Growth addiction threatens climate action

Advanced Economies Outlook 2024

Triodos Investment Management

In 2024, the tight monetary policies will bite. The result will be another year of meagre global economic growth, driven by a further slowdown across advanced economies. We expect consecutive recessions in the eurozone, the UK and finally the US. Although this is set to further ease inflation, it will also sustain pressure on living standards. Combined with increasingly limited fiscal space, climate plans will be an easy target in search of short-term spending cuts. Heightened geopolitical tensions will further decrease the sense of climate urgency. Against this background, it is more than ever worthwhile to think about post-growth solutions. Because climate action is a prerequisite to improving living standards for current and future generations.

Growth addiction threatens climate action

Stimulus has pushed weakness to 2024

For 2023, we project global economic activity to expand by 3.1%. This is below this century's historical average, but it still means added economic activity the size of the global economy in 1970. This is better than most economists expected at the start of the year: record-high inflation, an ongoing war in Ukraine and fierce monetary policy tightening all pointed towards consecutive recessions in most major advanced economies. But the eurozone and the UK narrowly avoided the highly anticipated downturns early in the year, and the US economy defied expectations of a recession later in the year by accelerating sharply during the summer. A short flare-up of stress in the US banking sector and the outbreak of the Israel-Hamas conflict also did not derail global economic activity.

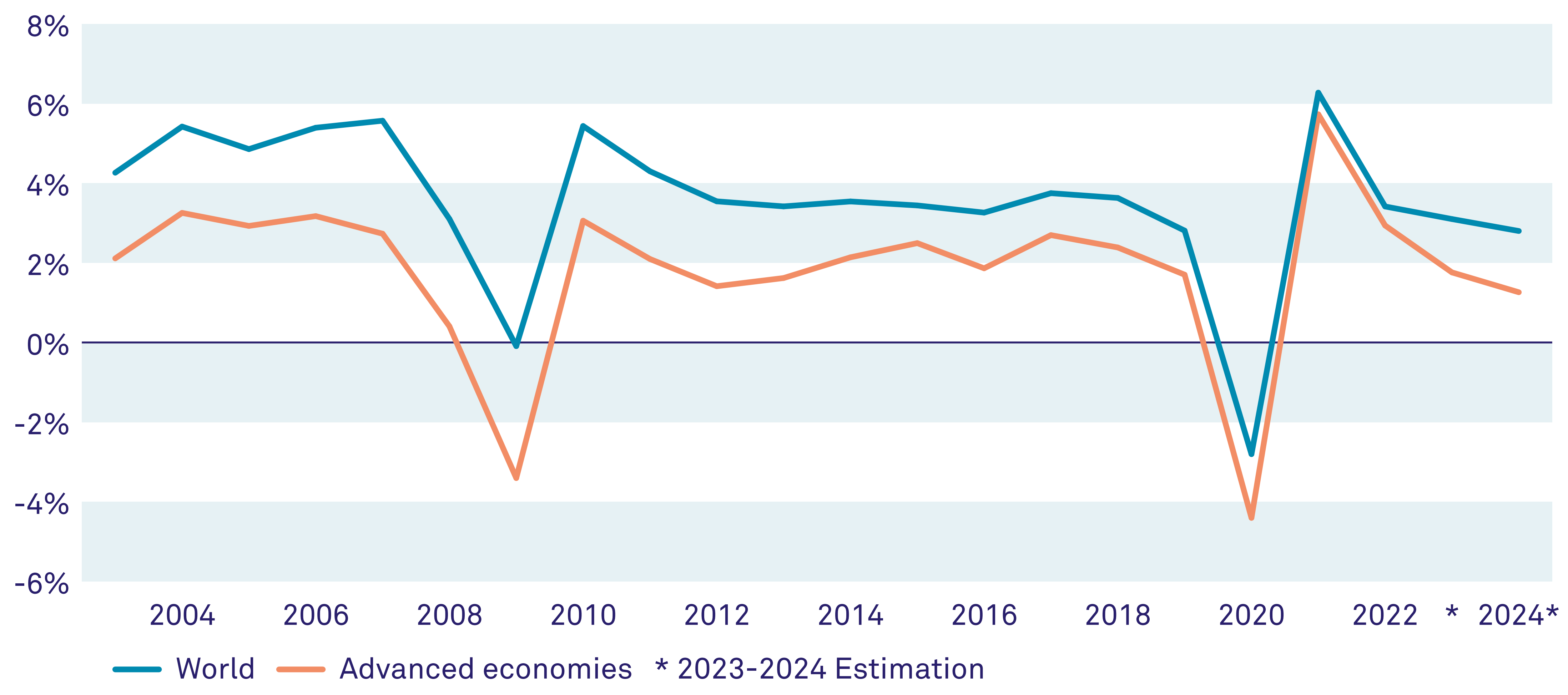
Looking back, one factor was clearly underestimated going into 2023, the ongoing economic sedation through both current and previous policy stimulus. Although major central banks hit the breaks in 2022, by that time the artificially low interest rates had already been locked in for longer periods. Governments, on the other hand, did not take their foot off the pedal, further shielding households through additional government debt. It is therefore at least remarkable that many took the better-than expected economic performance in 2023 as a sign of resilience, as it was mostly the fabricated through policy stimulus.

In 2024, we expect that these stimulus tailwinds will increasingly fade, however, meaning no more hiding from the severely tightened monetary stances across advanced economies. Consequently, for 2024, we project global economic activity to expand by 2.8%, which means another year of well-below average growth. This global weakness will be driven by a further slowdown across advanced economies (see figure 1).

As for the major advanced economies, we expect that the US economy will finally run out of steam in 2024, culminating in a recession in the second half of the year. The eurozone is probably already in a recession and will only experience a slow recovery in 2024. The UK will fall into a recession around the middle of 2024, and although we do not expect a recession in Japan, growth will be muted there as well. In our projections, a global recession will not materialise, as the timing of the recessions varies, and emerging economies will provide some counterweight.

It is important to realise that these expected recessions do not mean we are entering a post-growth economy. In such an economy, living standards wouldn't be so closely tied to economic growth, and we would have abandoned our current extractive and pollutive ways. Precisely for this reason, it makes sense to start thinking about ways to limit our growth dependency in the face of yet another year of meagre growth, and with six out of nine planetary boundaries already crossed. In our Long-term Outlook, we explore the origins of our growth addiction and outline several pathways to the necessary transformation of our economy.

Figure 1 GDP growth (year-on-year)



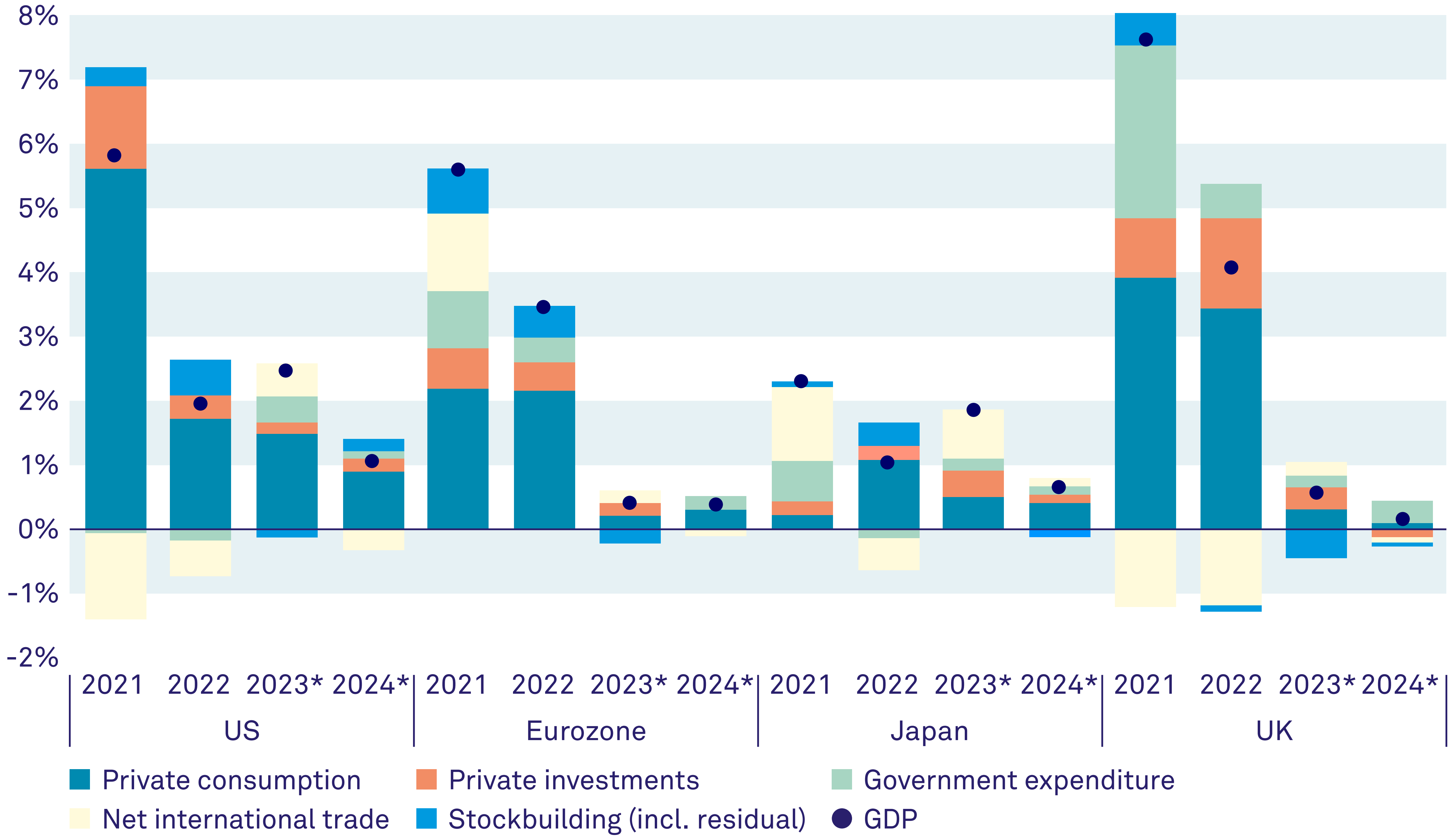
Source: NiGEM, Triodos Investment Management; Advanced economies proxied by OECD countries

Fading tailwinds expose households

Weakness in household consumption is an important driver of our muted annual growth expectations (see figure 2). On first sight, this might seem counterintuitive, as inflation has been the most important threat to living standards for the last few years, and headline inflation is finally easing considerably across all major advanced economies. Wage growth has, on the other hand, remained elevated and is falling more slowly, which would normally suggest an increase in disposable income. However, the effective cost of household borrowing has also risen sharply, and this has started to exceed wage growth. We expect this dynamic to continue in 2024. This will hold back consumption and be detrimental for living standards, especially because of the waning of three important sources of support:

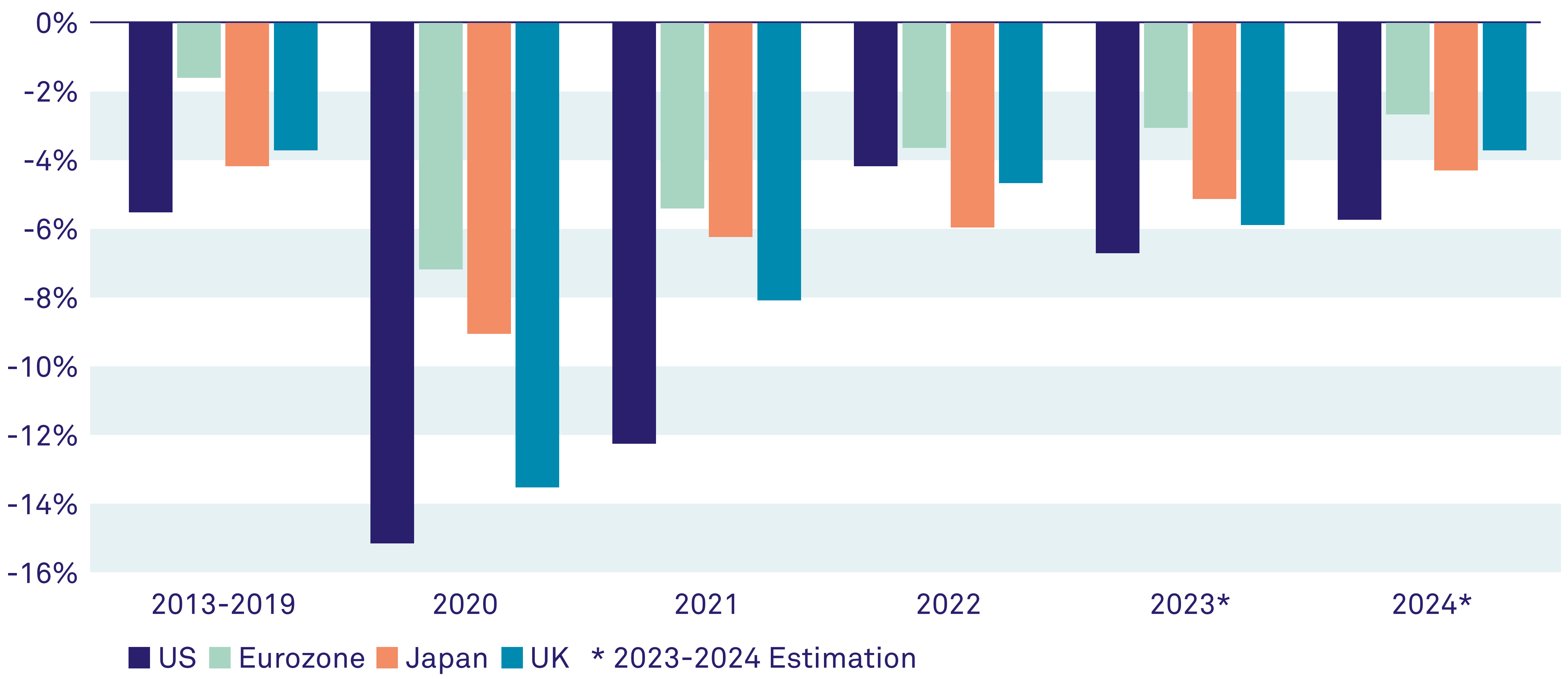
Fiscal stance turns restrictive: as shown in figure 3, in 2023 fiscal deficits were still running above their pre-pandemic averages in all major advanced economies. The fiscal stance for the aggregated advanced economies was still expansive, mostly because of the US. However, for 2024 we expect all major economies to experience a restrictive fiscal stance, as the high interest rate environment leaves little room for additional government borrowing to support

Figure 2 GDP growth (year-on-year) **- advanced economies**



* 2023-2024 Estimation Source: Refinitiv, Triodos Investment Management

Figure 3 Government budget balance (% of GDP)



Source: NiGEM, Triodos Investment Management households, and the energy-related support was a one-off. Consequently, fiscal deficits will lower in 2024.

US excess savings become depleted: The accumulation of excess savings across advanced economies has been huge because of COVID-related fiscal support. However, outside the US there has been no willingness to dip into these excess savings. This is likely the result of different savings habits in combination with a more dismal economic situation. We do not expect this dynamic to change next year. On top of that, we foresee US excess savings becoming largely depleted in the first half of 2024.

Labour markets continue to cool: Extremely tight labour markets have also acted as a buffer by creating additional jobs, providing job security and significant wage growth. Although peak tightness is now behind us, there are still significantly more vacancies than unemployed people in every major advanced economy except the UK. We expect a further gradual cooling of labour markets, but only the UK will reach its long-term average unemployment rate in 2024.

Looking at these fading supports, it is likely that the US will continue to see modest gains in consumption in first part of 2024, until the excess savings have been completely depleted. Consumption weakness has already arrived in the eurozone and the UK, and especially UK consumers will increasingly feel the effects of high interest rates as they are more exposed via flexible mortgage rates. Japanese consumption will stay muted.

Inflation will approach central bank targets

A bright spot next year will be the further easing of headline inflation across advanced economies. This is partly predicated on our assumption that energy prices will remain broadly stable at current levels. Next to that, we expect that the further cooling of labour markets will reduce wage pressure. Still, this will be a slow process, especially in the eurozone and the UK, where the peak in inflation was higher than in the US, and labour productivity growth negative, keeping unit labour cost growth more elevated. The situation in the UK is different from the eurozone though, with the UK experiencing an outright wage-price spiral.

Overall, towards the end of 2024 we expect headline inflation to be approaching the 2% central bank targets in the US and Japan, while eurozone headline inflation should by then also be below 3%. We expect UK inflation to still be hovering around 4%. The combination of a recession and easing inflation will likely be enough for the Federal Reserve, the European Central Bank and the Bank of England to start lowering their policy interest rates in the second half of 2024. We expect more aggressive rate cuts in the US and the UK, as we expect recessions in these countries in 2024. The Bank of Japan will likely finally leave behind the era of negative policy interest rates, be it at a modest pace.

The risks to this inflation outlook are tilted to the downside. The war in Ukraine and the conflict in the Middle East could both easily escalate further, resulting in renewed pressure on food and energy prices. This could force central bankers to further tighten monetary policy and would severely impact living standards through more elevated inflation and higher interest rates.

High refinancing rates will hamper business investment

Companies have so far seemed relatively immune to the sharp rise in borrowing costs. In fact, since the start of 2023, net profit margins have on average increased in all major advanced economies. This seems odd, but on closer inspection we find that this has been almost completely driven by large, cash-rich companies, which had ample pricing power and were able to ‘play the yield curve’. This means they locked in their financing needs when interest rates were still low and put their cash to work in the high interest rate environment. This will boost their net profit margins until debt must be refinanced. We believe that time will arrive in 2024. In combination with slowing demand, this will lower profits and thereby business investment. The smaller companies that did not have ample cash reserves could already be much closer to this boiling point.

Unfortunately, companies that are needed for the sustainability transition, such as renewable energy companies, have felt the pain of high rates the most, as their projects are capital intensive and require large upfront investment. A similar problem of our current system is visible in the housing sector. Residential construction has already been severely impacted by the sharp rise in interest rates, and we expect limited recovery. This is worrying, considering the housing shortages in advanced economies and the need to insulate homes to reduce energy demand. The current setup of boom-bust economic cycles clearly does not promote stable, long-term sustainable investment.

Weak trade for the wrong reasons

Global trade (volume) has declined after reaching its COVID-reopening peak in September 2022. The shift from goods to services consumption and slow global growth both played their part. We expect the trade weakness to continue in 2024, on the back of weakness across advanced economies. However, an upturn in the global manufacturing sector should eventually be the start of a recovery. For all major advanced economies, the contribution of net trade to economic growth in 2024 is expected to be broadly neutral, balancing between weak domestic and external demand. In 2023, trade was positively contributing to growth in all advanced economies, mostly because of weakening domestic demand as the COVID effects faded.

The ongoing geopolitical fragmentation is a clear threat to global trade. Surely, shorter supply chains would benefit the planet, but currently this comes at the expense of global living standards. On top of that, increased fragmentation would likely hurt the global cooperation required to address the climate crisis and stay within our planetary boundaries. In that respect, the US presidential elections in 2024 will be key, as a possible re-election of Donald Trump would likely accelerate this fragmentation. Either way, nearshoring and strategic partnerships will become more important, both from a geopolitical and sustainability transition perspective. But a true post-growth solution would be achieved through more global cooperation.

‘Post-growth’ would foster much needed transitions

The prospect of yet another year of meagre economic growth and an increasingly limited fiscal space is likely causing policymakers a headache. Like last year, many households will struggle, and policymakers will be tempted to prevent a deterioration of living standards by cutting spending on climate or other sustainability-related plans. The recent extreme weather events around the world have shown us, however, that the climate crisis is a real threat to both current wellbeing and future prosperity. Immediate action is thus needed, which would require policymakers to let go of the false trade-off between living standards and sustainability concerns. Especially lower income households, whose financial situation deteriorates the most in a low-growth environment, are also most exposed to for instance air pollution and extreme weather.

Luckily, some progress is already being made, as little by little advanced economy governments are embracing household wellbeing as a preferred measure instead of economic growth. But big changes must still be made if we want to return to within the limits of our planet. An appropriate next step would be ending fossil fuel subsidies, which are already under considerable public pressure. Promoting a shift from income to wealth taxation, in combination with increased pollution and resources taxes would also be great, as it would reduce inequality and overconsumption. In that sense, 2024 will be a year full of post-growth opportunities.

Real GDP growth (%)

	2022	2023	2024
Global	3.4	3.1	2.8
US	1.9	2.5	1.1
Eurozone	3.4	0.4	0.4
UK	4.3	0.6	0.2
Japan	1.0	1.9	0.7
China	3.0	5.0	4.6
India	7.2	6.6	6.2

Source: NiGEM, Triodos Investment Management

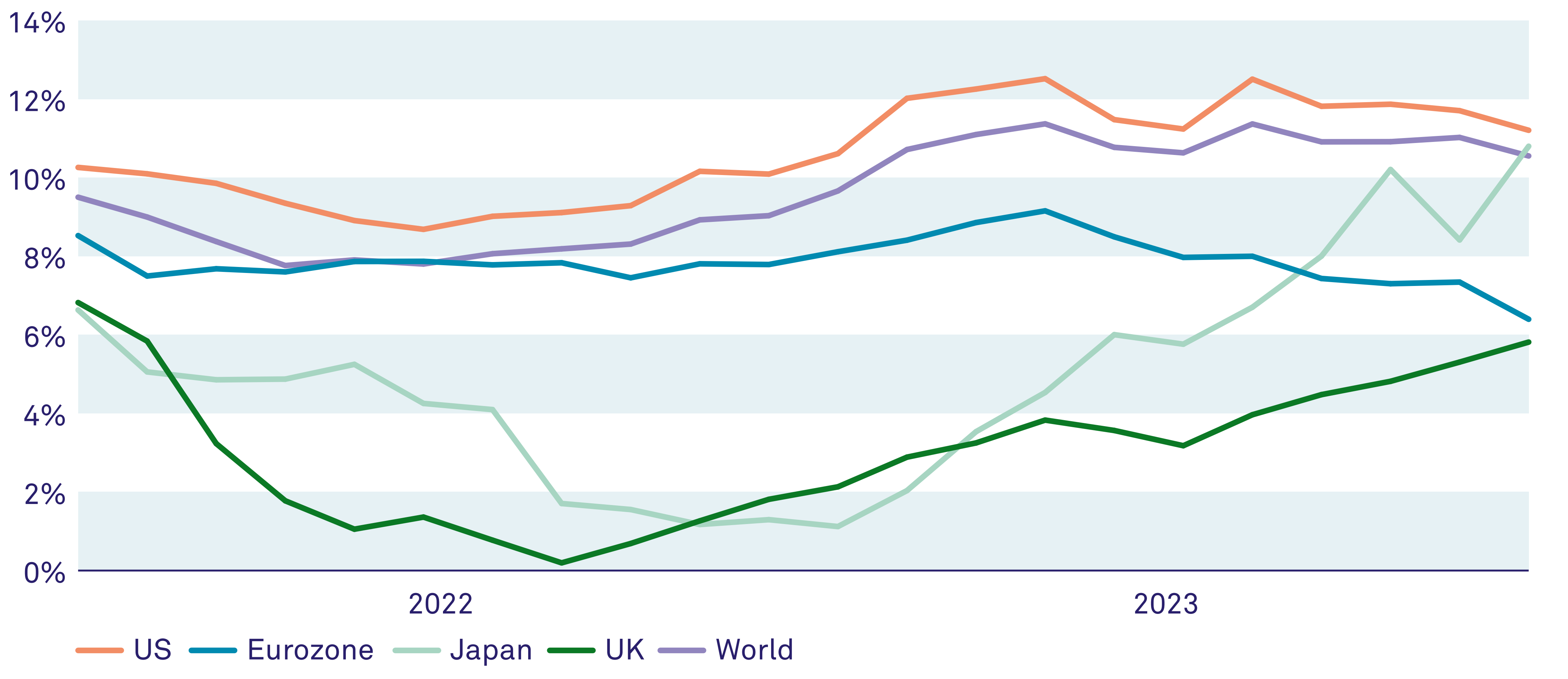
Investment outlook 2024

Financial markets have been tossed back and forth between soft landing hope and recession fear. Soft landing hopes have so far prevailed, but we think they are misplaced. Our below-consensus economic outlook warrants caution with respect to risk assets, certainly in the first half of the year. But with pandemic stimulus effects still not completely faded, we deem it wise to remain pragmatic for the time being, warranting a neutral allocation stance. Ultimately, policy rate cuts will provide relief for equity markets as we approach year-end.

Our outlook for financial markets is centred around our call that as previous stimulus dries up, households and corporates will be increasingly exposed to elevated borrowing costs. The result will be recessions in most major advanced economies, but no global recession. With the recent flare up in geopolitical tensions, it is not hard to see why we deem the risks to this market outlook to be to the downside, as disruptions in global trade and oil supply would certainly induce a risk-off sentiment. But we also acknowledge that it could take longer before previous stimulus dries up, allowing households and corporates to sit out higher rates until central bankers cut them again, thereby preventing substantial weakness in profit growth.

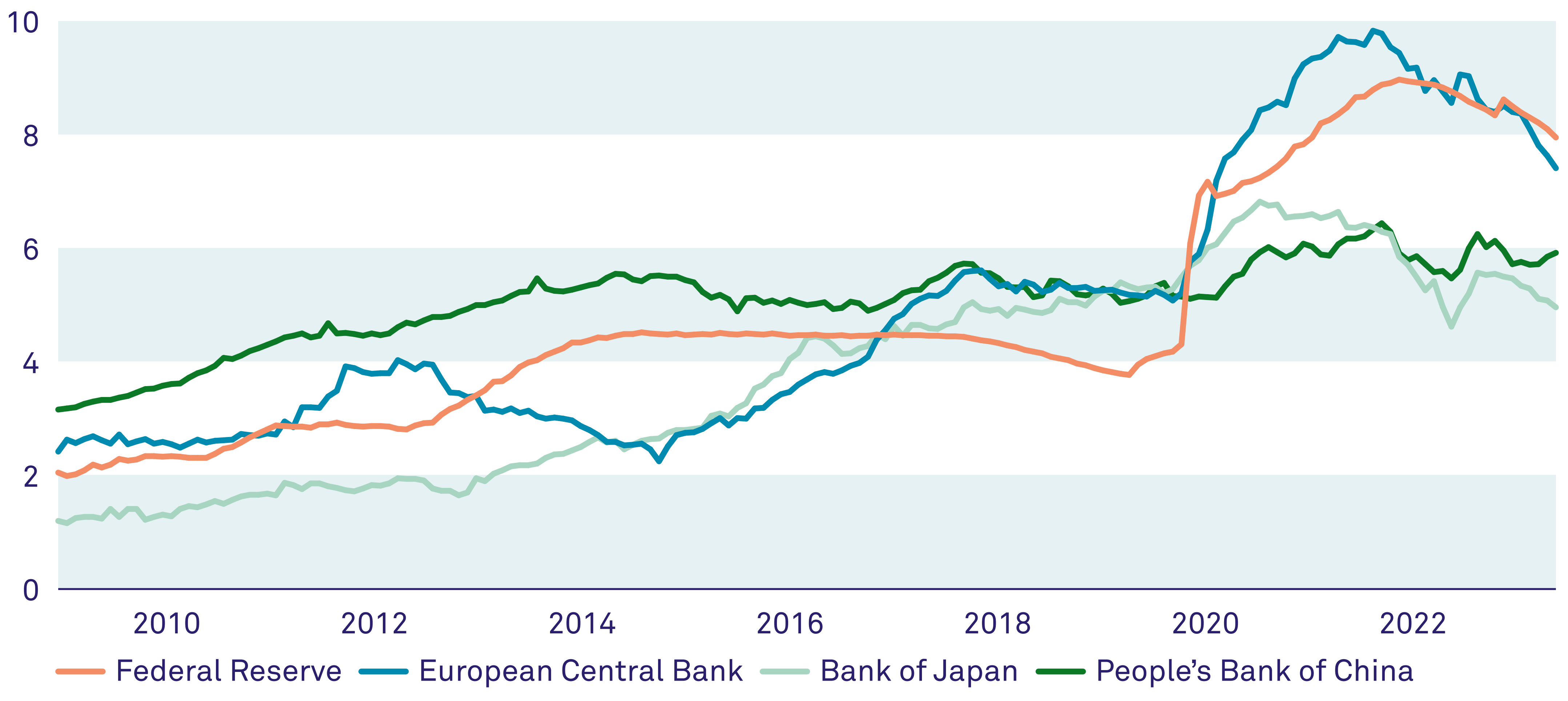
Equities: from heavy clouds to clear skies
Equity market performance has surprised us in 2023, with investors broadly ignoring the sharp increase in interest rates. A little dent in 2023 profit growth seems to be all that investors expected as a result of the aggressive monetary tightening, as profit growth expectations for 2024 are anything but humble. We think these expectations are unrealistic, however, as the latest earnings season has shown us that revenues are starting to come under pressure. We expect this dynamic to continue as global demand further weakens. As explained in our advanced economies economic outlook, we also expect profit

Figure 4 IBES MSCI - EPS consensus forecasts 2024 (year-on-year growth)



Source: Refinitiv Eikon, Triodos Investment Management

Figure 5 Major central bank balance sheets - total assets (USD trillion)



Source: Refinitiv Eikon, Triodos Investment Management margins to come under increasing pressure due to refinancing needs and reduced pricing power. The result should be significant negative earnings surprises in the course of 2024, resulting in falling equity markets. After that, policy interest rate cuts by the major central banks, which we expect to start in the second half of 2024, should eventually drive an equity market recovery.

Bonds: the year of rate cuts
For eurozone government bonds, the ECB's financial stability considerations have always been the main reason for us to expect that the sharp rise in yields since the beginning of 2022 was bound to be partly reversed. Now that eurozone headline inflation has eased significantly, and growth in the eurozone has been subdued, the ECB will have no more reason to further hike interest rates. We expect the ECB to start cutting rates in the second half of 2024, but already expect longer-term government bonds to continue their recent fall in the first half of 2024, as markets prepare for these rate cuts and investors further lower growth expectations, which in our view are still too optimistic. Safe haven flows due to geopolitical unrest could be an additional push downwards for yields. Of course, the continuation of central bank balance sheet reduction means a large buyer has left the government bond market, but history tell us that policy rate movements are more decisive for movements in yields.

Because we expect interest rates to continue to fall, we are long duration. However, we also expect that the high interest rate environment will result in corporate financial difficulties in the course of 2024, potentially triggering a rise in downgrades. We therefore continue to prefer high-quality names in corporate bonds.

Impact opportunities
We continue to see plenty of opportunities in the sustainable investment landscape. The European Green Deal, the EU's roadmap for making its economy sustainable, will be a counterweight to the populistic urges of governments in response to the subdued economic growth in 2024. The related green taxonomy will enable investors to steer their investments towards more sustainable technologies and businesses, and the creation of an EU Green Bond Standard will deliver a uniform tool to assess green bonds. The Sustainable Financial Disclosure Regulation (SFDR), part of the EU's Green Deal, also makes investors more aware of financial risks related to sustainability, and to some extent limits the options for greenwashing. The Green Deal will also force companies to become more transparent.

In Japan, we expect to continue to find sustainable investment opportunities, as corporate governance continues to improve due to top-down governance initiatives while bottom-up, initiatives such as the Sustainable Development Goals are high on companies' agenda. In the US, the Inflation Reduction Act will continue to spur the green transition with over EUR 350 billion of green subsidies. Overall, we will continue to contribute to the envisioned transition by focusing on investments that support climate mitigation and adaption and the fulfilment of the Sustainable Development Goals in this decade.

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With over 25 years of experience as a globally active impact investor, and as a wholly owned subsidiary of Triodos Bank, Triodos Investment Management has developed deep sector-specific insights across Energy & Climate, Inclusive Finance, Sustainable Food & Agriculture, and Impact Equities and Bonds. Offering impact solutions through private equity, debt, and listed equities and bonds, our assets under management amounted to EUR 5.5 billion as per 31 December 2022.

Investing in positive change

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Published
November 2023

Text
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Design and layout
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Cover photo
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Triodos Investment Management