ROBECO
The Investment Engineers

2024 OUTLOOK

Goldilocks: Exit stage right

Contents

November 2023

Investment outlook

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1. Introduction: Fooled by variable lags

The economist community deeply believes that economic reality is deterministic, and still, risk analyst Nassim Taleb points out that randomness may fool us all in the end.

Back in 2022, the majority of economists (us included) were predicting a Eurozone and US recession within the next 12 months. The unconditional probability for a US recession seemed sky-high. Not only were there reliable recession indicators – an inverted US yield curve – but also a timely April 2022 study reminded us that historically, a US recession arises in 100% of the cases within one year whenever inflation is above 5% and unemployment below 5% on a quarterly basis.

History also showed that an aggressive monetary policy tightening stance, like the Fed adopted in early 2022, often saw a steep trade-off between lower inflation on the one hand and rising unemployment on the other. A hard landing for the US economy was near unavoidable.

Yet, defying economic logic, the US economy has been enjoying surprising resilience in 2023 showing a rare amalgamate of historical lows in US unemployment persisting amid disinflation and the steepest monetary policy tightening cycle of the past four decades. This so-called "immaculate disinflation" as referenced by Bernanke and Blanchard has not been confined to the US.[1] The Eurozone is also experiencing spotless disinflation as unemployment reached an all-time low of 6.4% for the common currency block. Consumer spendthrift proved far more resilient than expected.

A soft landing narrative has become the overwhelming consensus view. According to this narrative, Powell and Lagarde have the rare opportunity of defeating inflation without tanking the economy in terms of rising unemployment. The Fed's own projections show a median unemployment of 4.1% for 2024 and a core PCE inflation of 2.6%. We think this is nothing short of a fairy tale outcome.

[1] Blanchard, O. and Bernanke, B., What Caused the Us Pandemic-Era Inflation? (June 2023). NBER Working Paper No. w31417, Available at SSRN: https://ssrn.com/abstract=4497998

2. Three scenarios

Base case

In our view, 2024 will be the swan song for immaculate disinflation. Next year will likely see stagnant G7 economies as high real rates start to dent real activity, exhausting consumer spending power and crowding out corporate investment activity. Yet, lacking broad weakness in corporate/housing balance sheets prevents a classic recession. China faces a totally different macro regime fending off Japanification as it continues its piecemeal stimulus approach. China manages to avoid entrenched outright deflation but a continuing downward trend in home sales and house prices inhibits a sustainable domestic consumption rebound.

While below-trend real activity growth in advanced economies will initially spur further headline disinflation, core inflation ultimately fails to move consistently well below 3%. The steep Phillips curve that has been the key driver of the immaculate disinflation narrative in 2023 is about to flatten again now that inflation is at lower levels; reducing inflation from 3% to 2% will therefore come at a higher unemployment cost and will prove to be much more difficult. Also, producer prices, which led headline inflation lower in 2023, will return in 2024 on the back of a modest recovery in the global manufacturing cycle, increasing external demand from China and higher energy prices. In addition, the tailwind from a decades-long disinflationary boost from globalization is reversing into an inflationary headwind for producers as global trade intensity decelerates. The increased efforts made by corporates to internalize their carbon footprint also cap disinflation.

Central bankers in global cycle-leading, small open economies, like Klaas Knot from the Netherlands, have been welcoming the transition from immaculate disinflation into a rare 'stagflation coinciding with full employment' that has been taking shape as the Netherlands entered a formal recession in Q2 2023. This might be a precursor for the rest of Europe in early 2024. While immaculate disinflation might initially be followed by a benign type of stagflation in G7 economies, this will likely prove to be a highly unstable macroeconomic equilibrium. Ultimately, the bite of longer, higher real rates will trigger a more sinister transition toward 2025 as initial cracks in the labor market propagate into full fracture, with unemployment rising by 1-2% instead of 0.3% as both the Fed and ECB envisage for 2024.

> *“ In our view, 2024 will be the swan song for immaculate disinflation*

Alternative scenarios

In our bull case we envisage a 'soft landing with jobs aplenty' for the G7 economies. Immaculate disinflation continues and remains increasingly spurred by evidence that unit labor costs are kept in check by advances in productivity as AI adoption has broadened. Core inflation drops within the 2-2.5% range, allowing central banks to cut rates. Biden's intense diplomacy with China paves the way for appeasement. Earnings recover from Q1 2024 onward as sales growth rebounds and pricing power returns. Spreads and equity multiples compress, the bond-equity correlation turns negative again.

In our bear case, 'stagflation bites', the world is confronted by yet another negative supply shock emanating from geopolitical turbulence, most likely from an escalation of the Israeli-Palestine conflict. Though the spike in oil prices proves to be short-lived, it pushes the global economy in a genuine recession with inflation remaining well above central bank targets. This would restrict central banks to cut rates by the usual 400 bps during a recession. Earnings decline by 20%, high yield spreads blow out while equity markets enter a new bear market.

3. Four factors to consider

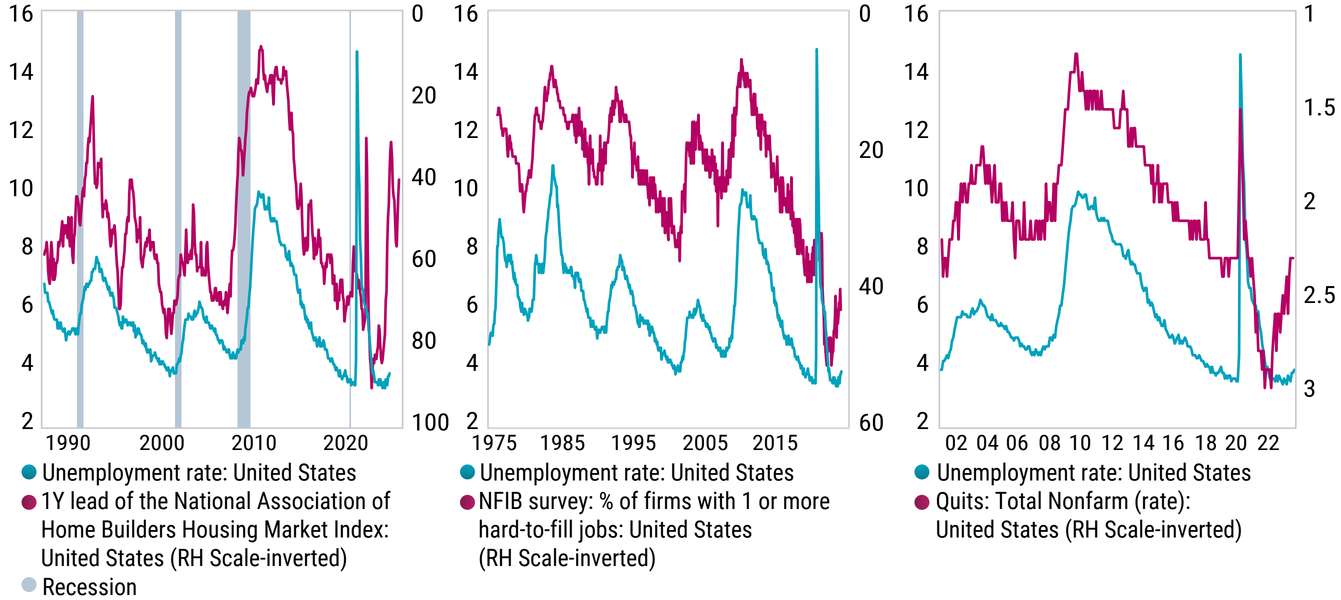
Diving deeper into our base case, we think the consensus soft landing narrative will be challenged as four factors that have contributed to a surprising resilient global economy in 2023 are set to fade in the next 6-12 months.

1. Further disinflation coinciding with higher job losses

Central banks have so far engineered the easy part of the disinflation process, now they are up for the difficult part. When initial inflation is high as it has been in the past year, the cost of disinflation in terms of job losses is fairly low, since the Phillips curve is quite steep in high inflation settings. Higher interest rates initially remove excess vacancies present in an overheated economy without directly cutting into actual jobs. In addition, the latest literature shows that deglobalization and digitalization also create steeper Phillips curves. However, once inflation subsides to lower levels, the Phillips curve flattens, implying disinflation starts to trigger proportionally more job losses compared to the high inflation episode.

For the US, our calculations show that bringing inflation down by 25 bps typically requires a 1% rise in unemployment on an annual basis, whereas over the past 12 months reducing inflation by a similar 25 bps only required a <0.1% rise in unemployment, as the Phillips curve was very steep. Therefore, the last mile for developed market (DM) central banks, bringing inflation down from the current 4% to 2% will likely see increasing job losses as the Phillips curve normalizes. In the Eurozone, we already see steeper declines in the number of vacancies in Germany and Spain while three US leading labor market indicators suggest US unemployment could very well end up between 5-6% in 2024 in our base case. Declining quits, declining housing market sentiment and a reported easing to fill outstanding vacancies by employers all signal the tide in the US labor market is about to turn.

Figure 1: Three leading indicators with the same message: The US labor market is set to cool

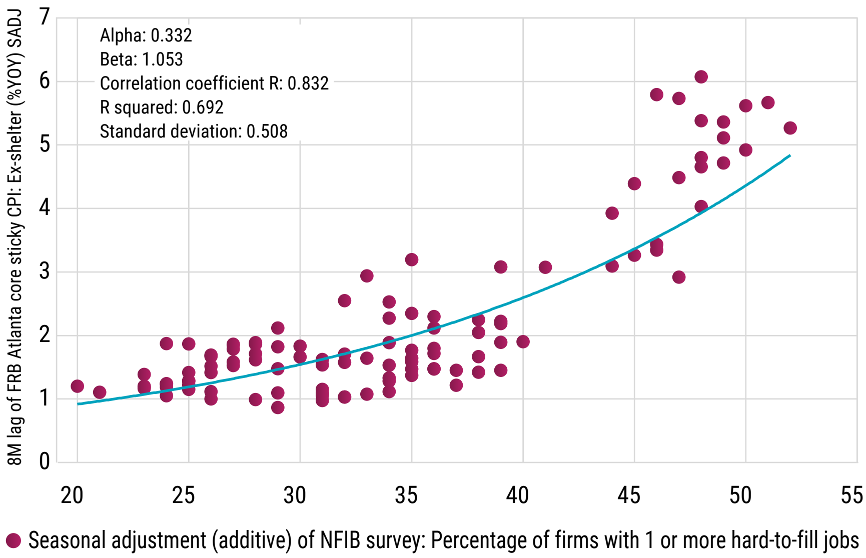


Source: LSEG Datastream, Robeco

Will the labor market cool enough? Central banks may be reluctant to cut amid a sticky core inflation backdrop.

We therefore expect to see stagnant DM economies in 2024 as the thrust of a hot labor market peters out. However, even an uptick in unemployment consistent with what leading indicators at this juncture suggest could still see core inflation remain stuck around 3% in 2024. This stagflationary twist will keep the Fed unhappy and reluctant to cut. For instance, the NFIB leading indicator '1 or more jobs hard to fill' needs a further decline below the 40% level to see core inflation ex-shelter drop toward 2%.

Figure 2: A lot of labor market slack is required to see US core inflation (ex-shelter) back at 2%



Source: LSEG Datastream, Robeco

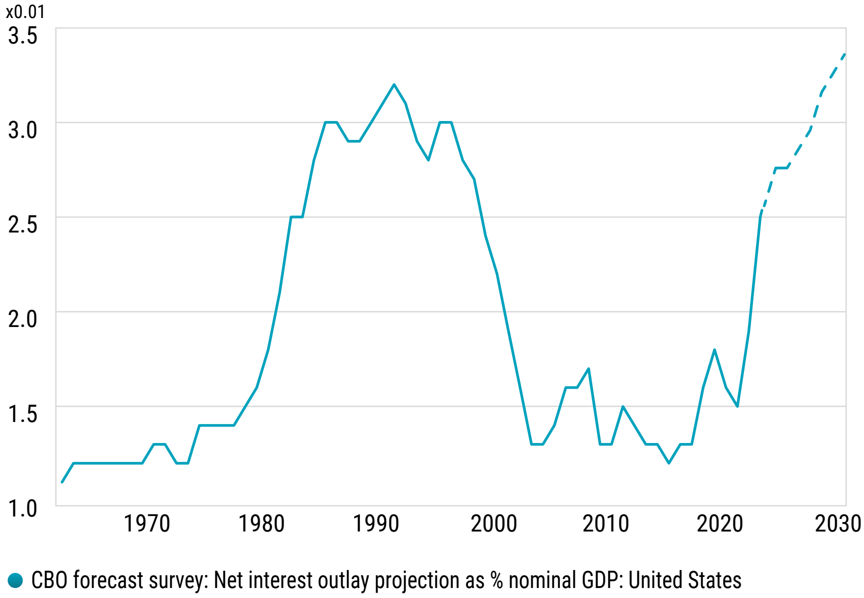
2. Fading rate immunization

Sovereigns, corporates and households have managed to establish very low interest rates in the QE era and the post-pandemic aftermath while also extending the duration of their debt, thereby immunizing their sensitivity to a rising interest rate environment. The post-GFC deleveraging phase also saw a shift toward fixed rate funding. Capital markets have functioned remarkably well in recent years, facilitating corporates and households and provided abundant cheap funding, keeping even zombie companies afloat. The year 2021 saw record-low delinquencies in both the household and the corporate sector but has troughed after central banks embarked on their 2022 tightening cycle. Effective immunization against a higher interest rate regime is set to fade further.

Sovereigns: New net issuance does not come cheap

For sovereigns, net issuance will likely increase sharply in 2024, and net cash requirement could amount to 15% of the market size.. With sovereign yields now at a 15-year high, this issuance could become expensive for several reasons. First, gross issuance will increase, partially as a result of the post-pandemic move toward pro-cyclical fiscal expansion. Continued fiscal expansion with real GDP growth already above trend prevents the necessary economy cooling to bring US inflation under control. Worries about fiscal slippage have partially contributed to the recent bear steepening in the US yield curve. Any further downgrades in the US credit rating – due to fiscal slippage or stickier-than-expected core inflation (2.6% for core PCE inflation by 2025) – could keep bond traders on edge. Second, central banks planning to shrink their balance sheets further into 2024 will also increase net sovereign bond supply. For instance, the ECB will likely reconsider whether to continue its PEPP reinvestments in early 2024. Third, higher interest expenditures on outstanding debt also requires more issuance. For the US, CBO estimates suggest net interest outlays for the US Treasury will amount to 2.7% of nominal GDP in 2024, the highest since 1998. As long as US fiscal efforts increasingly are allocated toward categories with a low or even negative fiscal multiplier (defense spending notoriously falls into the latter category) a pro-cyclical fiscal policy stance ultimately becomes self-defeating.

Figure 3: The legacy of fiscal profligacy



Source: LSEG Datastream, Robeco

Corporates: Decompression trade has begun reflecting refinancing risk

For corporates, IG and HY debt issuers are facing a maturity wall in 2025/2026 and are already forced to go to the market next year as refinancing dates approach. Presently, the BIS sees a more pronounced maturity wall for IG in 2024 and warns that “even solid balance sheets are poised to feel the effects of higher rates”. There are several indicators that suggest something is on the boil and central bank tightening has started to bite. While US corporate bankruptcy filings have risen by 29% since Q3 2022, the rising cost of UK capital is now most often cited as the key reason that limits corporates’ capital expenditures. In Germany, insolvencies have risen by 37% since last year. The HY market has started to pay attention. Spreads increased in September, but are still short of levels consistent with mild recession. Further corporate spread decompression into 2024 should reflect deteriorating balance sheet quality on the back of worsening interest coverage ratios.

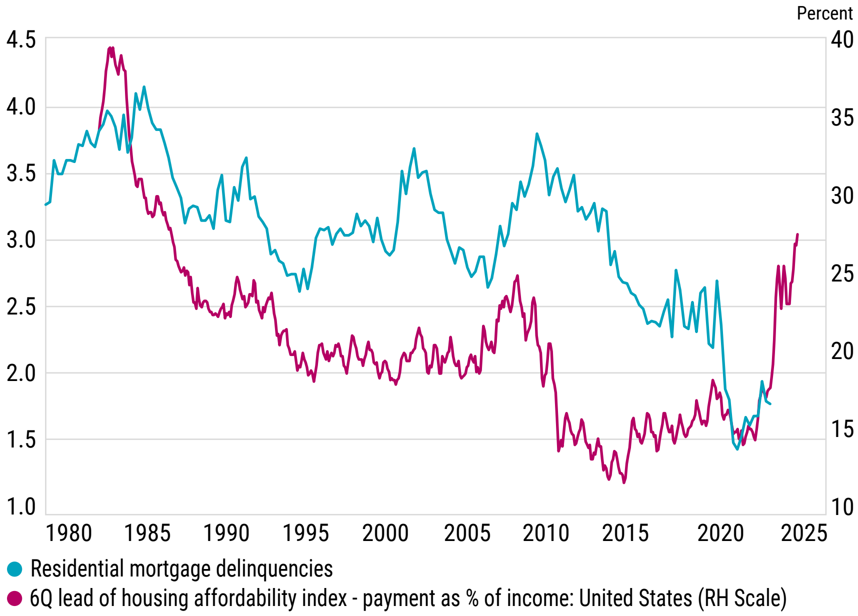
Households: Running out of credit leeway

A similar phenomenon is observable in the household sector. While mortgage delinquencies have risen from their all-time low in 2021, they are still subdued at 1.75%. However, looking at mortgage payments as a percentage of US household income, delinquencies are likely to rise even as the peak in mortgage delinquencies might very well materialize in 2025 instead of 2024. A further deterioration in US housing affordability (currently at its worst since 1985 with 26% of income going to mortgage payments) could cool housing demand and dent the wealth effect from housing.

Further US consumer exhaustion is expected, as excess savings have now been depleted, but are counterbalanced by a surge in revolving consumer credit. This offset is however increasingly challenged by prohibitive consumer credit interest rates. Home equity seems to have peaked, removing a tailwind for consumption expenditures. As a result, US retail sales volumes have been flatlining recently and we expect US consumption growth to decelerate to a below-trend pace in 2024 at a 1% annual growth rate.

In the euro area, the consumer cycle has been leading the US as retail sales volumes have been contracting. This also limits additional downside risk regarding consumer outlook relative to the US into 2024. Some stabilization is to be expected following rising real wage growth; however, elevated energy costs, rising mortgage refinancing bills and a slight deterioration in job security will probably cap willingness to spend real income growth. This could keep the recent uptrend in the Eurozone savings ratio intact, and Eurozone unemployment could increase by 0.5-1% toward 2025.

Figure 4: US household delinquencies set to rise



Source: LSEG Datastream, Robeco

3. Challenging 2024 (geo)politics

The year 2024 will see important elections within the G7: the US presidential elections are due to be held on 5 November and the European Parliament elections are due from 6 to 9 June. Both elections could be one of the most contentious elections in democratic history given the aftermath of the January 6th 2021 US Capitol attack, the rise of far-right European parties, a backdrop of wars in Ukraine and the Middle East, and a fractious relationship between the West and China. Financial markets find it difficult to predict the outcome of geopolitical events. However, rather than trying to predict outcomes, markets should instead focus on whether they accurately price the risks around potential outcomes. So far, we have seen an underreaction to the potential economic risks emanating from an increasingly fragmenting global world order. We expect the steady rise in global economic policy uncertainty to continue in the near term, which should also warrant higher risk premiums in financial assets.

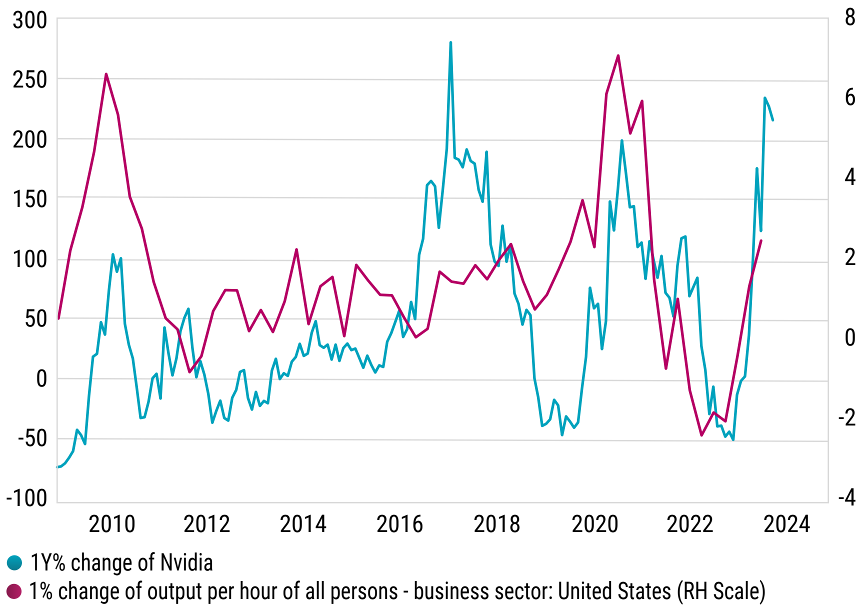
> *“ If data is the new gold, then generative AI is key to improving its mining*

4. Will AI live up to its hype?

If data is the new gold, then generative AI is key to improving its mining. Shares of Nvidia*, a prominent chips maker that de facto delivers the picks and shovels for AI engines, have almost tripled since the start of the year. This evidences that a genuine modern gold rush is underway, potentially prolonging benign disinflation by providing a welcome supply side boost to the global economy, denting unit labor costs. According to the IBM Global AI Adoption Index, only one out of five corporates worldwide wasn’t planning AI adoption in 2022. However, the positive supply side potential from AI adoption has yet to show up in 2023’s productivity numbers. US productivity growth remains subdued at 1.4% (year-over-year) as of Q2, below its post-Industrial Revolution 1.9% average. To paraphrase Robert Solow, we can see AI everywhere except in the productivity statistics.

* This is not a buy, sell or hold recommendation for any particular security. The information shown is for illustrative purposes only. No representation is made that these examples are past or current recommendations, that they should be bought or sold, nor whether they were successful or not.

Figure 5: Is Nvidia's recent stellar performance a bellwether for accelerating US productivity?



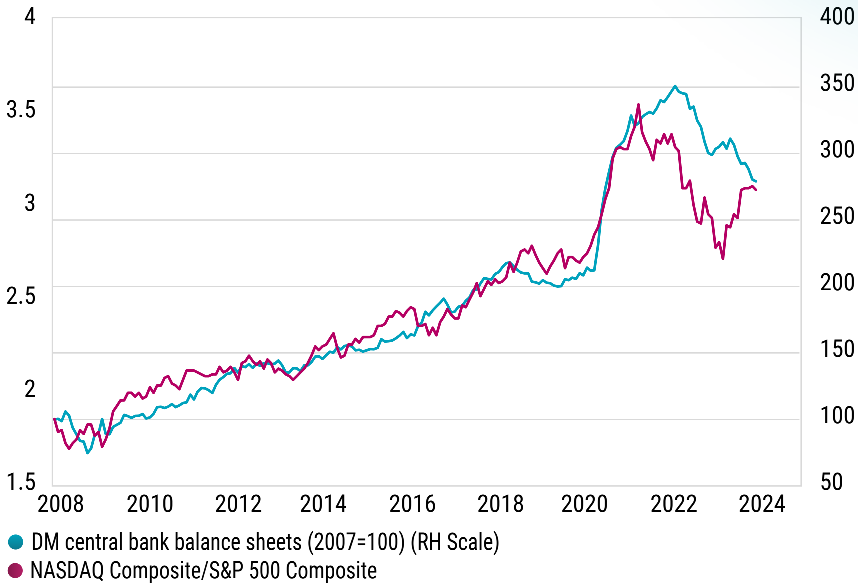
Source: LSEG Datastream, Robeco

A higher cost of capital will increasingly inhibit the required capital expenditures for especially smaller companies to advance toward the technological frontier in 2024. Weakness in the cloud segments from Nvidia's customers over Q3 could indicate the AI hype is dying down. Broader US capex intentions have plunged, hinting that the fixed investment contribution to GDP will likely dwindle in 2024. As such, broad AI adoption won't likely safeguard further benign disinflation. Still, productivity historically clearly lags the initial capex cycle. Some positive technology spillovers from past AI-related investments might transpire into 2024 G7 productivity growth numbers.

4. Financial markets outlook

Financial conditions have remained easy throughout 2023, despite significant monetary policy tightening. As measured by M2/GDP, liquidity has declined, but has still remained above pre-Covid levels. In addition, immaculate disinflation has also provided sustained thrust for risky asset performance as earnings growth surprisingly went up relative to consensus expectations.

Figure 6: Tech stocks have been able to ignore declining excess liquidity so far



Source: LSEG Datastream, Robeco

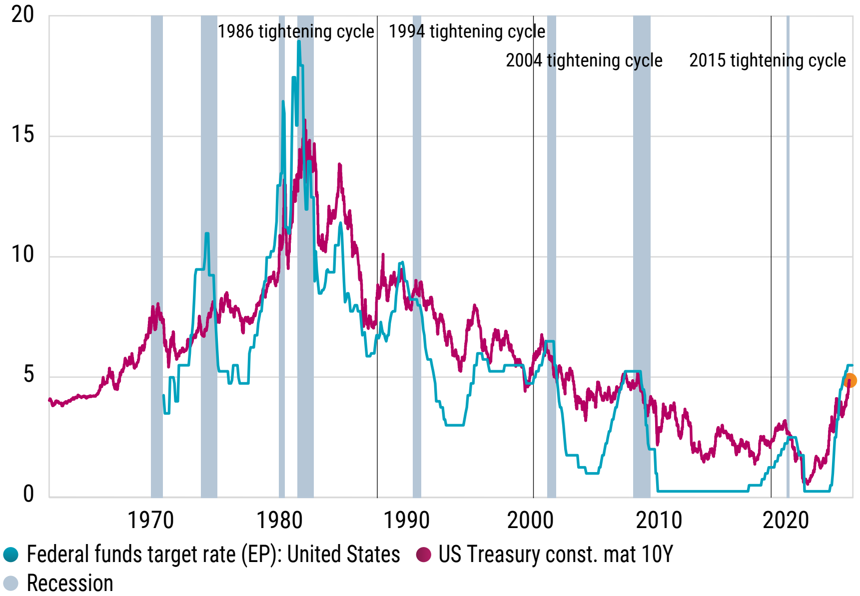
Bond and rates outlook: The steepened trade is not exhausted

Central banks have been unusually hawkish. For instance, the Fed normally cuts interest rates whenever the ISM declines below 50, even when inflation is still above target (the exception being the Volcker era in the early 1980s). However, with immaculate disinflation about to end in our view, we are approaching a phase in the monetary policy cycle where the trade-off between targeting inflation and maintaining full employment becomes steeper. Central banks will settle in on the rates plateau, emphasizing that rates will stay high for a prolonged period to see how things balance out. Regardless, while the hawkish pause might take even longer than currently discounted in the Fed funds futures curve, the change of gear could be abrupt, with the Fed policy rate likely ending up below the 4.75% market projection by the end of 2024.

It has been another tough year for global bond investors as the widely anticipated peak in sovereign bond market yields didn't materialize in early 2023. The emerging 'higher for longer' narrative on policy rates as well as worries about US fiscal slippage saw US 10Y yields surging to 5% instead. The peak in yields might still be ahead of us now that data dependent central bankers are settling in on the policy rate plateau, leaving it up to the bond market to figure out whether further action is needed in absence of strong forward guidance. Even the Japanese bond market won't escape this dynamic. History shows that the peak level in the US 10Y came very close to the prevailing peak in the policy rate in the last cycles, which could therefore see the US 10Y peak a bit above 5%

this time around. As long as US CPI is not convincingly below 3%, US long bonds are not a good hedge for equity risk.

Figure 7: 10Y Treasuries likely to peak, but below peak Fed funds rate



Source: LSEG Datastream, Robeco

With the Fed on hold for now, any further positive macroeconomic surprises for the US economy could create additional bear steepening, perhaps fueled by worries about net supply in 2024 with fiscal slippage requiring a higher term premium as well. Our analysis shows that curves typically steepen before the onset of recession, with the last four cycles seeing an average positive 60 bps spread between 10Y versus 2Y US Treasury yields at the start of the NBER recession.

	10-2s at onset of recession (in %)	10-2s level at which first fed cut appeared (in %)
Jul/90	0.4	0.4
Mar/01	0.7	0.5
Dec/07	1.0	0.6
Feb/20	0.2	0.0
Average	**0.6**	**0.4**

If history repeats itself, there could be additional curve steepening ahead of us into 2024, though it is unlikely that this fully classifies as bear steepening (i.e. predominantly driven by the long end of the curve), especially if we are approaching a US slowdown. As cracks in the US labor market become more obvious into H2 2024, increased odds of the Fed cutting would see bear steepening morph into bull steepening, with the 2Y end of the curve rallying in particular. Usually, 10Y US Treasury yields decline by 60 bps after a peak in the Fed policy rate within the following 12 months. While the UK and US long end of the curve looks attractively valued to enter a long duration position, our valuation models point out the 10Y Bund is still not cheap.

For risky fixed income, investment grade and high yield, we observe that the spread decompression trade has started, however its vantage point are stretched valuation levels. Our HY fair value model suggests the current market should trade around the 560 bps level instead of sub-500 bps. Even a mild recession typically sees HY spreads in the 700-800 bps range. A 200-300 bps spread widening in 2024 for global HY would not be inconsistent with the market recognizing that refinancing risk is on the rise while interest coverage deteriorates on the back of disappointing earnings (see equity section). Corporates with above average cash levels will be relatively shielded nonetheless. A good entry point for high yield could emerge in 2024 as this asset class is already relatively attractively valued versus equities. Meanwhile, high yield typically outperforms equities on a 12-month horizon once spreads are above 700.

Equity markets outlook: Earnings face headwinds

We think the equity market consensus is correct in expecting multiple compression for 2024 in light of a further expected decline in excess liquidity, turbulent geopolitics requiring higher risk premia, and the drag of high real interest rates for longer. Yet in our view the market is overestimating earnings growth. During economic slowdown, typically both multiples and earnings contract. The current consensus 2024 MSCI ACWI EPS growth forecast at 11.4% is hard to square with our view that G7 economies will largely be stagnant in 2024. After reaching a peak in G7 policy rates, the MSCI ACWI earnings per share typically declines by 2% in the subsequent six months and by almost 10% in the next year.

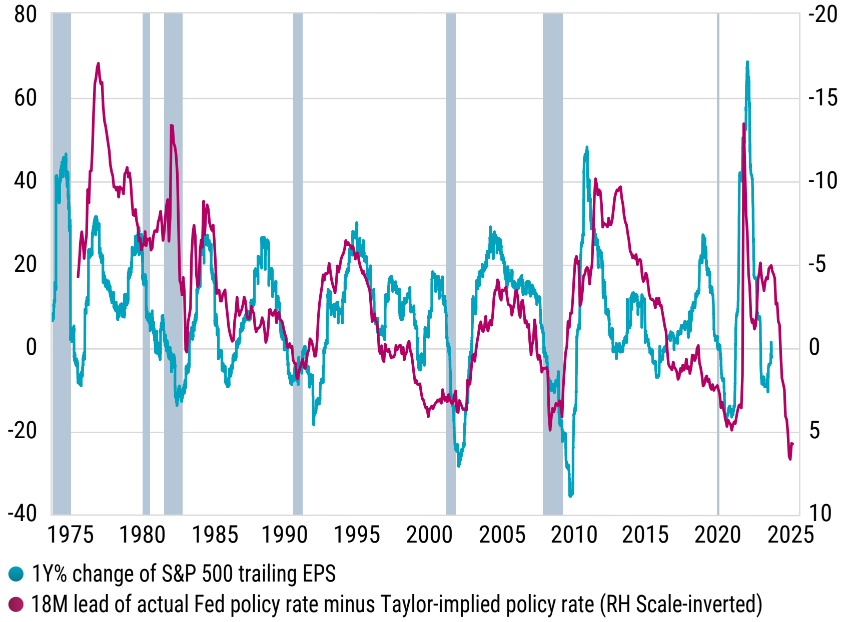
MSCI AC World EPS following peak G7 policy rates

	T+6M	T+12M
Feb/95	-5.3%	-16.2%
Dec/00	-3.2%	-21.3%
Aug/07	3.7%	2.2%
Dec/18	-1.7%	-4.0%
Average	**-1.6%**	**-9.8%**

Our Fed tightening metric (actual policy rate minus Taylor rule estimate) also hints at further weakness in overall earnings before a sustainable recovery can take hold.

“ A good entry point for high yield could emerge in 2024 as this asset class is already relatively attractively valued versus equities

Figure 8: Degree of Fed tightening suggests risk for 2024 EPS consensus tilted downward



Source: LSEG Datastream, Robeco

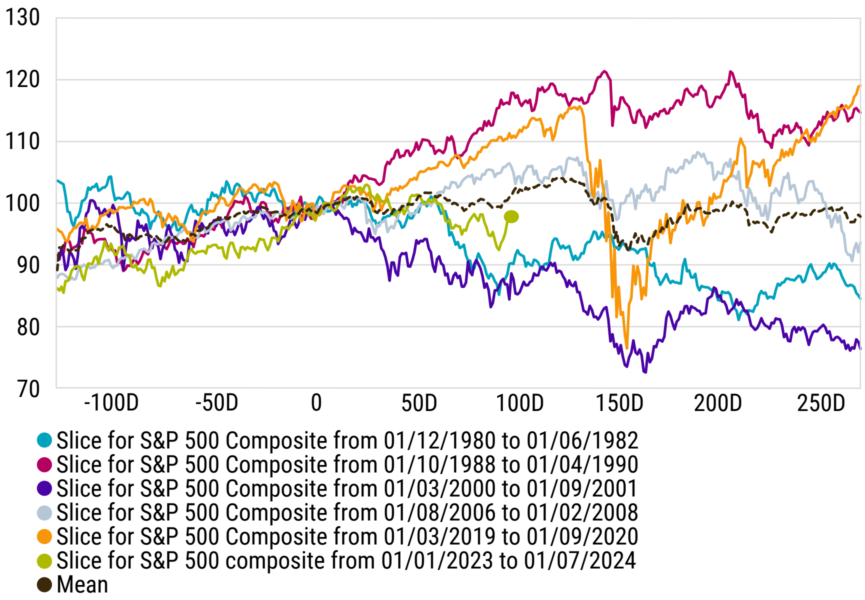
> *"The major upside risk to our base case view is the potential for strong multiple expansion in the broad equity market*

To summarize, the risks for the consensus 2024 earnings outlook are tilted to the downside in our view. However, an exception to this is Europe where EPS consensus growth estimates seem too downbeat at 3%, even if one sees only a sluggish recovery take hold after a mild Eurozone recession late 2023/early 2024. Buyback activity from cash-rich European companies provides a floor. Japan's equity market is not expensive on forward P/E. Relative performance of Japan versus MSCI AC World has lagged the weakening JPY, reflecting future yen appreciation. If USD-JPY stays above 130 into 2024, this could be a tailwind for Japanese exporters.

The EM equities discount versus DM equities is above historical average (35% discount on P/E). We see a good entry point for the emerging market (EM) as USD peaks and the flurry of recent stimulus measures in China starts to pay off and provides thrust for broader EM. However, the projected 15% consensus EPS 12M forward growth remains a very high hurdle to meet against the backdrop of 2024 G7 recession. Without strong recovery in global manufacturing it is difficult to stage a sustained broad rally in EM.

The US equity market is expensive, trading at a 30.8 multiple based on Shiller CAPE and has tended to trade lower on average one year after peak inversion of the 10-2s curve, corroborating our bearish view on both EPS and multiple contraction for the next six to 12 months. The major upside risk to our base case view is the potential for strong multiple expansion in the broad equity market. This is triggered by a steep drop in real yields, as the Fed delivers rate cuts because inflation has dropped toward target during a soft landing.

Figure 9: S&P 500 after peak 10-2s inversion: Following the Volcker era script?



Source: LSEG Datastream

FX outlook: Peak dollar, stronger yen

In our view, the US dollar is expensive, trading at an 18% premium on relative PPP (purchasing power parity). Also looking at 2Y rate differentials versus the euro, the euro-dollar pair should trade between 1.15-1.20. We expect a peak in the dollar rally as the Fed moves closer to the cutting phase of the cycle, moving ahead of the ECB. Another interesting pair trade to watch in 2024 is the dollar-yen as the discount of the yen on relative PPP has now even exceeded the 1982 record low at 34%. Triggers for a yen rally could be external as the Fed starts cutting policy rates or as the result of safe haven flows on the back of geopolitical turbulence. Internal triggers are the likely exit by the BoJ from its long-standing negative interest rate policy in 2024.

5. Summary

SIGNPOSTS 2024

	Check list	Now	Expectations in 12 months
While earnings have been resilient, equity prices have defied the gravity pull of higher rates in 2023, derating ahead as prices react to EPS downgrades.	Valuations		
Corporate earnings have surprised with signs of margin recovery. Still, full impact of rates are yet to materialize. Consensus is far too optimistic about 2024 global earnings outlook.	Earnings		
Fiscal impulse will likely fade into 2024, though it will stay net-expansionary in an important US/European Parliament election year.	Fiscal policy		
Policy rates will be higher for longer, as getting core inflation to the 2-2.5% bracket proves difficult.	Monetary policy		
Further (bear) steepening of the yield curve ahead, a recessionary signal. Repricing of recession risks and turbulent geopolitics will likely see long term bond yields peak in 2024. Short end of the curve holds better cards in 2024.	Yield curve slope ↑		
Spreads are likely to widen on repricing recession risk in 2024/2025 and tight financial conditions. Potential good entry point for HY late 2024, but investment grade attractively valued versus HY even as it might initially continue to suffer from duration headwinds.	Spreads ↑		
USD is expensive on deviation from relative Purchasing Power Parity, which should trade around 1.15-1.20 based on rate differentials versus EUR. However, it remains the only US-specific 'safe haven' as fiscal slippage hurts bonds via rebuild term premium. The yen is likely to appreciate against USD.	USD ↓		
Mild recession will likely see oil prices trend lower but significant upside risk remains due to geopolitical volatility.	Oil/energy prices ↓		
Financial conditions are set to tighten in 2024, with potential for things to break (leveraged loans, real estate).	Financial conditions		
Housing markets will likely cool on the back of deteriorating housing affordability and delinquencies.	Housing market		
US and Eurozone unemployment rates will be up by 1-2% by the end of 2024 as the sacrifice ratio from tight monetary policy rises.	Labor market		

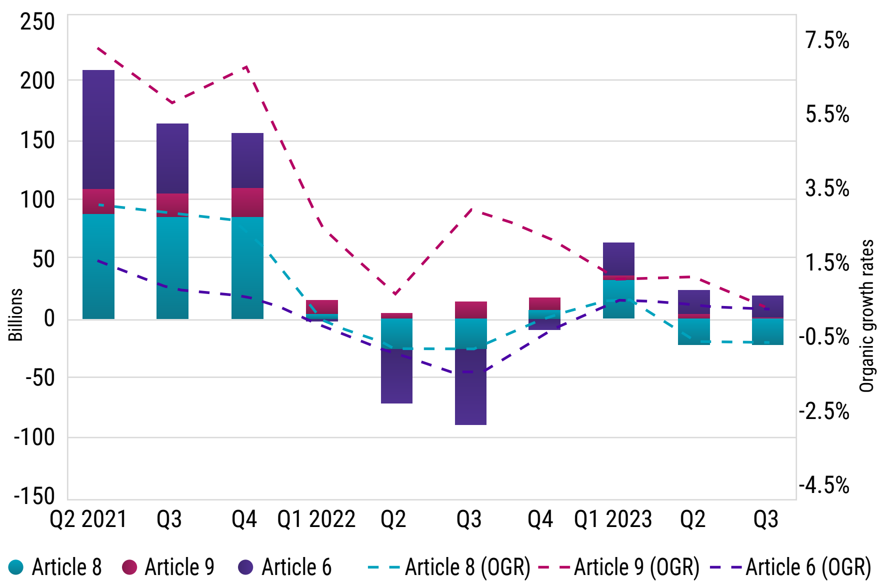
Sustainable investing outlook

Even though 2023 showed considerable headwinds for sustainable investing, long-term we still see sustainability firmly entrenched in upcoming regulations, bond issuances and shareholders meetings.

1. Introduction: Some headwinds, but long-term regulatory support for SI

Sustainable investing ran into some headwinds in 2023. First, there was a backlash against ESG in the US driven by political opinion, which significantly impacted companies and investors on a headline basis. Second, after many years of good performance, sustainable funds – which generally invest less in fossil fuels and more in renewable energy companies – were hit by lower performance. High oil and gas prices favored fossil fuel companies, while higher interest rates deterred renewable energy projects, in an already highly competitive industry. The poorer performance was reflected in fund flows, that lagged behind traditional investments for the first time in a long while (Figure 1).

Figure 1: Quarterly fund flows Article 8 and 9 (sustainable) versus Article 6 (non-sustainable)



Source: Morningstar Direct. Data as of September 2023. Based on SFDR data collected from prospectuses on 97.6% of funds available for sale in the EU, excluding money market funds, and feeder funds.

Anti-ESG movement to abate?

We understand that underneath the headlines and anti-ESG vocality, most financial institutions continue to do a lot of work on sustainability and more specifically on climate. However, 'green-hushing' is afoot in the US, where ESG strategies replace the term 'ESG' with 'climate' or 'decarbonization' etc., without any changes being made to the strategy to avoid political pressure. Monetary incentives like the Inflation Reduction Act (IRA) and state subsidies are creating noticeable economic upside alongside positive climate impact, and this is also true for many red states. Meanwhile, the US SEC is working on guidelines for companies to start reporting on climate risks.

Whether or not the anti-ESG movement will become less vocal after the elections also depends on the outcome. Under the same US administration, tax credits should remain a mechanism for change. With a different outcome, however, we don't expect ongoing projects to be discontinued or rolled back. Even before the IRA was introduced, there was an enormous amount of activity already invested in renewable energy, which continued despite a Republican administration. The same will most likely be the case now. In terms of vocality, it will be difficult to predict; however, we expect the anti-movement to remain strong at least on social issues.

> “ *New generations continue to expect financial institutions to use their influence to progress sustainable development*

What do we anticipate in terms of sustainable fund flows and performance? Given the significant tail risk of oil prices remaining elevated for longer in 2024 despite weakening growth, the inflection point in the performance of sustainable funds may not yet happen in 2024. As a result, this could mean fund flows will not (yet) return to previous levels. Meanwhile, there are still good sustainable investment opportunities around. About 500 gigawatts of renewable generation capacity will be added in 2023, according to the International Energy Agency, and at least USD 1 billion a day is being spent on new solar additions alone. Even if the wind and solar sectors are both highly competitive and seemingly less attractive at the moment, there are more alluring exposures in the supply chain of these companies, such as in electricity grid equipment software where demand should exceed expectations and entry barriers are much higher.

Long-term sustainable development is still firmly supported by several key trends:

- **Regulatory demand:** Both in the US and worldwide, legislation is still pushing for more, not less sustainable solutions. We expect regulations fulfilling the Kunming-Montreal Global Biodiversity Framework (GBF)[2] to follow soon. The detrimental consequences of climate change are becoming more tangible, with biodiversity loss following in close second.[3]
- **Client demand:** Demand for sustainable investments by end clients remains high – issuance of green investment securities, for example green bonds, is playing into that trend.
- **Societal demand:** New generations continue to expect financial institutions to use their influence to progress sustainable development, for example by engaging with companies and voting in favor of climate action in shareholder meetings.

[2] Adopted at the COP15 in December 2022, the Kunming-Montreal GBF sets out an ambitious pathway to reach the global vision of a world living in harmony with nature by 2050 including shorter-term targets for 2030.

[3] Our 2023 Global Climate Survey shows that climate change and biodiversity are both top of mind for investors.

2. The five most impactful SI regulations

Sustainability-related regulation has grown rapidly in recent years. This includes not only investor and corporate disclosure regulations, such as the European SFDR,[4] the CSRD[5] and the US SEC Climate Disclosure Regulation,[6] but also industry-specific regulation designed to change corporate behavior and drive change in the real economy.

A sweep of the sustainability-related regulatory landscape uncovers over 40 different laws at various stages of development on diverse social and environmental topics. These include carbon emissions, deforestation, workers' rights, consumer privacy, healthcare, and financial literacy which are being tackled through a variety of mechanisms including disclosures, taxes, trading schemes, and behavioral standards.

Much of the regulation hails from Europe, but the US is also prolific with sustainability regulation (often at state rather than federal level) and countries in Asia and Latin America are also visible. Moreover, the impact of regulation developed in Europe and the US often extends beyond legislative borders via multi-national companies and global supply chains.

Robeco's SI sector analysts have identified some of the most significant and noteworthy sustainability-related regulations. Typically, sustainability goals are aligned with desirable economic outcomes in the long run. However, in the short term companies often face higher capital expenditure needs and/or higher operating costs.

2021
- Chinese Data Security Law
- Revision of Japanese Corporate Governance

2022
- IRA
- US Uyghur Forced Labor Prevention Act

2023
- Japanese ETS
- Cybersecurity Healthcare Legislation in US
- Japanese Green Transformation Policy
- Increased Human Capital Disclosure Requirement for Japanese Corporates

2024
- CSRD
- US SEC Climate Disclosure Rule
- EU Circular Battery Legislation
- EU Network and Information Security Laws
- US National Drinking Water Regulation
- EU Digital Markets Act

2025
- Hong Kong Climate Disclosure
- Deforestation Law
- Chinese Plastic Producer Responsibility Scheme
- EU Building Energy Efficiency Directive Amendment IV

2026
- CBAM in EU
- CSDDD
- IRA Drug Pricing Discounts

2030
- EU Circular Textile Vision

2035
- De Facto EU Ban on New Internal Combustion Engine Cars

Unclear timeline
- EU Ecodesign for Sustainable Product Regulation
- EU Green Claims Directive
- US Green Guides Update
- EU Critical Minerals Act
- EU Waste Directive
- AI Regulation

[4] Sustainable Finance Disclosure Regulation, promoting transparency toward investors from financial market participants.

[5] Corporate Sustainability Reporting Directive, requiring large and listed companies to report on the social and environmental risks they face, and on how their activities impact people and the environment. It replaces the previous Non-financial Reporting Directive.

[6] The SEC Climate Disclosure Rule, proposing new rules for disclosing climate-related financial risks in SEC filings. Public companies will be required to disclose their climate risk management and greenhouse gas emissions in their registration statements and annual reports.

1

The US IRA of 2022 continues to be the most financially material regulation in the energy space. Carbon capture, utilization and storage (CCUS) received a big boost in terms of financial incentives, and with more warnings in 2023 of irreversible climate damage, it's likely that investment in CCUS projects will continue to ramp up in 2024.

Exploration, production and refining companies are well placed to capture this opportunity, as they have the knowledge, economies of scale, and resources. Sustainable aviation fuels (SAF) are currently a hot topic. At the moment less than 1% of aviation fuel is bio-based, but its potential is much higher because the airline industry needs to cut emissions by 65% by 2030.[7] Other governments are likely to follow suit in incentivizing SAF development.

The IRA also has implications for the US healthcare sector, though the goal of making drugs more affordable will naturally dampen the pricing power of pharmaceutical companies. The impacts will not be felt until after the drug patent exclusivities start to run out. However, in 2024 companies will learn more about the price discounting that will apply in 2026. Already, the IRA is influencing biopharmaceutical companies' innovation strategies as they reassess their pipelines to prioritize larger and faster successes given the new pricing evolution guidelines.

2

The EU Regulation on deforestation-free supply chains will come into force at the end of 2024 for large companies and will have a significant impact on the supply chains of consumer companies, potentially triggering wider inflationary pressures in the next one to two years. Food producers, staples retailers and restaurant operators will need to expand their product-based due diligence on commodities (wood, palm oil, cattle, soy, cocoa, coffee) to prove they are deforestation-free.

Input materials must be traceable to an individual plot-level through satellite monitoring, or they must be proven to not infringe upon any deforestation-relevant laws of supplier countries, or human rights legislation under UN law. Corporates with advanced supply chain traceability, or those who already work with more sustainable suppliers, are likely to have an advantage, while brands with strong pricing power may be able to pass on (some) of the costs to consumers.

Others will have to develop alternative supply chains, which can be time-consuming and expensive. With sustainably sourced materials already premium-priced, this could increase the cost of food and other consumer goods. Beyond 2024, the EU Corporate Sustainability Due Diligence Directive (CSDDD) will extend requirements to human rights and other environmental issues.

3

In the real estate sector, version 4 of the Energy Performance of Buildings Directive (EPBD) is imminent with the proposal expected to take effect in 2025. On the agenda are stricter criteria for both new and old buildings, the introduction of zero-emission building requirements, calculations of life-cycle global warming potential, and minimum energy performance standards. Property investors will need to act quickly in 2024 to review portfolios and upgrade where necessary to avoid asset impairments.

[7] IATA: https://www.iata.org/en/pressroom/pressroom-archive/2021-releases/2021-10-04-03/

4

Although less likely to bite in the next 12 months, long-term investors should be mindful of resource-related regulations coming to fruition. For example, the EU Critical Raw Materials Act will have an impact across multiple sectors. Its goal is to ensure a secure and sustainable supply of critical metals and materials in Europe, promote recycling and help meet European climate objectives.

Metal producers already committed to recycling will be well positioned for the transition and others will have to follow suit well before the implementation date of 2030 if they want to be competitive. For industries that rely on a supply of critical metals, such as technology hardware and semiconductors, there is likely to be cost pressure in the medium term if local supply capacity cannot be established quickly enough to meet demand.

5

The EU's Carbon Border Adjustment Mechanism – the 'world's first carbon border tax' came into effect in October 2023. As of now, high-emitting sectors (cement, fertilizers, iron and steel, aluminum, hydrogen, and electricity) need to declare the quantity of carbon emissions embedded in their EU imported products. While a carbon price will not be charged until 2026, when all sectors will be included, the next year or two will see companies (and their investors) trying to quantify the financial impact to their company. Recyclers and critical material producers are also well positioned, while high carbon emitters can expect higher costs.

These five key regulations merely scratch the surface of the numerous and complex impending sustainability-driven regulatory changes that will alter company behavior and operations in 2024. Regulation is often years in the making but investors need to be aware of the implications of new regulations long before they take effect.

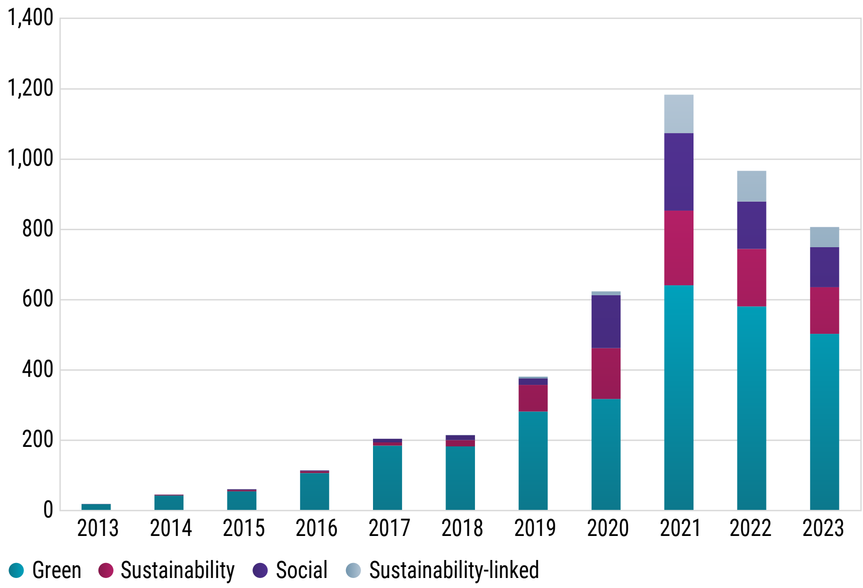
Many of these regulatory developments will force companies to bear the costs they were previously able to pass on to society. And transitioning business models will need to factor in capital to invest in sustainable solutions, which the growing ESG market is enabling.

3. Predicting next year's ESG-bond market growth

ESG bond issuance, also known as GSS+ bonds,[8] is set to increase next year, but whether it achieves record levels as in 2021 will depend on supply and demand. On the supply side, as interest rates look to decline in 2024, entities will be more willing to finance their sustainability plans at lower costs which could have positive implications for the growth of the ESG bond market. Moreover, the ongoing US anti-ESG movement might imply slower growth in issuances, yet we expect the high potential from the APAC region and other EM countries to compensate and we anticipate issuance from Europe to remain strong.

On the demand side, regulatory developments like the EU Green Bond Standard (adopted in October 2023 and expected to take effect in late 2024) and the vast number of taxonomies popping up in emerging market countries (like Brazil and Mexico) are expected to foster greater transparency and investor interest. Furthermore, a disappearing 'greenium' (borrowing cost difference between ESG and non-ESG bonds) will represent a relevant signal of a maturing market and incentivize investors to participate more actively. This aligns with an increasing appetite for impact investing strategies and the desire to demonstrate sustainability commitments.

Figure 2: ESG bond issuance by type (USD in billions)



Source: Bloomberg NEF. Information as of September 2023 (2023 data YTD). For illustrative purposes only. Data does not represent any specific Robeco investment strategy.

[8] Labeled green, social, sustainability, and sustainability-linked bonds are collectively known as thematic bonds, GSS, GSS+, ESG, or sustainable bonds (World Bank, 2022).

We expect the growth in issuance will be heterogeneous among the different segments, with green bonds expected to remain the most dynamic. Furthermore, we expect increasing diversification in the categories of green bond proceeds. While climate change mitigation remains the most dominant category, we see significant proceeds allocated to projects concerning biodiversity or the ocean economy ('blue bonds'), a trend we expect to continue. The recent guidance on blue bonds, issued by a group from both the ICMA and UN bodies, will further support the quality and issuance of these instruments.

As for social and sustainability bond sales, we also anticipate an uptick, albeit at a slower pace, driven by interest from APAC issuers (e.g., South Korea, Japan) and supranational institutions, respectively. Finally, sustainability-linked bonds might recover even further than in 2023, as more issuers are likely to implement the recommendations from ESMA and ICMA. This would thereby improve the structure of these bonds and strengthen trust from the investor side.

4. Shareholder action: what can we expect from the 2024 AGM season?

With the increasing importance of sustainability, shareholders have become more active in making use of their shareholder rights. Not only has participation increased, but shareholders are also changing their tune in terms of the topics they want to address. Shareholder resolutions are usually a reliable proxy for what institutional investors have on their minds.

Climate change has captured much of the attention in recent years and will continue to do so. However, resolutions on equal opportunity, diversity policies, funding, and pricing policies on vaccines have reflected pressing societal issues. Despite the lack of resolutions filed so far, initial indications suggest that climate issues will remain a focal point in 2024. Tax transparency and artificial intelligence – topics that have long been part of Robeco's engagement program – have recently captured the interest of several investors and we expect further resolutions to be filed on these topics.

Road back to reason?

As shareholder discussions start to reflect wider societal concerns, these discussions have also become more polarized and politicized. This has given rise to a so-called anti-ESG movement that has posited itself against the idea that the investment arena should make space for ESG. Several shareholder resolutions were filed to oppose CEOs who had become too 'woke' and were perceived as seeking a broader perspective than only chasing the bottom line.

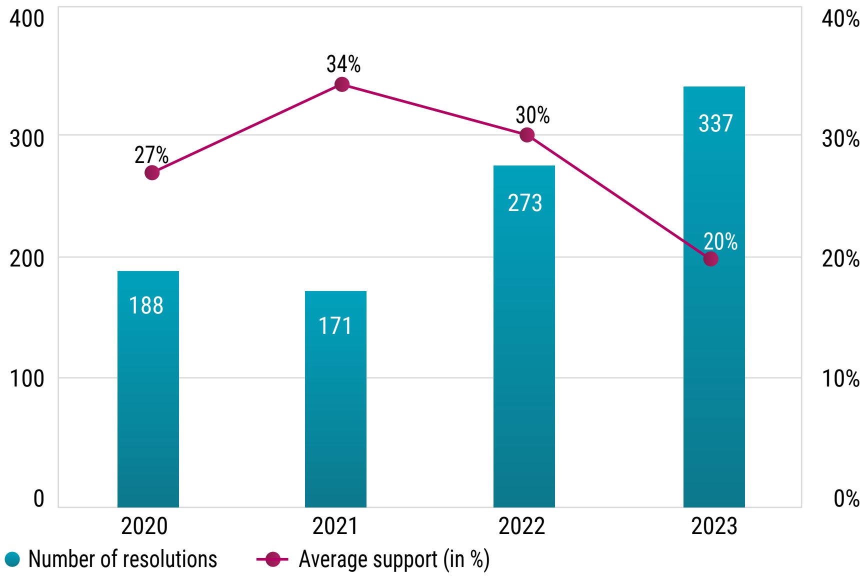
On the other hand, several ESG-minded shareholders are frustrated with the slow progress on topics like climate change and Sustainable Development Goals, often leading them to escalate their engagement and take stronger positions in voting. Regardless, it seems as if the upward trend for support on E&S resolutions retracted in the last two years (see Figure 3), with public debate focused on the far end of the spectrum and a lack of emphasis on practical progress. In order to shift the narrative, rather than focusing on disagreement the conversation should focus on achievable results in the medium term and planning for the longer term. Our expectation for the next year is that ahead of several key elections, the tone around AGMs in 2024 will revolve around escalation before there is a return to constructive dialogue.

SRD 2.0

The implementation of the amended Shareholder Rights Directive (SRD) required EU companies to ask for shareholder approval on their remuneration policies every four years as of 2020. Companies engaged in ongoing dialogue with their shareholders on remuneration plans generally avoided any unwanted surprises.

However, those companies that had ignored market dissatisfaction and failed to obtain necessary approval were forced into more discussions between remuneration committees and shareholders as a consequence of insufficient remuneration resolutions. As companies have to request shareholder approval on their policy every four years, 2024 will probably trigger more debate. This provides an opportunity to further push for incentive structures that align management with investor needs, both from a financial and sustainability perspective.

Figure 3: Environmental and social shareholder resolutions: Volume and average support



Source: Morningstar proxy-voting database. Data as of 28 August 2023. Note: Chart shows data for US companies for proxy years ended 30 June.

5. Conclusion: navigating change

Even though 2023 showed considerable headwinds for sustainable investing (and we cannot guarantee tailwinds will blow again in 2024), long-term we still see sustainability firmly entrenched in upcoming regulations, bond issuances and shareholders meetings. The five key ESG regulations discussed in this chapter merely scratch the surface of the numerous and complex sustainability-driven regulatory changes that are set to alter the behavior of companies in 2024 and have a lasting impact on how companies operate. Investors beware! ESG and sustainability bonds will continue to gain interest. The disappearance of the 'greenium', the cost advantage of ESG bonds over non-ESG bonds, signifies a maturing market and may encourage increased and more investor participation.

Lastly, at companies' AGMs, proponents and opponents will continue to address ESG issues via shareholder proposals. With the public debate focused on the far ends of the spectrum, we believe there is not enough emphasis on practical progress. The conversation should be more productive and focused on achievable results and forward panning. Our expectation is, however, that with several key elections coming up, the tone around AGMs in 2024 will continue to trend toward escalation, before shifting back to constructive dialogue.

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ROBECO
The Investment Engineers

The 2024 investment outlook has been compiled by **Peter van der Welle** (Multi-Asset Strategist) and **Colin Graham** (Head of Sustainable Multi-Asset Strategies) from Robeco's Multi-Asset team. The sustainable investing outlook was created by **Masja Zandbergen** (Head of Sustainability Integration), **Michiel van Esch** (Head of Voting), **Rachel Whittaker** (Head of Sustainable Investing Research), **Gino Betata** (FI Analyst/Researcher) and **Malene Christensen** (FI Analyst/Researcher).

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