Bridgewater®
Daily Observations
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What's Priced In for 2024

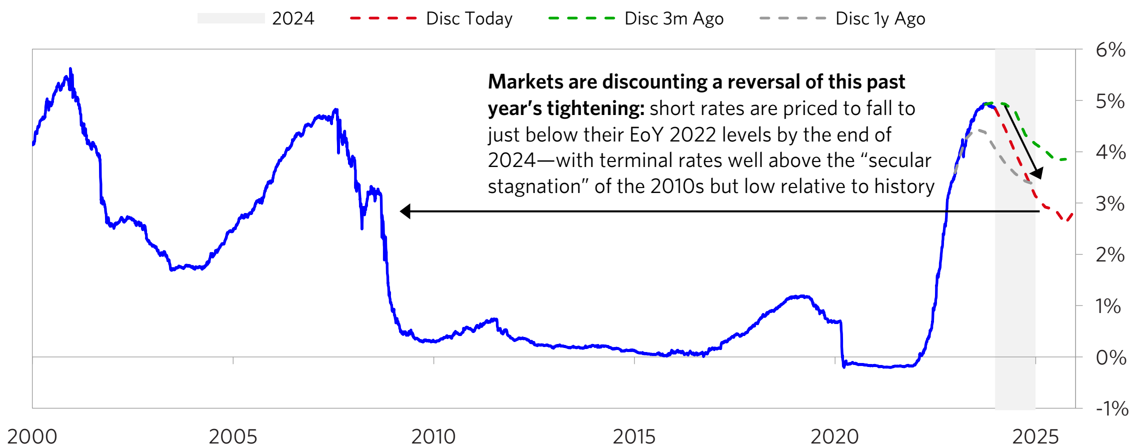
Goldilocks cyclical conditions, lower asset yields, and low discounted risks.

Market returns are driven by how events transpire relative to what is discounted and how the discounting of the future changes. Understanding the current pricing is an essential first step before investors can compare that pricing to their own thinking. So in today's *Observations*, we describe what we see as currently priced into global markets and discuss how that pricing has evolved over the course of the past year. Below, we highlight the key themes that we now see in the market discounting:

- **A return to cyclical perfection:** inflation is priced to continue falling and to approach or meet central bank targets across developed economies. Central banks are now discounted to use this disinflation dividend to reverse about a third of their tightening cycle; the asset price moves associated with this change in discounting in recent months are a support to growth heading into 2024. While a normalization of policy is sensible, the degree of easing priced in now looks overstated to us—particularly in the US, where growth remains strong. Equity pricing, analysts' earnings expectations, and economists' projections all indicate that growth rates are expected to stabilize close to potential growth in 2024, allowing unemployment rates to stay near cyclical and secular lows.
- **Lower asset yields and compressed risk premiums:** cash rates are discounted to fall to levels that are elevated relative to the "secular stagnation" of the 2010s but low relative to history, especially in the developed world outside of the US. This is a shift from the much higher terminal rates that were priced in only a few months ago. Bond yields are also low, particularly outside of the US, notwithstanding large structural fiscal deficits. Rate cuts are discounted to produce a flatter—rather than inverted—yield curve by the end of 2024, but the yield curve is priced to remain much shallower than is typical. In the US, equity multiples are high (and yields low) as risk premiums have been compressed. Asset returns, especially in the near term, will depend on how conditions evolve relative to what's discounted, and stronger growth, further risk premium compression, or more easing than priced could still lead to strong performance for equities, bonds, or other assets. Central banks are no longer seeking to slow their economies and cool asset prices, which removes a huge bearish pressure on assets relative to cash. But risk premiums and (in many cases) valuations are stretched thin as investors have continued to move out the risk curve. This combination of low cash rates, a flat yield curve, and low risk premiums translates to low asset yields and a higher hurdle for future returns for much of the global financial asset stock.
- **Highly coordinated policy across the developed world:** markets are discounting a very similar path of easing in the US, Europe, the UK, and Canada in 2024 despite diverging conditions today, with US growth much stronger. While interest rate levels are priced to be slightly higher in the US than in Europe or Canada at the end of 2024, this difference looks small to us given their respective macroeconomic conditions. Japan stands out as one place where a normalization of policy (toward some tightening) is not priced in, even as inflation has risen to a normal rate. US exceptionalism continues to be priced into the equity market. In our view, many emerging economies have competitive currencies, cheap assets, and more room to lower rates from high levels than is currently discounted.
- **Low volatility:** across most asset classes, discounted volatility is low relative to history. Implied volatilities are low in equities and currencies and somewhat low in commodities, despite domestic political and geopolitical risks. They are somewhat higher in rates, which reflects rates no longer being pegged near zero.

We begin with some perspectives on the path of monetary policy that is now priced in for developed economies in 2024 (excluding Japan, where the policy dynamics are different).

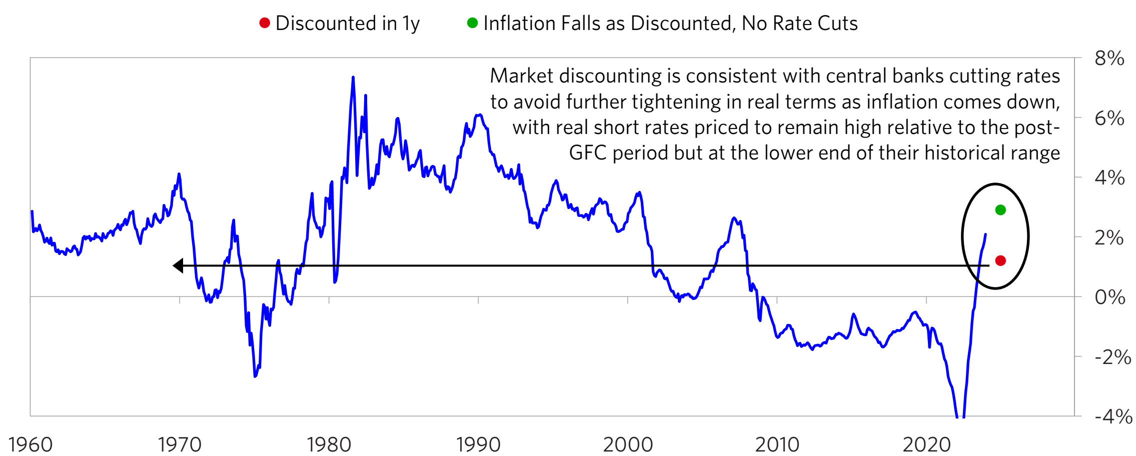
Dev World Nominal Short Rate with Forward Discounting (ex-JPN)



GDP-Weighted Average of USA, EUR, GBR, CAN, AUS

The easing priced in for 2024 is consistent with central banks normalizing policy as inflation continues to fall. If central banks do not ease in nominal terms, they would effectively tighten at a time when they no longer need weaker growth to bring inflation down. Markets are discounting an ultimate level of real short rates that is well above that of the post-GFC period of stagnation but low relative to most of history outside of the 2010s.

Dev World Real Short Rate with 1-Year Forward Discounting (ex-JPN)

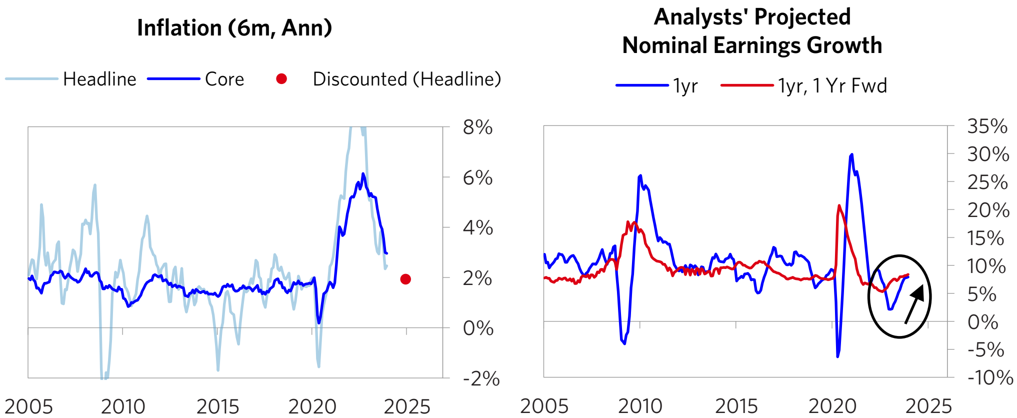


GDP-Weighted Average of USA, EUR, GBR, CAN, AUS

Market discounting is consistent with Goldilocks cyclical conditions in developed economies this coming year, with inflation discounted to be around target and analysts projecting about normal earnings growth. Economists are projecting fairly normal GDP growth rates, and the long-term earnings growth discounted in equity markets is also solid.

Developed World (ex-JPN)

Rate cuts are discounted in response to conditions that will increasingly call for neutral policy, with markets pricing in around-target inflation in 2024...

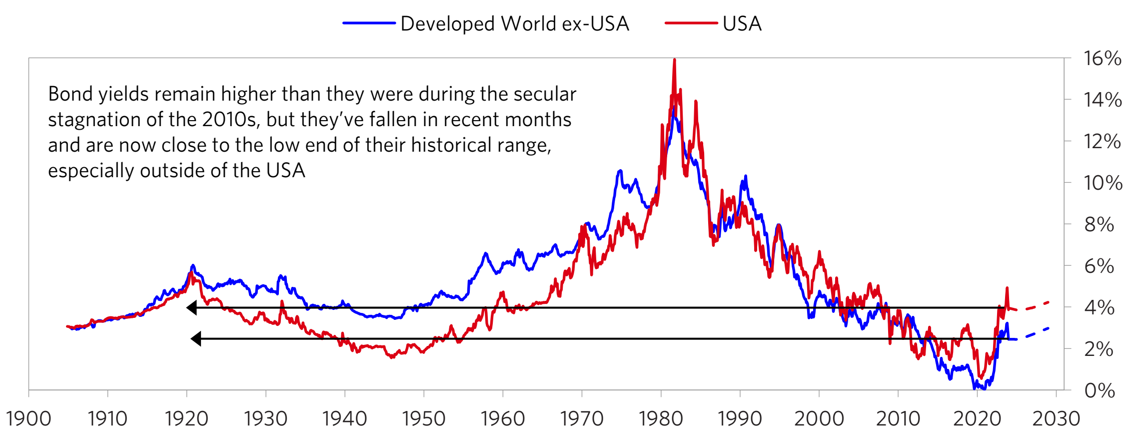


...and, for the first time since central banks began to tighten, analysts no longer expect earnings growth to drop off in the year ahead (on average across developed economies)

GDP-Weighted Average of USA, EUR, GBR, CAN, AUS

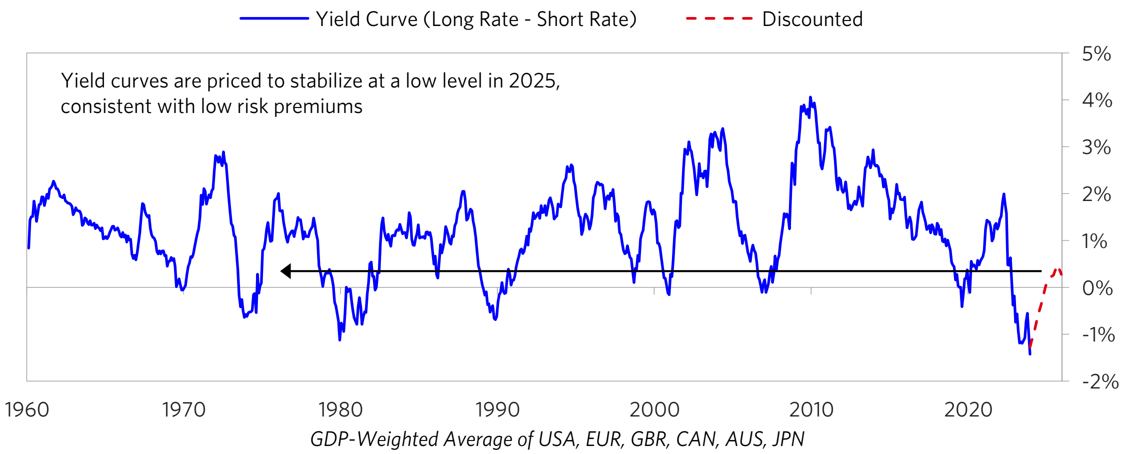
The next charts show longer-term bond discounting. Bond yields ended 2023 around where they began it after the significant fall in rates in recent months. They are discounted to dip slightly over the coming year as the high cash rates of 2024 fall out of the pricing before then rising a bit. Rates are less depressed in the US than in other developed economies. Across the board, they are priced to remain low relative to most of history and low relative to cash rates but high relative to the decade of secular stagnation before the pandemic.

Nominal Bond Yield with Forward Discounting



The yield curve has been very inverted for some time. To us, this has mostly reflected central banks' desire to keep short-term rates high in order to slow economies down. This is more a read of policy intent than a direct driver of economic activity, like the level of rates. The long end has also been kept low by suppressed government issuance despite large deficits and low private credit demand in an income-driven expansion. Rather than indicating a likely recession, these dynamics underlying the inverted yield curve have been stimulative. Looking ahead, the yield curve is priced to revert as central banks cut rates on the short end. But it is discounted to remain much flatter than it has been historically.

Developed World Aggregate Yield Curve with Forward Discounting

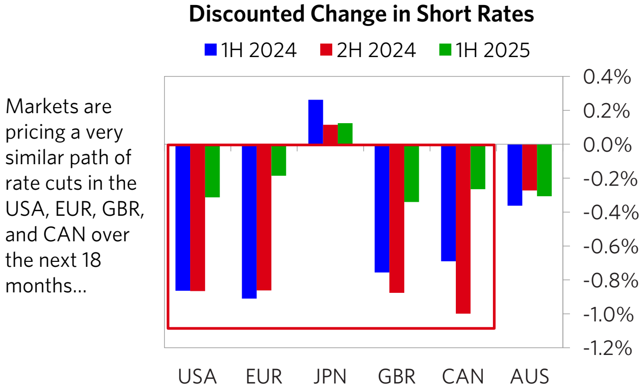


GDP-Weighted Average of USA, EUR, GBR, CAN, AUS, JPN

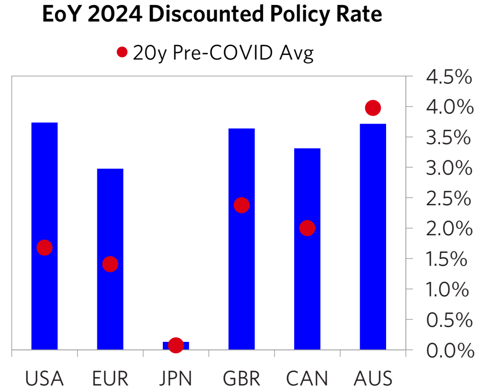
Central Banks Are Priced to Cut Rates in Tandem Across Most Developed Economies, Despite Diverging Conditions

As we show below, markets are discounting highly synchronized monetary policy across most developed economies, with central banks priced to cut rates in lockstep over the next 18 months (Australia and Japan are notable exceptions). Yet cyclical conditions are diverging. Growth is materially weaker today in the Eurozone, the UK, and Canada than it is in the US. And while economists' and analysts' expectations are not the same as market pricing, they are consistent with this gap persisting in 2024 (though this gap is smaller if one accounts for higher potential growth rates in the US, and expectations for growth are mostly consistent with flat unemployment at secular lows across the board). The pricing today indicates that market participants are processing the slightly higher starting level of rates in the US as sufficient to account for these cyclical divergences, with similar directional pressures on policy makers. But given the outsize strength of conditions in the US, we see greater pressures to cut rates elsewhere.

Discounted Change in Short Rates



EoY 2024 Discounted Policy Rate



...despite divergent conditions on a coincident basis and expected in 2024, with growth weaker in GBR, EUR, and CAN, and stronger in USA (but cyclical conditions remaining fine everywhere)

	Conditions Today		Expected in 2024		
	Growth (3m, Ann)	Core Inflation (6m, Ann)	Consensus Growth	Analyst Proj Earnings Growth, Adjusted for Historical Bias	Breakeven Inflation*
AUS	1.8%	2.9%	1.4%	-4.8%	3.2%
USA	1.5%	3.2%	1.2%	4.6%	2.0%
JPN	0.8%	2.7%	0.9%	3.2%	1.2%
CAN	0.2%	2.7%	0.5%	0.4%	2.0%
EUR	-0.3%	2.7%	0.5%	-1.7%	1.6%
GBR	-0.3%	2.3%	0.3%	0.2%	2.7%

Stronger conditions

Weaker conditions

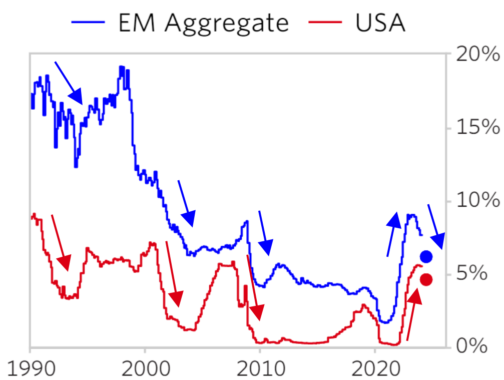
Blue = Conditions more aligned with easing

* Reflects Bridgewater estimate of market expectations where no traded instrument exists

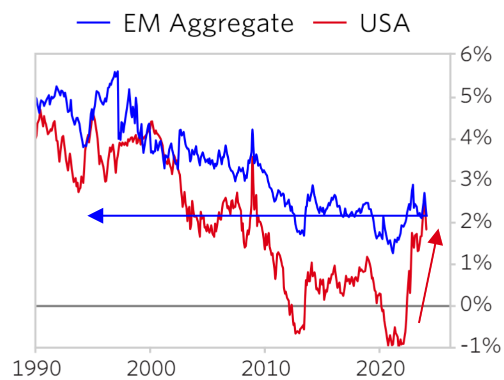
Market discounting is consistent with central banks beginning to normalize policy soon in most developed economies—but in many emerging economies, they have already begun. As we explored [in a recent *Observations*] and illustrate below, central banks in emerging economies have been unusually proactive this cycle, leading the Fed in tightening. Many of them have now started to cut policy rates from high starting levels, with further cuts discounted in the coming months. And unlike most developed economies, where real yields are discounted to settle at a neutral rate that is well above the stagnation of the 2010s, emerging markets on average are priced to be able to adopt a less restrictive policy stance than they have in recent decades. Lower and less volatile inflation, stronger balance sheets, and a reduced reliance on fast money flows to support their currency will likely allow for slightly easier policy than the past.

Short Rate with 6m Fwd Dot

Monetary policy in emerging economies typically lags that of major markets like the USA; this cycle has been different, with emerging economies tightening first and now leading on the way down



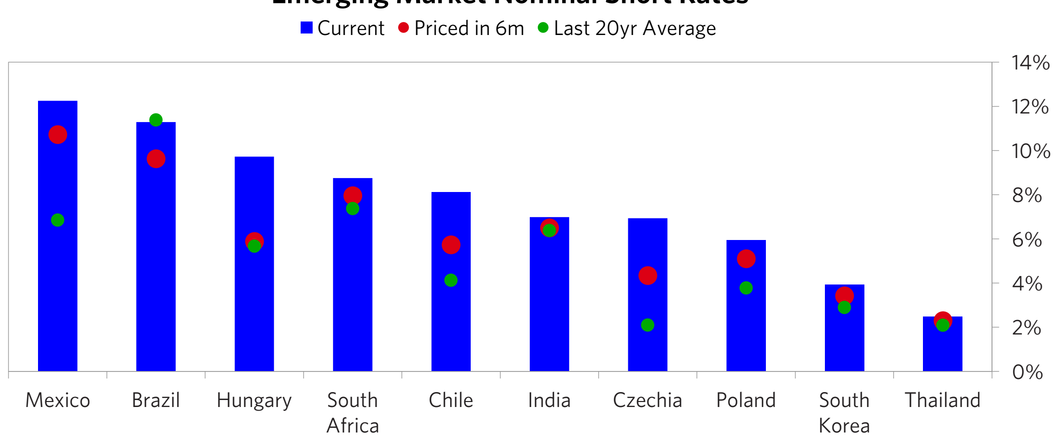
Real Yield



Unlike in the USA (and most other developed economies), where rates are priced to settle at a high level relative to recent history, emerging markets are priced to maintain a lower level of real rates than in past decades

Emerging Market Nominal Short Rates

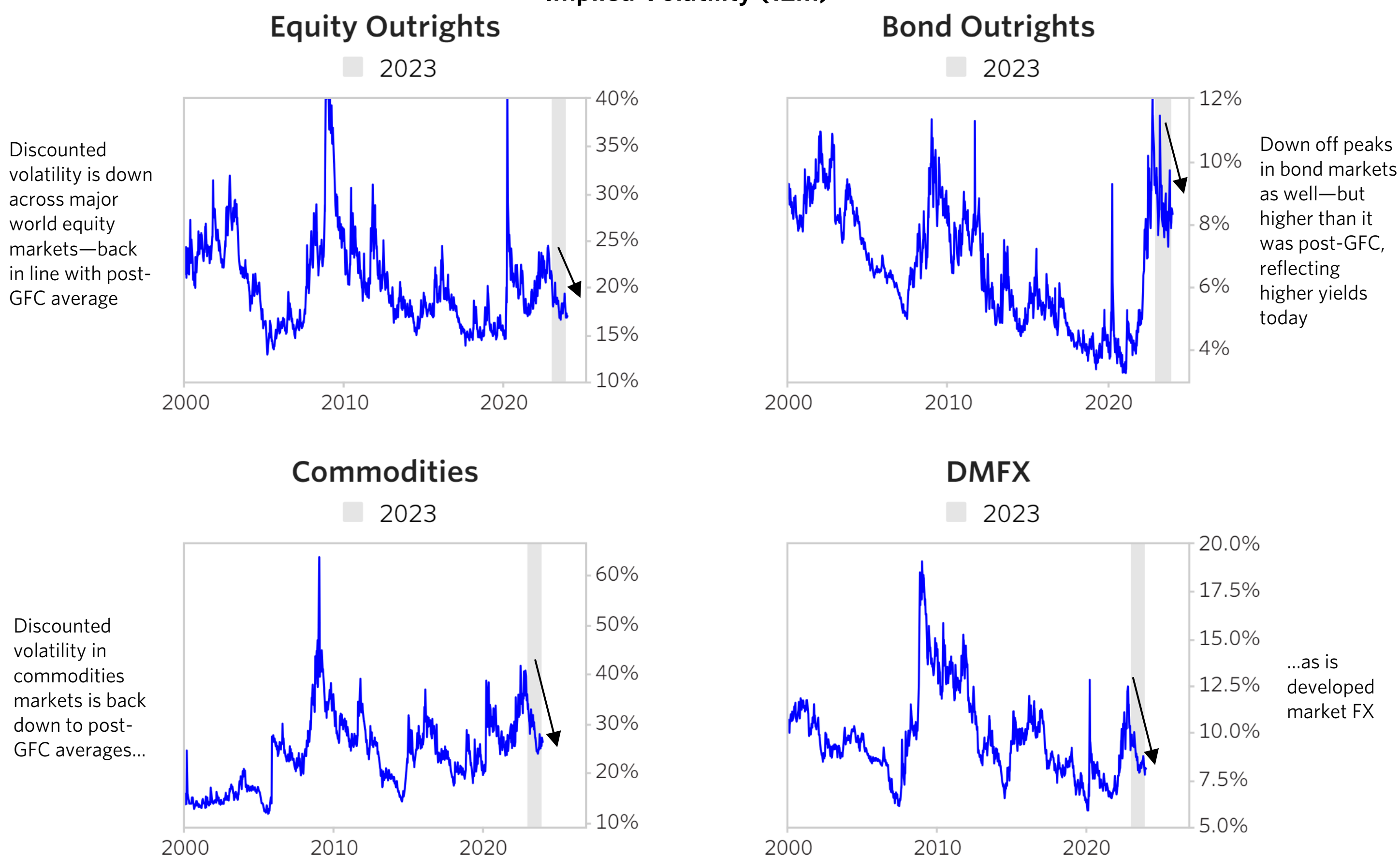
Nominal short rates are priced to fall in almost every emerging economy over the next six months, with particularly rapid cuts in Hungary, Chile, and Czechia



Options Markets Are Discounting Relatively Low Risk

Options markets are pricing in a narrow range of outcomes for 2024 relative to history. This pricing does not reflect much risk of either rate cuts causing inflation to reignite or of policy makers remaining too tight for too long and cracking their economies. It also indicates that markets are not discounting domestic political risks and geopolitical risks to exceed the experience of recent decades. Below, we show the 12-month volatility priced into options markets for different assets (aggregated across major countries). The only asset with high discounted volatility relative to history is bonds, where higher volatility is a consequence of higher rates as rates near zero don't move very much.

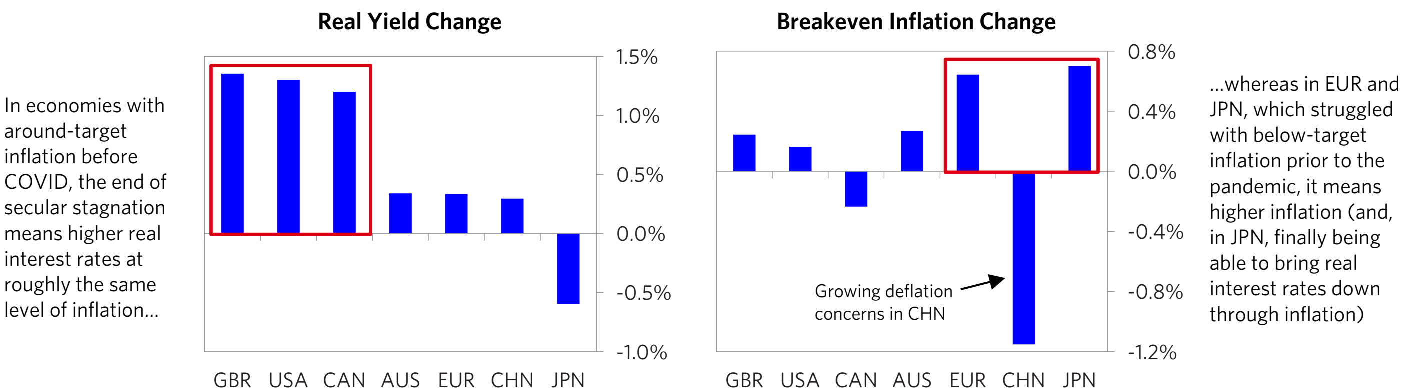
Implied Volatility (12m)



Bond Markets Are Pricing the End of the Post-GFC Secular Stagnation, but Interest Rates Are Still Low Relative to a Longer History

Across developed economies, bond yields are above their levels following the global financial crisis but remain low relative to the decades before the GFC. The overcoming of secular stagnation has flowed through to bond markets differently across economies. In developed economies where inflation was around target before the pandemic, real interest rates have risen, as policy makers are priced to remain slightly tighter to achieve similar levels of inflation. In economies that struggled with very low inflation, like the Eurozone and Japan, shifts in the secular environment have primarily translated to higher breakeven inflation at similar—or, in the case of Japan, lower—real yields. Market pricing reflects China heading in the opposite direction, with a steady drop in priced-in inflation as Chinese policy makers grapple with [an ongoing deleveraging] and demographic shifts; China's breakeven inflation has now approximately converged with Japan's.

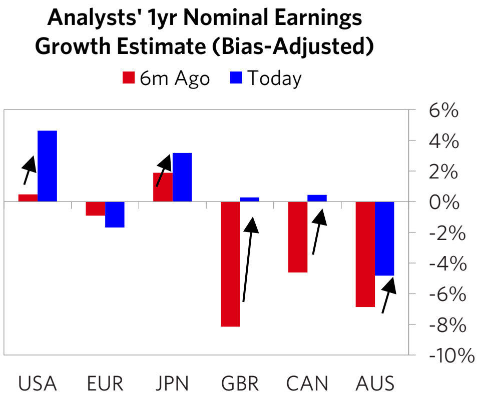
Bond Yield Components: Today vs 2010s Average

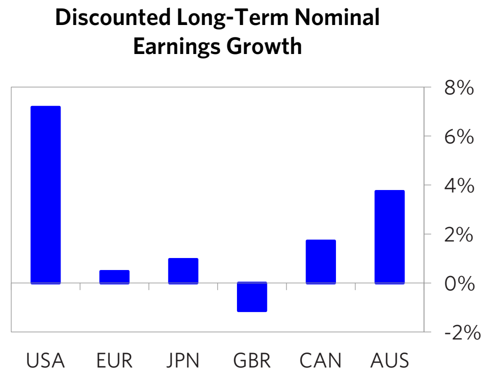


Equity Markets Continue to Discount a Large Gap Between the US and the Rest, but the Earnings Outlook Has Improved Almost Everywhere

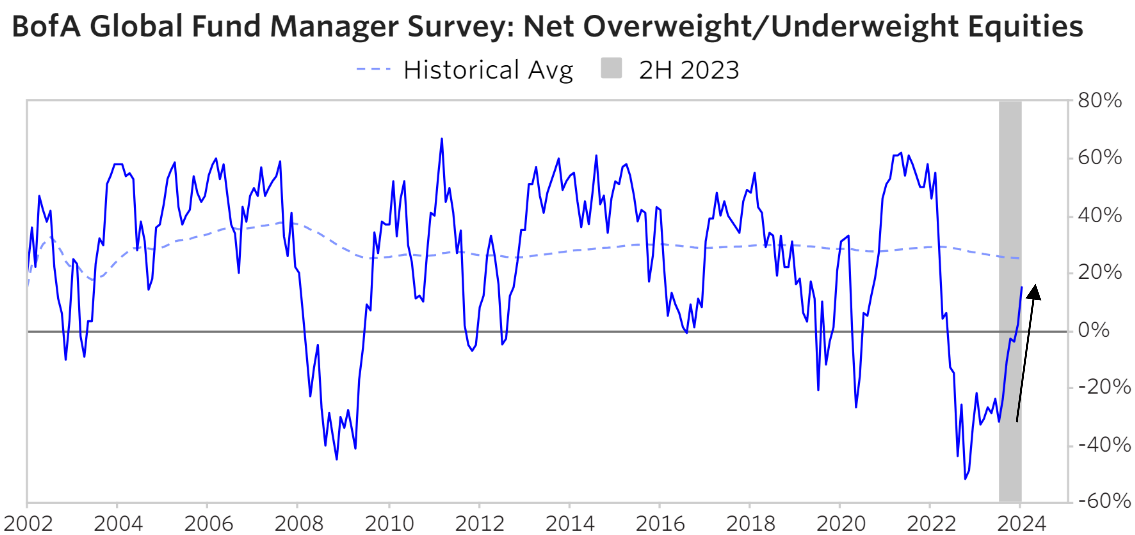
Both analyst numbers and our estimates of the pace of earnings growth priced into equities suggest that equity markets are now pricing reasonable short-term and moderate long-term growth rates. Analysts' short-term earnings outlooks improved significantly across almost every major developed market over the second half of 2023 as inflation fell; they are now consistent with above-average earnings growth in 2024 in most developed economies. Other indicators of equity market sentiment are consistent with this assessment. Global fund managers' sentiment has normalized rapidly over the past few months, consistent with more money flowing into equity markets and bringing risk premiums down. This shift has likely been supported by lower inflation rates, which make it more likely that central banks will ease to offset any unexpected equity weakness. The long-term rate of earnings growth priced into equities is now strong in the US, moderate in Australia, and more middling-to-weak in other markets.

1-year earnings expectations have improved almost everywhere as inflation has come down without much pain; differences in relative expectations across economies have mostly persisted





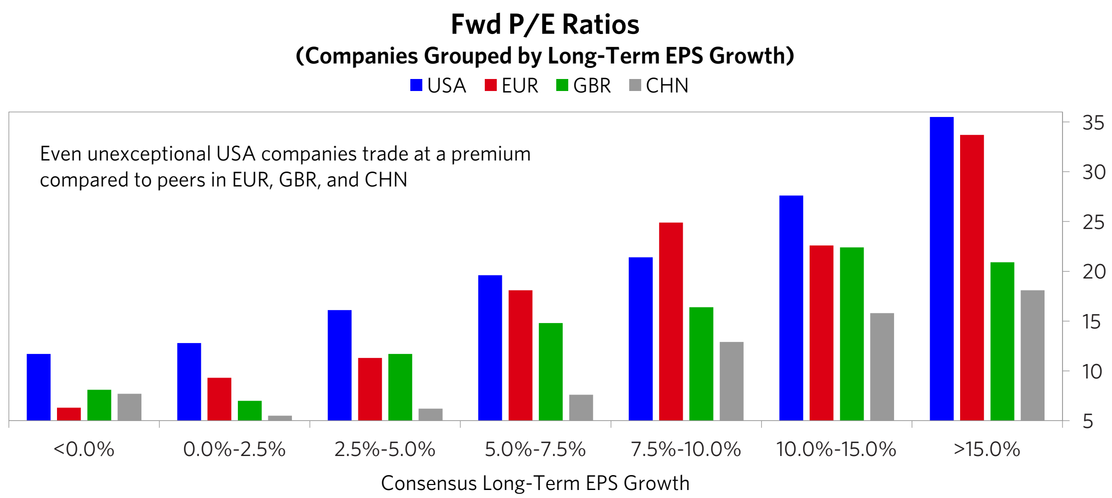
Equities pricing is consistent with much greater long-term earnings growth in the US than elsewhere



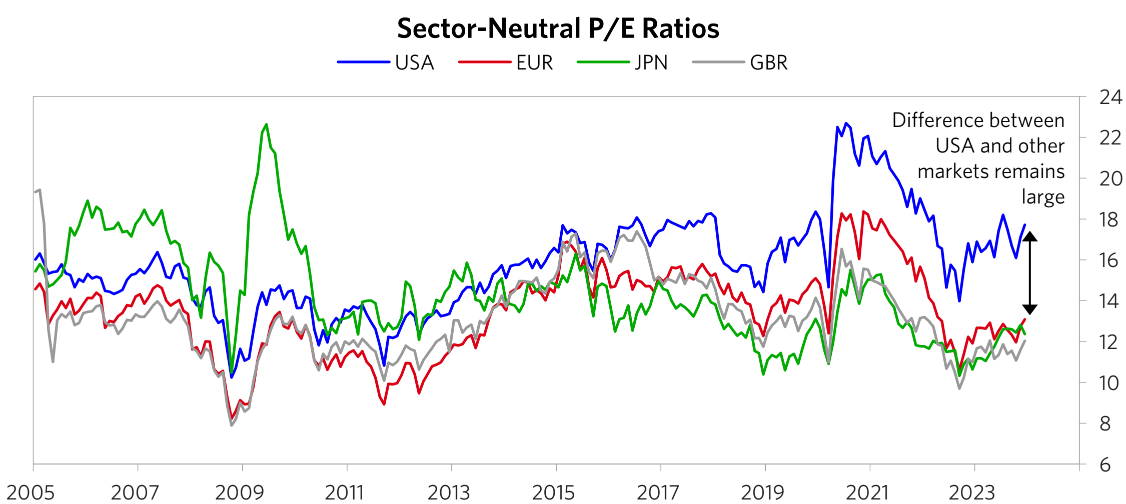
Sentiment among investment professionals has recovered in recent months

One of the key stories in equity markets today is the continued discounting of US exceptionalism. This pricing partly reflects the emergence of AI and the unique ability of the large US megacaps to benefit from it. But that is only part of the story. To illustrate how widespread the US premium is, below we show the price-to-earnings ratio of companies across the US, the Eurozone, the UK, and China, grouped by analysts' long-term earnings growth projections. Even US companies that are expected to see very little long-term earnings growth trade at a premium to comparable companies in other economies. This premium is particularly striking given the US's higher interest rates, which mechanically mean that future expected earnings are discounted more than in other economies (i.e., US companies would have *lower* P/E ratios than others if market participants expected the same earnings growth across economies).

Fwd P/E Ratios



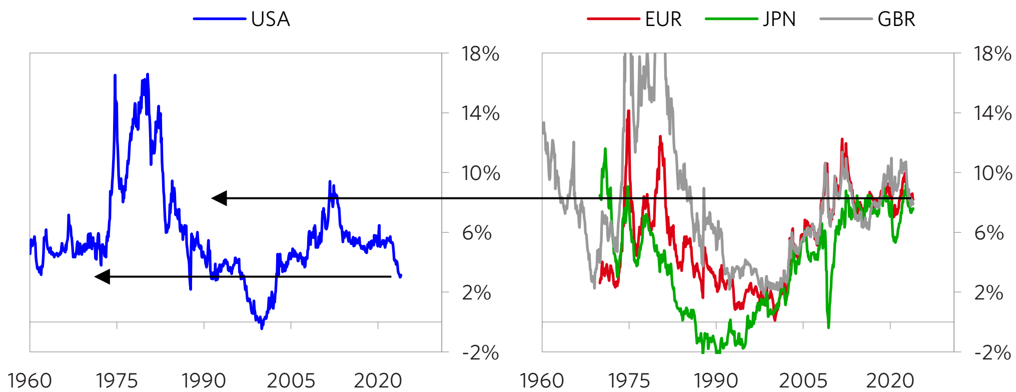
The chart below illustrates the relative pricing of different equity markets through time, controlling for differences in sectoral composition. US equities have traded at a premium since shortly before the pandemic, and that gap has persisted over the last year, leaving US corporates with a much greater hurdle for outperformance than they had in the prior decade.



As another perspective on relative equity valuations across economies, we show the difference between the earnings yield (the inverse of the P/E ratio) and the real yield on a government bond. In the US, the premium on equities is very low relative to history; it is much higher elsewhere, both compared to the US and relative to history.

Equity Earnings Yield vs 10yr Real Yield

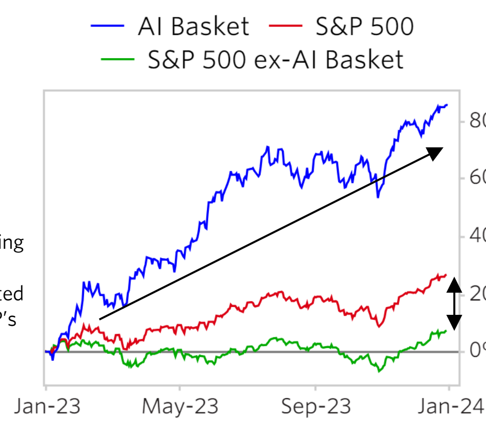
The spread between the equity earnings yield and real bond yield is around its lowest ever in the US outside of the dot-com bubble; in other major markets, it's high relative to history



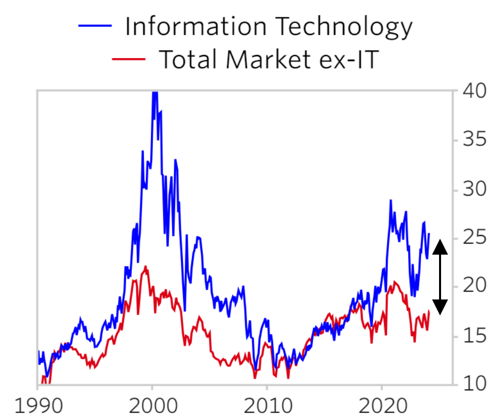
Equity pricing today also reflects large divergences in expected earnings growth across sectors. Most notably, markets have shifted over the past year to reflect surging enthusiasm about the potential impacts of AI technology, whose implications for growth and corporate profits we have discussed in recent *Observations*. On the left below, we separate out the 2023 returns of companies whose prices were highly exposed to developments in AI from the rest of the S&P 500. These companies contributed the lion's share of the index's returns over the past year. Largely due to this shift, tech companies are now trading at a large premium to the rest of the stock market; the difference between tech company P/E ratios and those of the rest of the S&P is even greater than it was during the pandemic, when very low interest rates meant that each dollar of tech companies' far-off earnings was mechanically worth more in the present than it would be today.

2023 Returns

A large shift in pricing for AI-linked companies accounted for most of the S&P's returns in 2023...



1-Year Forward P/E



...with the discounting of US tech stocks now again consistent with much more rapid earnings growth than other companies

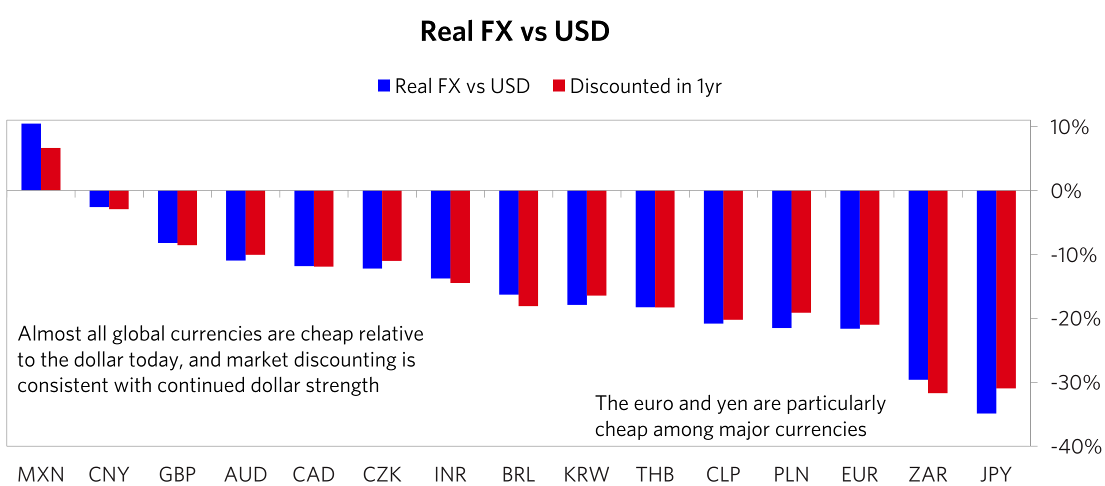
The table below provides a more detailed perspective of divergences across sectors in different equity markets today. Multiples are higher in the US across most sectors.

	USA		EUR		JPN		GBR		CHN	
	Weight	P/E	Weight	P/E	Weight	P/E	Weight	P/E	Weight	P/E
Total	100%	20.2	100%	12.4	100%	14.1	100%	10.8	100%	13.4
Cyclical Services	14%	20.6	5%	21.2	21%	20.7	13%	18.4	7%	14.0
Non-Cyclical Services	3%	15.4	5%	12.0	1%	11.1	6%	12.0	3%	10.8
Information Technology	38%	25.4	19%	19.0	32%	22.3	3%	15.3	25%	14.6
Industrials	8%	19.0	19%	16.7	19%	13.8	9%	18.0	12%	10.5
Cyclical Consumer Goods (incl. Autos)	2%	25.8	6%	5.5	5%	8.9	0%	13.7	7%	14.1
Non-Cyclical Consumer Goods	16%	18.0	23%	15.1	15%	21.9	28%	12.6	18%	18.4
Resources	5%	11.5	6%	6.6	1%	8.2	22%	8.5	7%	8.6
Financials	15%	15.7	19%	7.3	4%	10.4	19%	7.5	21%	4.9

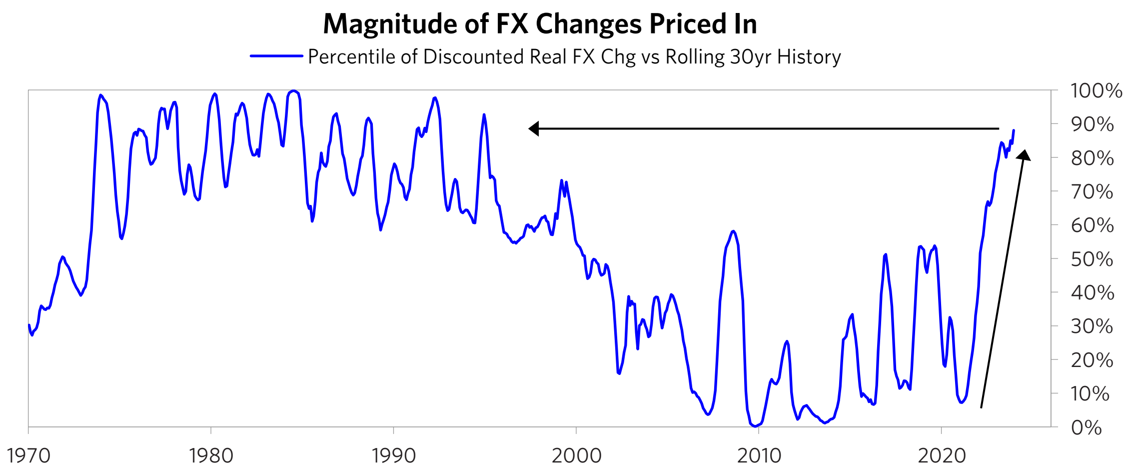
FX Markets Are Discounting Big Moves, Reflecting Wider Rate Differentials

Currency markets moved moderately in 2023, with wide dispersions remaining in the relative strengths of different currencies. The dollar stayed around secular highs, supported by higher rates in the US than in most peer economies and the resilience of the US economy and assets to the Fed's tightening. While the dollar has come down from its peak in recent weeks as US rates have fallen somewhat relative to peer economies, it remains quite strong. Among other developed economies' currencies, the yen is particularly cheap today due to the BoJ's maintenance of extremely easy policy while most other central banks tightened. Most emerging economies' currencies have held up fairly well to tightening in the developed world, with those of Latin American countries that tightened most aggressively performing particularly well. We now expect central bankers in many emerging economies to ease until they start to see more currency weakness.

Below, we show our estimate of the strength of different global currencies against the dollar today. Most currencies are cheap relative to the dollar and priced to remain so. In countries where policy is tight, like Brazil and Mexico, the currency is priced for further depreciation against the dollar.



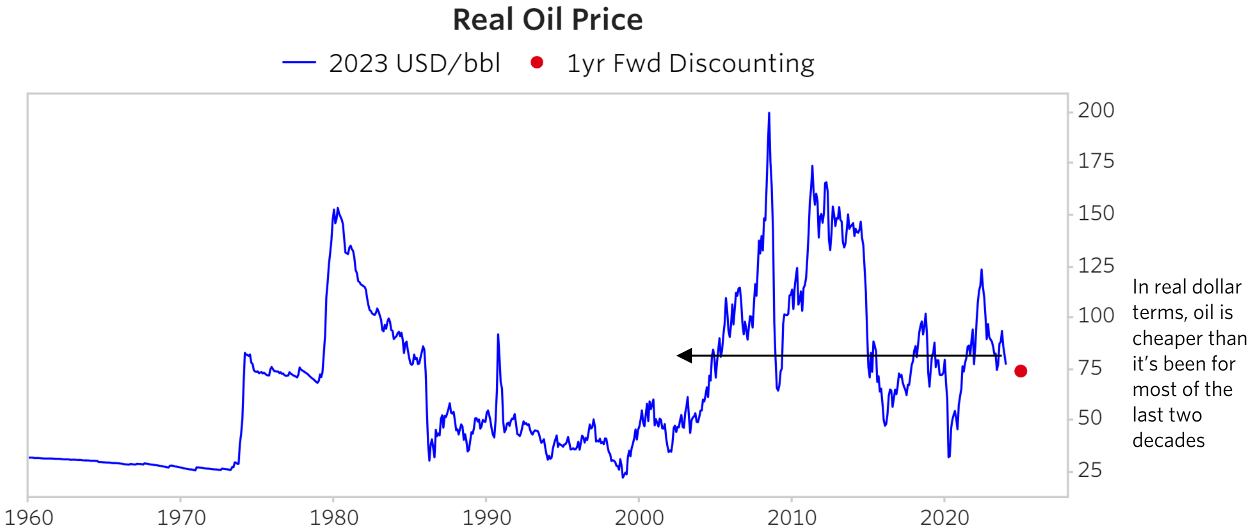
Forward discounting for currencies is a mechanical reflection of the relative level of interest rates among economies, as interest rates set the price of a currency in the future relative to the present. But market participants must still compare their views to this discounting, and currencies often diverge from it based on real money flows and varying cyclical pressures across economies. Over the last few decades, the degree of change priced into currency markets declined as business cycles became increasingly synchronized and rates fell toward the zero lower bound in many developed economies, reducing the magnitude of rate differentials across economies. While directional moves in interest rates have been highly correlated across economies during this tightening cycle (a dynamic that is priced to continue), the size of differences in the level of interest rates has grown as rates have risen, leading FX markets to discount some of the largest moves in decades. We discussed this dynamic in [a past *Observations*]. The size of these moves creates opportunities to take bets where the discounted changes look inconsistent with the different pressures across economies.



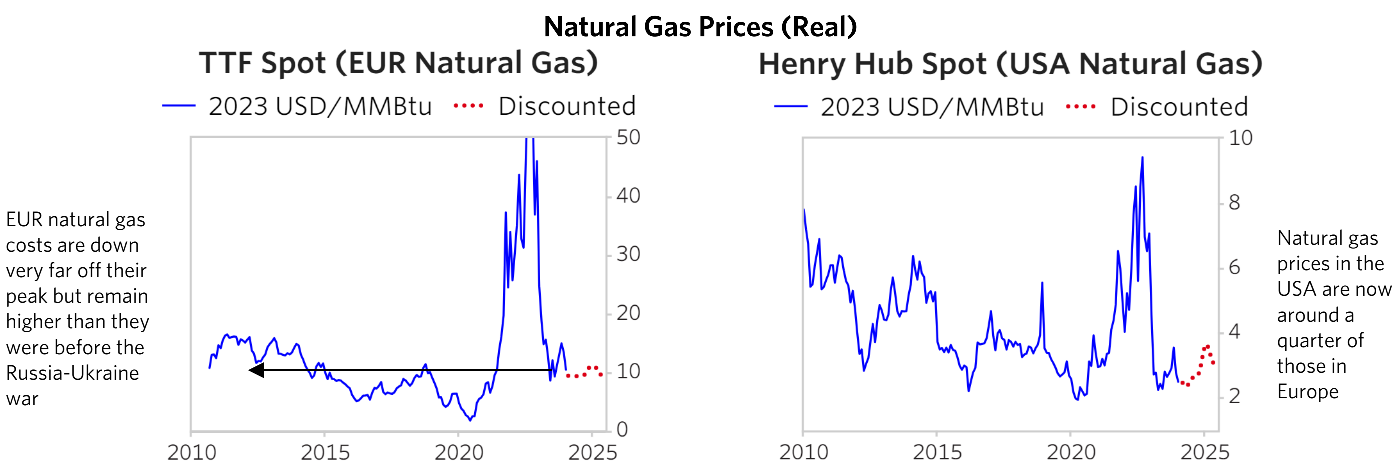
Commodity Price Levels Are Moderate Relative to History, with Minor Shifts Discounted

Different commodities have different geographic exposures, growth sensitivities, and supply dynamics, so we are wary of overgeneralizing about commodity prices. The charts below give some perspectives on the current pricing and market discounting across a range of commodity markets. Most major commodities are discounted to remain around current levels in 2024. This would be a big shift from the volatility in commodity markets in the recent past, which has seen huge price swings due to the pandemic, the Russia-Ukraine war, and China's reopening, among other drivers. But it would be consistent with moderate economic growth in 2024 and continued healthy supply growth for many commodities.

Oil prices were on average 16% lower in 2023 than in 2022, as US production surprised to the upside (offsetting midyear OPEC cuts) and prices fell off of highs reached in the wake of Russia's invasion of Ukraine. In real terms, oil prices are now lower than they were for most of the last two decades.

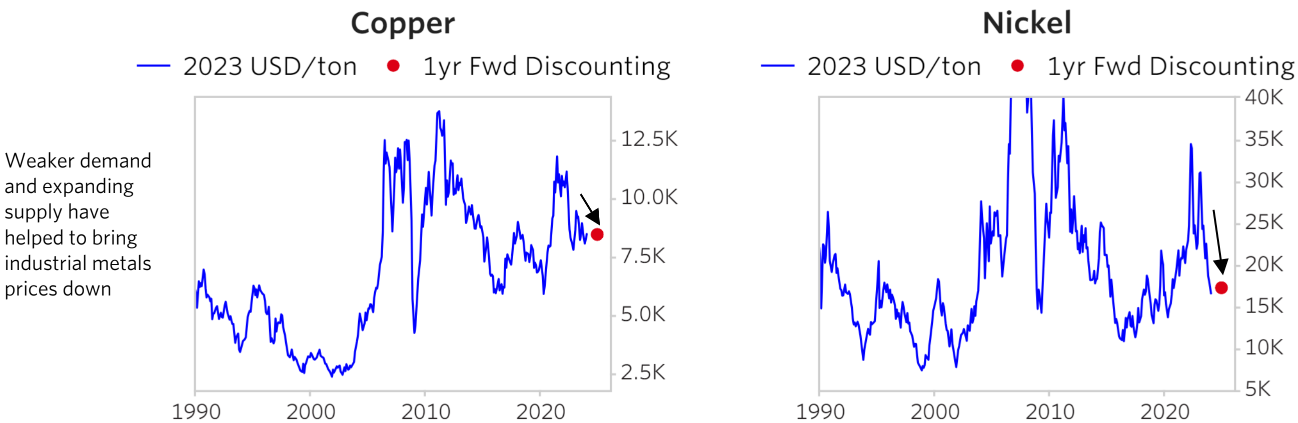


The Russia-Ukraine war has had a more sustained impact on the natural gas market. While prices have come down from their 2022 peaks, European natural gas prices remain about 50% higher than their average in the five years before COVID in real terms. High natural gas prices continue to inflict pain on Europe's industrial economy, contributing to outsize growth weakness among more manufacturing-intensive economies like Germany—where we estimate that growth is around -1% on a coincident basis, compared to around 0% in the Eurozone as a whole.



Industrial metals prices also moderated over the past year, weighed down by ongoing weakness in China's property sector, an industrial recession in the developed world (caused partly by high natural gas prices), and upside surprises from Chinese copper smelting capacity and nickel and lithium supply. As we explored in a prior *Observations*, the trajectory of industrial metals prices going forward will be determined in part by how the green transition plays out—in particular, how fast it occurs and how much governments are able to incentivize proactive supply growth.

Industrial Metals Prices (Real)



Gold prices were up slightly in real terms in 2023, remaining well above their pre-pandemic levels despite the typical sensitivity of gold prices to high interest rates (which increase the opportunity cost of holding gold). The resilience of gold prices has been driven primarily by geopolitical instability, along with growing fears of currency debasement in the developed world. Many central banks were prompted to buy gold as a safe store of wealth after Western governments moved to cut Russia off from their currencies following its invasion of Ukraine.