage will continue to struggle under the increased cost of debt. This will put pressure on their debt service coverage covenants and will cause increases in defaults. As a result, restructurings will increase, especially for those direct lending funds that have lent with aggressive loan structures to cyclical companies. Fund raising will be difficult for these funds as investors will continue backing more conservative direct lending strategies.

Some companies will struggle to find liquidity to refinance their loans as they approach maturity. This means that only the strongest and most stable companies will be able to access the market, and companies will have to pay a premium to borrow. This should lead to increased yields on loans and better documentation and protection rights for lenders.

2024 will likely be a great year for direct lenders who have been disciplined in their lending approach, and therefore not dealing with restructurings.

Vincent Nobel
Head of Asset Based Lending

The interest rate rises we have seen have been a direct benefit to floating rate debt investors, such as those invested in real estate debt. The relative volatility in the underlying real estate market has caused bank lenders in particular to reduce their lending appetite, which has helped the margins that non-bank lenders can charge on new loans. For new investments, lenders have seen both rates and margins rise, showing the relative value the asset class can deliver.

With rates now closer to long-term normal levels, we have seen the real value that real estate debt can have in an investor's portfolio. Senior real estate debt portfolios continue to deliver income in line with underwriting, albeit with collateral that has lost some of its realisable value since those loans were made. However, with many senior loans having been made at modest leverage, the expectations are that impairments on senior loans should be minimal.

As a senior lender, our strategy is specifically designed to work in "all seasons", which means that the question of where rates go next year should be less relevant to us. The portfolio should perform in all scenarios. A reduction in rates will typically help the asset values of the properties that serve as collateral for our loans. Rates rises will increase the returns on our existing loans. Higher rates do, however, add refinancing pressure for our borrowers, who will have to repay our loans in due course with more expensive debt. This is not a problem when rates movements are modest, but the moves we have seen in recent times have not been modest.

In this environment it is thus important to have collateral of high quality. Properties that feel dated, are in need of refurbishment or are in the "wrong" location will struggle to attract new financing. This is therefore an important theme for next year; a continuing divergence between assets that can find buyers and lenders, and those that cannot. 2024 may be another rocky ride for those investors holding assets that underperform in the eyes of an ever-more discriminating investor base.

China

Jonathan Pines
Head of Asia ex-Japan

There are four large components of our Asia ex-Japan benchmark: China, Korea, Taiwan and India. Of these, China and Korea's performance over the last at least decade and a half has been particularly poor. China trades at a record low valuation relative to the rest of the world. Korea trades on an average price-to-book multiple of below one. Many individual stocks in both countries trade on single digit price-to-earnings multiples and unusually high dividend yields.

China's poor performance and cheap valuation results from a relationship with the West that has deteriorated and slowing growth, caused in turn, by a property sector that became too large relative to the rest of the economy. Korea's cheap valuation can be attributed to a high weighting of cyclical companies, many of which are anticipated to have (for now) declining earnings, and poor corporate governance that results in the mistreatment of minority shareholders.

Still, given the extreme absolute and relative valuations on offer, we are betting on both Korea's and China's stock markets to outperform. When stocks are this cheap, it only takes news to be less bad than feared for stocks to rise. In China the impetus might be provided with a softening of tensions with the US and continuing stimulatory policy support (followed by fear of missing out by underweight fund managers). In Korea, a rise in stock prices may result from an anticipation of the beginning of upcycles in key industries and a slow improvement in governance (from a low base) as a more muscular Korean activist investor class continues to emerge.

Kunjal Gala
Head of Global Emerging Markets

China is the world's second-largest economy, accounting for a third of the emerging market universe and half of emerging market GDP. China is a significant player in the global supply chain and a leader in critical areas such as renewable energy technologies, electric vehicle batteries and mature chip production. It is also fast catching up in several other high-end areas such as biotech, automation, robotics and artificial intelligence (AI). Hence, it is not possible to ignore the market entirely. We do not share the view many hold in the market that "China is largely uninvestable," and we see a favourable risk-reward situation in China.

China is at a crucial junction with multiple challenges, including a geopolitical rivalry with the U.S., the fallout from the pandemic, and stresses in its property sector, to name a few. These are immensely challenging issues that will test the resolve of the Chinese leadership.

While the challenges are significant, we are hopeful that the leadership has not succumbed to the market demand for a significant fiscal stimulus, as this will amount to "kicking the can down the road" over resolving the structural issues within the economy. China firmly believes in deleveraging, which we think is the correct strategy. Hence, our focus has shifted beyond the reopening of the economy to the economic transition to a higher value-added economy.

While deleveraging is painful in the near term, it will help the economy grow sustainably over a more extended period without worrying much about debt/asset bubbles. A credible policy to stabilise the economy will help China outperform global indices in the short term. However, its long-term performance will depend on how successfully the leadership in China manages the economy's transition.

The economic transition involves shifting away from a reliance on property and heavy resource orientation (a reliance on an ever-increasing supply of commodities and energy to fuel economic activity) towards other more sustainable growth drivers, such as rising middle-class consumption, improving people's quality of life, and increasing focus on higher value-added activities – which, will help the economy develop with better and more effective and productive capital allocation.

Mohammed Elmi
Senior Portfolio Manager – Emerging Markets Fixed Income, Federated Hermes Inc.

China is fast becoming a dominant theme in risk markets and if the situation worsens it could weigh on sentiment in Emerging Markets (EM) in 2024.

Many hoped that the opening of the economy following the end of zero-Covid curbs would fuel an economic surge, as when China rebounded from the 2008-09 global financial crisis, lifting the rest of the world. This view failed to account for the fact that China's myriad issues pre-date Covid, and its heavy-handed handling of the Covid-19 pandemic only made things worse, psychologically scarring the population. While some of the high frequency economic data has turned slightly more positive (perhaps indicating a cyclical bounce), the medium-to-long term issues remain. In 2024, policymakers will have to address the real estate market and its associated debt in the form of developers' borrowing and mortgages for growth to meaningfully recover. Directly and indirectly contributing to around 25% of GDP[1], a solution to the real estate recession would be welcome and could prove to be significant.

The 2024 U.S. Presidential Election also has the capacity to affect EM risk in a profound manner, as any change in bilateral relations between the U.S. and individual EM countries or blocs can impact spreads. One of the most significant geopolitical risks in this context, is an escalation in trade tensions with China. A Biden win could see a continued softening in relations, as witnessed in their most recent talks in California. A Trump win could see the return of a transactional foreign policy where sanctions are used to achieve key policy objectives, but is also realistic to anticipate that any change in the White House could once again spark an escalation.

In our opinion the Chinese fixed income space in 2024 remains challenged and unattractive on a valuations basis. Therefore, the importance of looking beyond China cannot be understated, as recently highlighted by the outperformance in countries such as Mexico, Brazil, Peru, and Turkey.

[1] Peak China Housing, National Bureau of Economic Research.

Innovators

Martin Todd
Sustainable Global Equity Portfolio Manager

They say innovation thrives in difficult circumstances and that constraints can be the catalyst for problem solving and creative thinking. The dramatic rise in the cost of capital since early 2022, may therefore have accelerated the pace of innovation, rather than slowed it.

Going into 2024, we have rarely been more excited by the transformative innovation across a multitude of sectors. The convergence of generative artificial intelligence (AI) and augmented reality (AR) has the potential to redefine user experiences and drive productivity.

In healthcare, the story of 2023 was GLP-1's (a class of type 2 diabetes drugs that improve blood sugar control) and anti-obesity medication. In 2024, however, we can look forward to the development of precision medicine and see how advanced data analytics can revolutionise patient care. Customized treatment plans, using individual genetic profiles and real-time health data, will likely become more prevalent, ushering in more personalised healthcare solutions.

The energy sector remains dominated by fossil fuels, but there continues to be innovation in sustainable technology, for instance in next-generation solar panels and energy storage solutions. Advancements in materials science and nanotechnology are also helping to drive the efficiency of renewable energy sources, bringing us closer to achieving a greener and more sustainable future.

Blockchain technology has been forgotten by many, but continues to evolve in applications beyond cryptocurrency. In 2024, we can anticipate the widespread adoption of blockchain in supply chain management, ensuring transparency and traceability across complex global networks. This innovation is set to streamline processes, reduce fraud, and enhance overall efficiency in various industries.

Advancements in 6G technology are set to revolutionize communication networks, enabling faster and more reliable connectivity. The Internet of Things (IoT) will benefit from these developments, leading to smarter and more interconnected cities, homes, and industries.

In summary, 2024 promises a wave of innovation that could shape the future. From healthcare to energy, blockchain to 6G, these advancements have the potential to drive meaningful improvement in living standards.

Steve Jobs once said, "innovation distinguishes between a leader and a follower". There is rarely much reward for the latter in public markets; at the time of writing, Apple remains the world's most valuable company. Innovation is indeed a crucial capability in the companies we invest in, and with the step changes in technology we are witnessing today, it's never been more important.

Hamish Galpin
Head of Smaller Companies

This last year has been a perfect storm for small & mid cap (SMID) stocks, with the market concerned about the effect of rising interest rates and costs, and levels of borrowing. The result has been that performance relative to large caps overall has been the worst since the middle of the last decade, and even longer for small caps in the U.S.

However, looking through the distortions caused by the "Magnificent Seven" at the top end of the market cap range, and the nearly 50% of U.S. small caps that are unprofitable at the bottom end, there are still a great number of small and mid-range companies that are dynamic and forever responding, and adapting to, current markets.

These stocks can provide relatively safe exposure to innovation; SMID cap stocks are, in reality, large corporations in the overall scheme of things (i.e. versus unquoted companies and SMEs) and their new ideas emerge from already well-established businesses; far better, in my view, to have the reassurance of being in a relatively high quality business with some attractive optionality, than to bet the ranch on a set of binary outcomes from early stage ventures. The sort of business in which we invest will typically have high market shares in their particular niche, so that their innovation has not only a sound base, but can also still compete against larger entities.

Industrials is the largest sector in the of the Global SMID benchmark and comprises just under a quarter of it, which compares with a low double digit percentage for the whole market. In addition, Materials, Health Care and Information Technology between them average about 10% each of the benchmark. So, in aggregate, sectors where there is considerable innovation comprise over half of the investible universe.

The attraction of small caps is to latch onto their faster growth. Yes, this comes with higher risk, but the extra return can offset the extra risk in the long term and there is great potential for exposure to tomorrow's products and services.

Brooks Harrington
Partner – Head of North America, Private Equity

The United States, and the rest of the world, has been awash in capital over the past decade through monetary and fiscal stimulus. The recession of 2008/2009 followed by the unprecedented global pandemic pushed governments and central banks to respond in ways not seen in modern times. Government stimulus programs ensured that consumers and businesses were able to draw on additional sources of funding to meet payroll and provide tailwinds to consumer spending. After a 40-year absence from the developed economies, inflation returned with a vengeance and has forced governments and central banks to curtail spending and start to remove capital from the global economy.

Asset classes that came to maturity during this time period were able to draw on rising valuations, readily available credit for debt packages and the funding of cash intensive business models, as well as a consumer that was both willing and able to spend. The next 10 years will be driven by different tailwinds. In 2024 and beyond, investment returns will more heavily rely on organic revenue growth and cash flow generation. Successful investments will be driven by business models that are not only exciting and providing real economic value today, but will also be exciting and valuable in five or 10 years' time. Technology and innovation will continue to be a major growth engine coupled with healthcare, renewables, and business services. Cutting edge industries such as blockchain and AI will provide further potential opportunity for investors that are able and willing to participate, but are also able to separate the hype from reality from an investment perspective.

The decrease of available capital within the private equity space will reward investors who have dry powder, have the experience and track record of investing through cycles and have a global reach. This could provide an abundance of potential investment opportunities than can be then applied to rigorous underwriting standards. Global investment engines with the flexibility to navigate an increasingly turbulent geopolitical environment will also be rewarded.

As with any economic environment, there will always be prudent investment opportunities and new tailwinds taking shape that flexible global investment frameworks can take advantage of.

Natural capital

Mitch Reznick
Head of Sustainable Fixed Income

On August 2nd, 2023, the planet hit Earth Overshoot Day. This is the day each year that the planet consumes its annual budget of natural capital required to generate economic value to humanity in that year. Beyond Earth Overshoot Day, the planet eats into the following year's budget of natural capital. As such, from Earth Overshoot Day we are running natural capital budgets. When scientists first calculated Earth Overshoot Day in the 1970s, it occurred in late December; 10 years ago it occurred in late August. The trend is moving in the wrong direction.

Moreover, scientists at the Stockholm Resilience Centre (SRC) have estimated Earth is now operating outside of six of its nine Planetary Boundaries. The SRC believes that planet must remain inside of these nine boundaries to remain stable and provide for the growing population. If there ever were a red flag on the weakening ability of the planet to provide for humanity in perpetuity, this is it.

Why does this all matter? According to the World Economic Forum, over half of global GDP "is moderately or highly dependent on nature and its services". With natural capital under threat, so then is the generation of global economic value. This is, therefore, a systemic risk.

Fortunately, a myriad of international organisations, countries, regulators, companies, and investors recognise this and are responding. This global pushback on the planetary effects of the Anthropocene Age generates forces that lean into sustainability—changes in regulations; shifting value changes and evolving consume preferences. These forces are triggering systematic changes in the economy and, consequently, finance.

The companies that have the visibility and the governance to see these structural changes, and adapt to them—managing risks and/or capturing opportunities—are the resilient companies of the future. They are the winners through this irrevocable change in the economy. As we look ahead to 2024, valuation permitting, these are the companies that we seek to direct debt investments, because we believe they will be sources of alpha for our clients and positive impact for the environment and, therefore, society.

Gemma Corrigan
Head of Policy and Advocacy

We expect that natural capital themes will continue to rise on the agenda in 2024. To date, we have largely taken nature and its permanence for granted — but as we reach critical and irreversible tipping points, there will be limits to growth and the potential for huge financial losses if we continue on our current trajectory. The good news is that we still have an opportunity to fix this problem.

COP16[2] will be key to delivering the commitments needed for this change. Countries will be expected to deliver national biodiversity strategies and we will be pushing governments to deliver on both their 30% by 2030 goals and the more detailed targets outlined by the Global Biodiversity Framework. This means protecting the most important biodiversity hotspots, reorienting subsidies to reward nature friendly activities and tackling the main drivers of biodiversity loss.

Political will needs to be translated into clear, effective and fair policies, with governance systems that protect tropical forests and oceans and other critical ecosystems. Existing companies should consider how they are impacting and dependent on nature, and how they can restore the subsequent damage. We need to move our collective focus from risk mitigation to nature positive by developing new regenerative and circular business models and revenue streams. There are already lots of innovative companies developing solutions, and we need equally innovative financing solutions. Blended finance will be key to delivering the outcomes we want to see in the most precious ecosystems, particularly in the global south where financing must be scaled significantly.

With mandatory climate disclosures increasingly widespread and voluntary adoption of the Taskforce on Nature-related Financial Disclosures recommendations gathering speed, regulators and standard setters – including the International Sustainability Standards Board – will soon turn their attention to nature-related disclosures.

Disclosure is not the end in itself. As data availability improves, regulations are emerging that are pushing corporates and financial institutions towards concrete action. In the EU, for example, 2024 will see the agreement of the Corporate Sustainability Due Diligence Directive to require corporates and potentially also financial institutions to take action to identify and mitigate social and environmental adverse impacts in their value chains.

[2] 2024 United Nations Biodiversity Conference (COP16) of the Parties to the UN Convention on Biological Diversity (CBD) is planned to be held in 2024.

AI

Geir Lode
Head of Global Equities

Artificial Intelligence (AI) will transform how businesses operate, and in many industries integrating the technology will be essential for survival. Companies recognise that embracing AI, for example by optimizing their supply chains, opens new paths for boosting productivity. As with the internet and the cloud, AI will quickly become business as usual.

We recognise, however, that there is currently considerably more talk than action, and often more optimistic talk where current profitability is challenged. True monetization from AI has barely begun. We anticipate the greatest short-term gains being on the enterprise, rather than consumer side, and we look for credible plans to boost efficiency rather than companies embracing the AI buzzword without identifying how the technology can be implemented.

Predicting which companies will leverage AI most effectively in the next 10 years is challenging due to both the rapid progress in AI innovation and the evolving landscape of AI regulation. The uncertainty is further amplified by the remarkable pace at which computational resources continue to expand, fuelling AI's capabilities and applications. In 2023, the sheer depth and scale of AI's potential has driven a rally in AI hardware stocks, for example specialist semiconductor and infrastructure providers. The question then becomes when and where will the rally spill over into software stocks.

With monetization in such early stages, and with valuations of the companies more directly exposed to AI at lofty levels, it is inevitable that headlines will question when the "bubble" will burst. This is the typical trajectory for a transformational technology. There will be mistakes, there will be pockets of irrational exuberance, and no doubt the market will at some point step away from these names due to fear rather than fundamentals. We foresee 2024 as the year in which we see the first steps towards AI implementation, helping to turn the hype into reality.

Bruce Duguid
Head of Stewardship, EOS at Federated Hermes

AI is fast becoming one of the most important themes in investment. While AI has the potential to drive a fourth industrial revolution and is creating unprecedented new opportunities for businesses, it introduces new ethical dilemmas and risks.

The need for ethical AI was highlighted earlier in the year when over 1000 researchers and executives called for a halt to what they described as a 'dangerous' arms race in AI development. More recently, an inaugural global AI Safety Summit, hosted by the UK at Bletchley Park, sought to address the risks posed by frontier AI.

The potential risks of AI are well documented and include misinformation, unintended bias, a lack of transparency or explainability, and disruption of the workforce. The urgency to address these concerns has led to a global, yet fragmented, race towards new regulation – from the EU's AI Act to China's Generative AI Regulation.

EOS has been in dialogue with companies about AI since 2018 and currently engages on over 60 AI-related objectives and issues. Our Digital Rights Principles set out our expectations for companies to disclose how AI algorithms work, the variables considered, and to allow users to decide whether these should shape their experiences. They also call on companies to eliminate unintended racial, gender, and other biases. Much of our engagement is aimed at ensuring that companies establish ethical AI governance principles, which we view as foundational to effective risk mitigation.

In 2024, as AI deployment accelerates, we expect the importance of strong AI governance to become more apparent. In 2023, companies began to face industrial and legal action over issues ranging from workforce disruption to unintended bias and misinformation. In 2024 this trend is likely to continue, given the increasing number of use cases for AI. We expect that, while governments will seek to establish common ground on regulation, regional differences will persist, given conflicting priorities regarding innovation and end-user protection. This will make it essential for companies that operate internationally to adhere to high standards of AI ethics and self-regulate in a manner that can mitigate risk across multiple jurisdictions.

Renewables

Ingrid Kukuljan
Head of Impact and Sustainable Investing

The sentiment towards renewables has been overly negative over the past 12 months. This has been driven by perception that renewable projects no longer offer attractive returns due to the higher cost of capital, the view that rates will remain higher for longer combined with elevated construction costs as a result of the inflationary pressures. The negative sentiment was exacerbated recently by Orsted, Danish wind company, which cancelled two offshore wind projects in the U.S. and took a $4 billion write-down due to escalating costs and higher interest rates. This was followed by BP cancelling two of their U.S. offshore projects at a cost of $540 million, citing similar reasons and calling out governments for not keeping pace with the fast growth of the sector.

However, short-term headwinds should not take the focus away from the issues we need to address to ensure sustainable living conditions for our planet. It is becoming a reality that we are unlikely to reach the Paris Climate targets. However, if we are to get at least close to 1.5 degrees, we need to considerably amp up spending on clean and renewable energy.

The energy transition is still in the early stages and the demand for renewables remains elevated as they account for less than 30% of the total global energy generation. The path to renewable energy is not a nice to have, but a must, which means the sector is poised to grow over the long-term, despite the short-term headwinds. This will be supported by regulatory tailwinds such as EU Green Deal and Inflation Reduction Act in the U.S.. As such we consider, renewables as one of the most attractive investment opportunities for the long-term.

In 2024, the outlook for renewables is promising as the world continues to prioritize sustainable solutions in response to environmental challenges. Solar energy, in particular, is witnessing significant advancements as innovations in photovoltaic technology are driving increased efficiency and affordability of solar panels. Wind energy is undergoing a transformation with the development of more efficient turbines. We are hoping to see more government policies and incentives post COP 28 and expect, in 2024, global commitment to clean energy to strengthen as countries are expected to implement ambitious renewable energy targets and carbon reduction goals.

Perry Noble
Head of Infrastructure

2023 proved to be a challenging year for developers of new renewable energy projects globally. Rising supply chain and debt costs, essential for funding construction, have weighed on the industry. The macroenvironment in the UK has been exacerbated by the Government's windfall tax on 'exceptional' generation revenues, whilst extended delays for grid connections and planning consents continue to hamper progress.

The last year has seen several leading players postpone construction of previously approved projects, citing cost increases of 40% to 50%, and the Government's imposition of a windfall tax on renewable energy. However, 2024 should see activity resume.

Following zero bids in the UK's 2023 wind auction – reflecting the low maximum strike price on offer – the UK Government has increased the strike price for offshore wind at the 2024 wind auction by over 60%. Softening inflation will help supply chains to adjust and the cost of debt should stabilize and may even begin to reverse. From a longer-term perspective, focus will be on the National Grid's Ofgem approved reforms to the connection management system that will dispense with the first come first served queuing system and prioritise shovel ready projects, and the Government's commitment to radically reduce the time required to obtain planning permission for new developments. These changes are essential if the UK is to meet its target to increase offshore wind capacity four-fold to 50 gigawatts by 2030.

The events of 2023 are a timely reminder that renewables are not a one-way investment bet. The capital-intensive nature of building renewable energy infrastructure means that rising input prices during construction can expose over optimistic construction cost, debt and power price assumptions. Once operational, there are few levers to pull to address financial challenges or to respond to regulatory developments that increase operating costs. If power prices are lower than expected when debt costs were hedged or power purchase agreements entered into, then the underlying economics can begin to unravel compromising the investment. In 2024 and beyond, it will remain prudent to create headroom in the investment case to provide a buffer against the known unknowns and unknown unknowns.

PR001246 0016246 11/23

Federated Hermes

Limited

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns and, where possible, to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

For more information, visit **www.hermes-investment.com** or connect with us on social media: