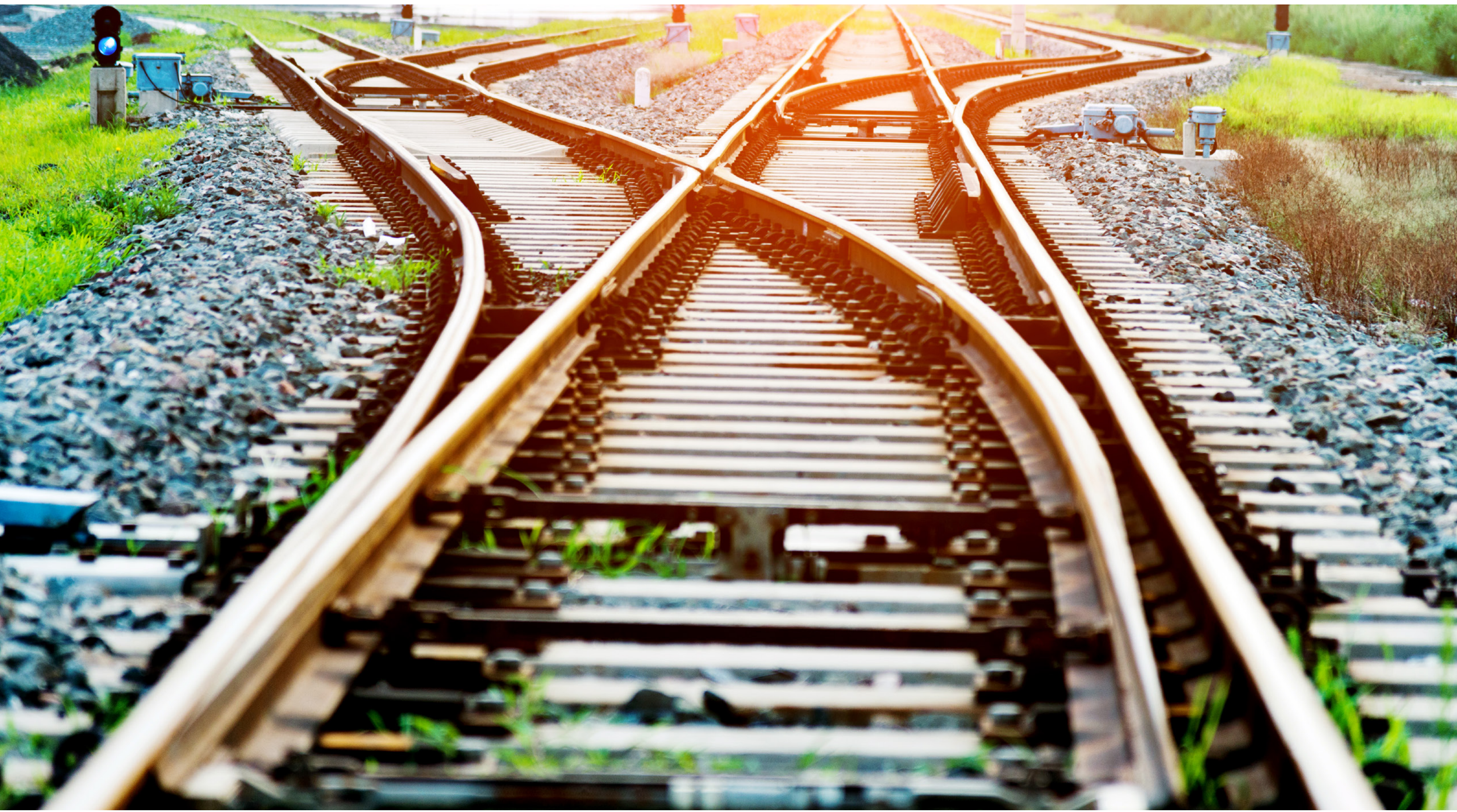

RAHEEL SIDDIQUI
Senior Research Analyst, Global Equity Research

NEUBERGER BERMAN

Equity Market Outlook 1Q 2024

Making Sense of Mixed Signals

Against long odds, 2023 marked a year of magnificent returns and the return of investor optimism.

As fears of sticky inflation faded, a combination of global liquidity injections and AI optimism helped buoy markets and push a handful of mega-cap names—the so-called Magnificent Seven—to astonishing heights. More recently, expectations of aggressive rate cuts by the Fed broadened the rally and soothed hard-landing concerns.

In our **1Q 2024 Equity Outlook**, we examine the sustainability of the potentially precarious drivers that, in our view, are underpinning the market rally. We also highlight lesser-known investment characteristics of the Mag 7, as they will likely continue to shake up active-management scorecards in 2024. Against this ever-challenging backdrop, *we continue to emphasize quality equity portfolios with low Beta and minimal sensitivity to the underlying business cycle.*

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Investment Themes and Views[1]

Based on their relative sensitivity to changes in inflation and financial conditions, and their historical beta to the stock market, we offer the following as our overweight and underweight views:

OVERWEIGHT VIEW ON:

Factors and Styles:

- Low beta
- High quality
- Large caps
- Momentum
- High earnings visibility
- U.S. stocks

Industry Groups:

- Household & Personal Products
- Telecom Services
- Food & Staples Retailing
- Health Care
- Utilities
- Food Beverage & Tobacco
- Equity Real Estate Investment Trusts (REITs)

UNDERWEIGHT VIEW ON:

Factors and Styles:

- High beta
- Low quality
- Small caps
- Low earnings visibility
- Speculative growth
- Ex-U.S. stocks

Industry Groups:

- Automobiles & Components
- Energy
- Banks
- Consumer Durables & Apparel
- Transportation
- Semiconductors & Semiconductor Equipment
- Technology Hardware & Equipment
- Capital Goods

NEUTRAL VIEW ON:

- Value
- Growth

[1] For illustrative and discussion purposes only. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. The firm and its portfolio managers may take positions contrary to any views and themes expressed.

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Taking Stock of a Strong 2023 and the Year-End Rally

It is hard to recall another year in recent memory during which the interplay between the economy and markets was more of a head-scratcher for bears, bulls, the Fed and the broader community of commentators. It was a year in which the S&P 500 and the real economy diverged quite meaningfully. We believe the nature and drivers of this divergence offer important cues for our outlook on equities in 2024.

Cyclical Decline

As we anticipated, the cyclical economy began to buckle under the weight of higher interest rates over the course of the year. That cyclical slowdown in the U.S. manifested in myriad ways in 2023:

- *Labor:* Both the breadth and duration of unemployment rose;[1] cyclical employment growth stalled;[2] continuing claims moved higher;[3] and hours worked shrank.[4]
- *Production:* Both industrial production and the manufacturing PMI have declined.[5]
- *Investment:* Fed surveys find that companies are reducing their capex plans for 2024;[6] home sales and single-family units under construction declined;[7] non-residential fixed investment declined;[8] and loan growth, leading indicators and money supply (measured by M2) contracted.[9]
- *Growth:* More U.S. states exhibited sequential economic weakness;[10] small business sales contracted;[11] corporate bankruptcies and consumer delinquencies rose;[12] consumers' share of discretionary spending contracted;[13] tax receipts dropped;[14] and net earnings revisions for the S&P 500 fell into negative territory.[15]

Easing Inflation

Despite gradual deterioration in the cyclical economy, the market chose to focus on inflation, which eased steadily.

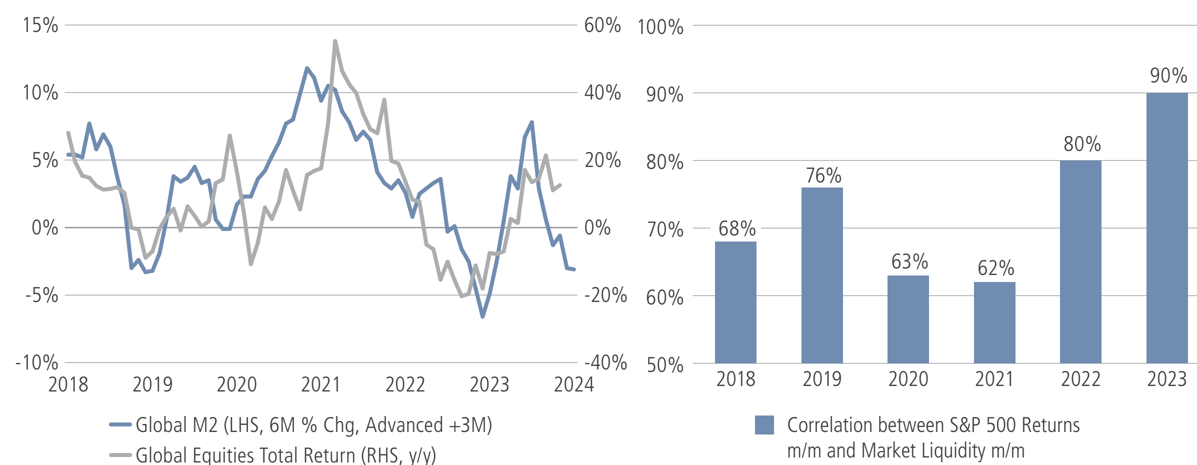
As 2023 progressed, the Flexible CPI (which primarily tracks goods and energy prices) decelerated sharply toward deflation, while the Atlanta Fed's Sticky CPI (driven mainly by labor costs) descended halfway to the Fed's 2% target from where it ended in 2022.[16]
For much of the year, the market action was dominated by a stunning recovery in tech, and a handful of mega-caps pulled the S&P 500 along. The AI hype helped, as did their earnings, which proved better than expected. These events—along with substantial injections of liquidity earlier in the year—helped boost equity valuations, despite the Fed's aggressive hiking cycle.

[1] Source: FactSet. Data as of November 30, 2023.
[2] Ibid.
[3] Ibid.
[4] Ibid.
[5] Ibid.
[6] Ibid.
[7] Ibid.
[8] Ibid.
[9] Ibid.
[10] Ibid.
[11] Ibid.
[12] Ibid.
[13] Ibid.
[14] Ibid.
[15] Source: Mill Street Research. Data as of December 15, 2023.
[16] Source: FactSet. Data as of November 30, 2023.

Oceans of Liquidity

In addition to easing inflation, we believe substantial liquidity injections have significantly buoyed global equity returns, as shown on the left side of figure 1. (For additional context, please see the "Liquidity Dynamics" sidebar.) On the right side, we show that the correlation between market liquidity and equity returns averaged an extraordinary 90% during 2023—the highest level during the six years for which we have data.

FIGURE 1: LARGE INJECTIONS OF LIQUIDITY HAVE HELPED SUPPORT GLOBAL EQUITY MARKETS



Source: Left chart: Neuberger Berman and FactSet. Data as of November 30, 2023. Right chart: GFR Macro. Data as of December 5, 2023. **Past performance is not indicative of future results.**
Note: Annual market liquidity (shown in the right-hand chart) is estimated by the average inverse of the normalized bid/ask spread for the overall equity-options market.
For illustrative purposes only.

Absent these significant liquidity injections, we believe conventional wisdom would have predicted a flat to slightly negative market return in light of the weakening economic backdrop. Instead, all that liquidity stoked a lopsided market in which traditional bellwethers of economic revival—small caps and value-based sectors—trailed long-duration growth stocks with ostensibly below-average economic sensitivity. (More on the mega-cap tech rally below.)

Liquidity Dynamics in 2023

- Starting in the fall of 2022 (when S&P 500 was treading in the 3500s), roughly $8 trillion in new liquidity—mostly from China, Europe and Japan—washed over the global economy in just three months.[17] The stock market welcomed it, and the S&P 500 rallied 14% by the end of January.[18]
- Next came the U.S. banking crisis in March 2023. To prevent a run on the banks, the U.S. injected an estimated $378 billion of net liquidity into the financial system.[19] We believe this potent offset to the shrinking U.S. M2 money supply eased tightening financial conditions and boosted the stock market further.

  Following the fall of Silicon Valley Bank, the Treasury was able to provide fiscal stimulus without siphoning liquidity from the banking system and, ultimately, the economy. The Fed's quantitative tightening (QT) campaign, along with the build-up in the Treasury General Account, could have drained $1.44 trillion from the system; however, cash flowing out of the Fed's Reverse Repo Purchase account (RRP)—also $1.44 trillion—financed the Treasury's needs without pressuring bank reserves. By our estimate, U.S. liquidity effectively expanded by $381 billion over the course of 2023.[20]
- At the current rate of decline, the RRP may be fully drawn sometime in Q1 2024. At that point, the government will have to finance itself by issuing coupon-bearing debt, which we anticipate would simultaneously drain reserves from the banking system. If not accompanied by forceful rate cuts, we fear the reduction in systemic liquidity could become a drag on the equity market.

Powell's Pivot and its Potential Consequences

Federal Reserve Chair Jerome Powell recently ignited a massive rally in nearly all financial markets, easing financial conditions very broadly and providing a stimulus for the economy in 2024. Encouraged by the progress seen in inflation and inflation expectations, the Summary of Economic Projections dialed back a 2023 hike, hinted at a 2024 cut and forecast an additional four cuts by 2025. In effect, the Fed telegraphed 75 bps in rate cuts *en route* to a potential soft landing.[21] As of December, investors expected even further relief: Fed fund futures as of mid-December implied 138 bps in potential cuts.[22]

After Powell's pivot, equities, bonds and precious metals soared, and the dollar's retreat was unmistakable. Interest rate-sensitive segments of the stock market—already on the rise since October 23, when the 10-year yield peaked at 5.02%—continued to rally and significantly outpace the S&P 500's more modest, though still substantial, 12% gain.[23]

Investors welcomed the increase in market breadth and have begun to extrapolate it into 2024. The FOMC, on the other hand, disagreed with the market reaction, perhaps revealing how out of tune it had been with the market's mood. In an orchestrated expression of surprise, the Fed's leading doves broadcast concern with the market's leap of faith, hinting that hikes were still on the table and rate cuts were a premature discussion.

[17] Source: Neuberger Berman Research and FactSet. Data as of November 30, 2023.
[18] Source: FactSet. Data as of December 15, 2023.
[19] Ibid.
[20] Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023.
[21] Source: U.S. Federal Reserve. Data as of December 13, 2023.
[22] Source: FactSet. Data as of December 15, 2023.
[23] Source: FactSet. Data as of December 15, 2023. Since October 23, 2023, the S&P 500 Home Builders Index rose 35%; the KBW NASDAQ Regional Banks index, 31%; the PHLX Semiconductor Index, 24%; the S&P Small Cap Value Index, 22%; the S&P 500 Real Estate Index 21%, and S&P 500 Retailing Index, 20%.

It was a striking attempt at regaining narrative control, but in our view investors seemed uninterested. After the Fed's media appearances, yields for 2-, 5-, 10- and 30-year U.S. treasuries tumbled between 26 and 37 bps, the Bund and JGB followed suit and the S&P 500 advanced another 3.8% in straight gains.[24] If "Don't fight the Fed!" was the old adage for investors, December's message from investors to the Fed felt more like "Don't fight the markets!"

We believe it would take a series of resolute actions by the Fed to reestablish its commitment to tighter monetary policy and restore its place in the pecking order relative to the market. If Powell dampens the mood by not cutting rates soon, we fear a significant tightening of financial conditions could precipitate a sharp selloff in stocks and bonds.

Growth Challenges

While improvements in market breadth suggest that a more inclusive rally could be on the horizon, we believe a sustained rebound will require significant economic growth and liquidity—and risks to both, in our view, remain substantial.

First, fiscal stimulus is waning and broadly less supportive of growth. Consumer spending remains robust, but its drivers are fading fast: Household cash balances are being drawn down; consumer credit conditions have deteriorated; delinquencies are rising; and with inflation waning, the social security cost-of-living adjustments in 2024 will be a much smaller 3.2% versus 8.7% in 2023.[25]

And while stabilizing margins among the S&P 500 have improved the earnings outlook, topline growth is flagging, with positive sales surprises falling noticeably behind earnings surprises. Significantly, the next-12-month sales growth for the index is expected to remain below the fed funds rate.[26] Should that trend not reverse soon, the cost of financing sales may disincentivize companies to pursue new growth initiatives.

Good News Looks Priced In

Given the onerous mix of a Fed-induced rally and a still-weakening economy, we believe a lot of good news is now priced into stocks.

First, according to Deutsche Bank, total equity exposure among discretionary investors (hedge funds and mutual funds) has reached the 86th percentile of weekly data dating to 2010.[27] Similarly, elevated positioning levels have historically reverted to the mean in short order, which we think is likely next year. Additionally, positive sentiment is extremely high: Since 1987, equity investors polled in the recent AAII Investor Sentiment Surveys have been more bullish only 8% of the time,[28] and we roughly estimate that U.S. large caps are now pricing in only a 5% recession probability.[29]

[24] Source: FactSet. Data as of December 15, 2023.
[25] Source: Social Security Administration.
[26] Source: FactSet. Data as of December 15, 2023.
[27] Source: Deutsche Bank. Data as of December 15, 2023
[28] Source: FactSet. Data as of December 15, 2023.
[29] Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023. Note: To approximate the degree to which we believe the odds of recession are priced into a given security, we calculate a probability ratio equal to the stock's decline from its previous all-time high versus its median decline in earlier recessions.

Second, we believe a favorable demand-supply balance has been providing further support for equities. J.P. Morgan estimates that, in 2023, institutional demand for stocks (primarily driven by equity long/short funds) exceeded supply by roughly $2.5 trillion, which supported the market rally.[30] But the script looks likely to flip next year: The bank estimates that the supply of equities could exceed demand by $1.6 trillion in 2024, as big funds look to moderate their long positions from historically elevated levels.

In light of these developments, *our analytical framework still calls for caution.* Credit growth across the economy remains negative and the real Fed Funds Rate is still elevated. And while inflation continues to fall, the Fed may not be out of the woods yet: The labor market remains tight; wage growth exceeds 5%;[31] and above-trend savings and household net worth are fueling consumption among those with higher incomes.[32]

In this environment, we believe the Fed's anticipated rate cuts, should they materialize, could run the risk of stimulating enough broad-based growth to reignite higher prices. Despite the market's collective hopes, inflation—albeit seemingly in the rearview—may not have been fully tamed, and we fear a potential re-pivot by the Fed, amidst historically extreme investor optimism and positioning, would not bode well for equities.

[30] Source: "Flows and Liquidity: Equity demand and supply for 2024", J.P. Morgan, November 30, 2023.
[31] Source: FactSet. Data as of November 30, 2023.
[32] Source: Neuberger Berman Research and FactSet. Data as of September 30, 2023.

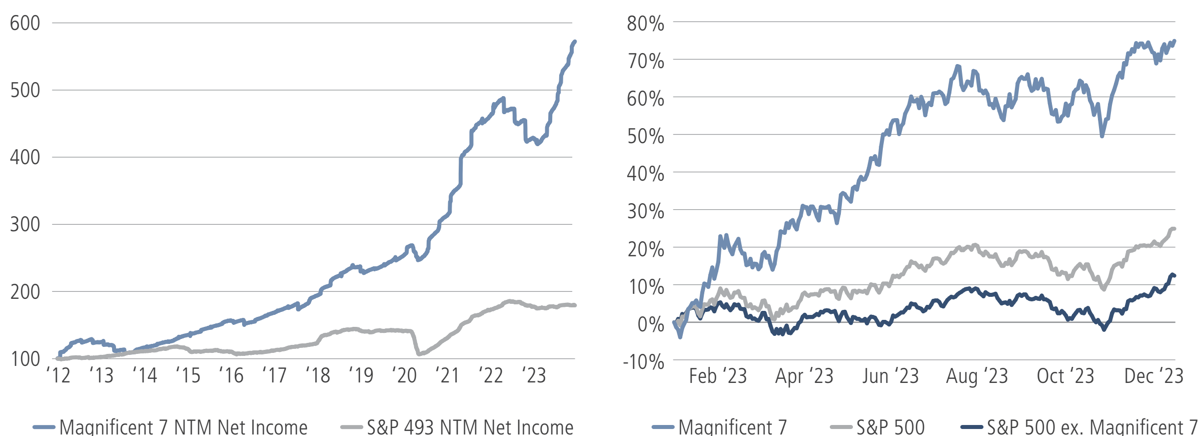
The Magnificent Seven: Resplendence and Risk

All That Glitters…

Envy of the other 493 stocks in the S&P 500, the so-called Magnificent Seven—including Apple, Alphabet, Amazon, Meta, Microsoft, Nvidia and Tesla—wears extraordinary stripes. In the seven years prior to the Covid-19 pandemic, their collective top line grew at 15% compounded annually, versus just 2% for the rest of the index. Since 2020, the Mag 7 have increased sales by 16% a year.[33]

Even in a challenging growth environment, these heavyweights delivered impressively in 2023: The Mag 7's net income grew 34% versus 1% for the other 493 stocks in the index (see the left side of figure 2), and in a show of investor confidence, their collective P/E multiple expanded 30% compared to 9% for all the rest. As a group, the Mag 7 generated a 75% return for the year versus 25% for the S&P 500; without them, the broader index would have risen just 12% (as shown on the right).

FIGURE 2: THE MAGNIFICENT SEVEN HAVE DOMINATED THE OTHER 493 NAMES IN THE S&P 500 INDEX



Source: FactSet. Data as of December 15, 2023. **Past performance is not indicative of future results.**

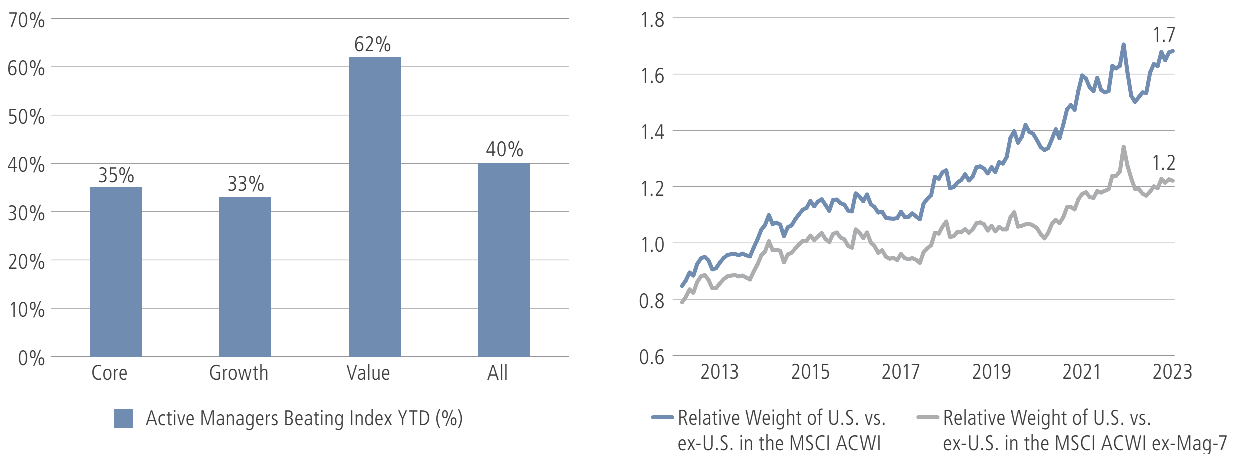
Big tech's influence on sector performance was palpable, too. Without these seven names, the Tech sector would have returned just 15% rather than 50%; the Communication Services sector, 7% versus 50%; and the Consumer Discretionary sector, 6% versus 33%.[34]

We believe the collective heft of the Mag 7 has even broader implications for U.S. investors. The influence of this group—which now comprises nearly half the market-cap weight of the Russell 1000 Growth index and 28% of the S&P 500—has been boldly on display. In 2023, just one-third of U.S. core- and growth-oriented funds outperformed their Mag 7-heavy benchmarks, whereas nearly twice as many value funds outpaced their benchmarks, which don't include the Mag 7 (see the left chart in figure 3).

[33] Source: FactSet. Data as of December 15, 2023.
[34] Source: Strategus. Data as of December 5, 2023

The Mag 7's influence spans geographical borders as well. The weight of U.S. equities in the MSCI ACWI index has risen to an all-time high of 63% from just 46% in 2013. Less appreciated, perhaps, is that fully a third of this increase is due to the rise of the Mag 7! As a result, the U.S. now accounts for 1.7 times the weight of the rest of the world combined; without the Mag 7, the figure is a more modest 1.2 (as shown on the right). Such a reduction in geographical diversification within the index, we believe, could have longer-term implications for asset allocation and risk management.

FIGURE 3: THE COLLECTIVE HEFT OF THE MAG 7 HAS BROAD RISK-MANAGEMENT IMPLICATIONS



Source: Left side: Lipper Analytical Services, BofA Equity & Quant Strategy; right side: FactSet. Data as of November 30, 2023. Past performance is not indicative of future results.

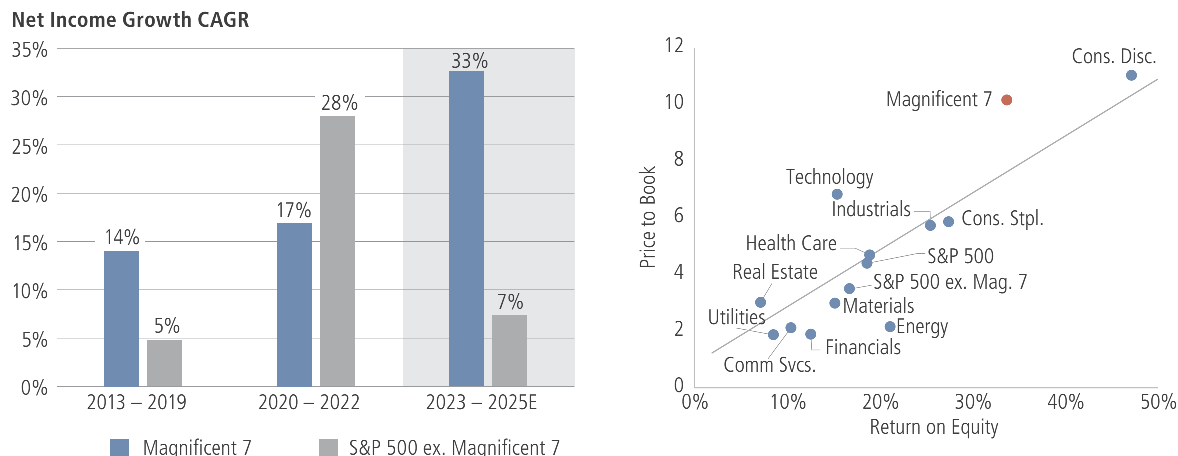
In light of their sheer size and influence, we expect the Mag 7 will continue to shake up active managers' scorecards relative to their benchmarks in 2024, and beyond.

…May Not Keep Turning to Gold

The Mag 7's achievements in 2023 notwithstanding, we fear these marquee stocks could face headwinds in the coming year.

First, valuations appear precarious, in our view. Wall Street expects the Mag 7's earnings and revenues to grow 33% and 17% per year, respectively, through 2025 (see the left chart in figure 4). Yet even considering the group's relatively high returns on equity (shown on the right), the Mag 7 has the unnerving distinction of being the largest and most expensive grouping within the S&P 500. At current valuations, we believe this group—which now represents more than a quarter of the S&P 500—is roughly 60% more expensive on a P/E basis than the rest of the index, making them potentially vulnerable to even minor hiccups in the coming year.

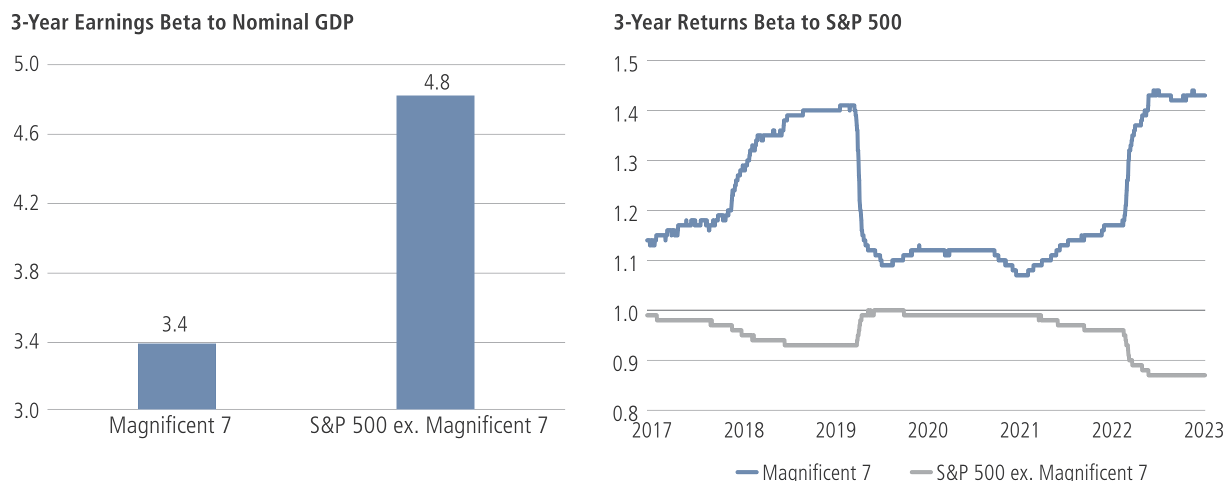
FIGURE 4: THE MAG 7'S STRONG EARNINGS EXPECTATIONS ARE COMMANDING RELATIVELY RICH VALUATIONS



Source: FactSet. Data as of December 15, 2023. Note: For the right-hand chart, data for the Technology, Consumer Discretionary and Communication Services Sectors are shown excluding the Magnificent 7 stocks. **Past performance is not indicative of future results.**

Second, the Mag 7 may prove more cyclical than investors seem to expect. These giants are often considered defensive businesses given that their products drive the relentless modernization of society, and that they also boast strong balance sheets and relatively high, stable profit margins. Indeed, over the last three years, the Mag 7's earnings beta to nominal GDP has been 30% lower than the rest of the S&P 500 (see the left side of figure 5); however, the price beta of these stocks—at 1.4—was 50% higher than the rest of the S&P 500 (as shown the on right).

FIGURE 5: THE MAG 7 MAY BE LESS DEFENSIVE THAN INVESTORS ANTICIPATE



Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023. **Past performance is not indicative of future results.**

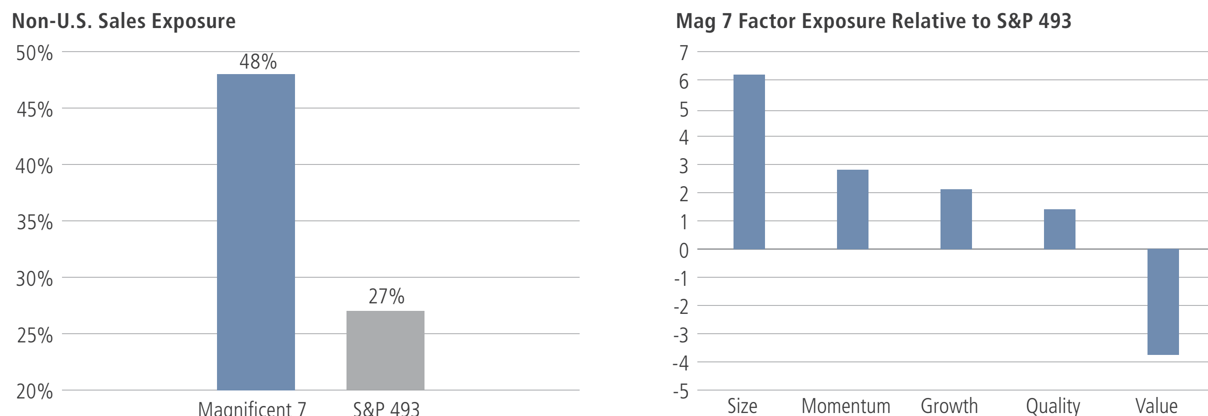
Third, we believe the price returns of these seven stocks are highly correlated to each other—meaning that, from a portfolio perspective, owning them as a group is akin to inviting additional risk rather than diversifying away from it. Since 2017, the average pairwise correlation of the Mag 7 has been 55%—that's 70% higher than for the rest of the 493 stocks.[35] Furthermore, we find that correlation tends to rise during selloffs, which could make holding these stocks even riskier in a downturn.

Therefore—and despite some of their defensive characteristics—we fear that investors may have overlooked the inherent cyclicality and correlation of the mega-caps, potentially magnifying the investment risk should the Mag 7 begin to lose favor.

Looking at these stocks another way—through a factor lens—makes us conclude that overweighting these stocks is essentially a wager on specific factors that have contributed to their outperformance.

One of those factors is international exposure. As shown on the left side of figure 6, the Mag 7 derives roughly half of its revenues from outside the U.S., about twice the percentage for the average U.S. publicly traded company. Adding the Mag 7 to an equity portfolio could increase its sensitivity to international growth—a potential benefit when the global economy is humming, but a potential drag in a broader slowdown.

FIGURE 6: SPECIFIC FACTOR EXPOSURES MAY DETERMINE THE MAG 7'S OUTPERFORMANCE



Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023.

Additional factors may determine the Mag 7's performance in 2024. Specifically, and relative to the index, the Mag 7 are rich in size, quality, momentum and growth factors, and outperform when these factors are in vogue. As noted in our previous 4Q 2023 Equity Outlook, these factors tend to be rewarded when economic growth slows—as it did in 2023—while being relatively shunned in favor of small size, lower earnings quality and high value when growth eventually rebounds.

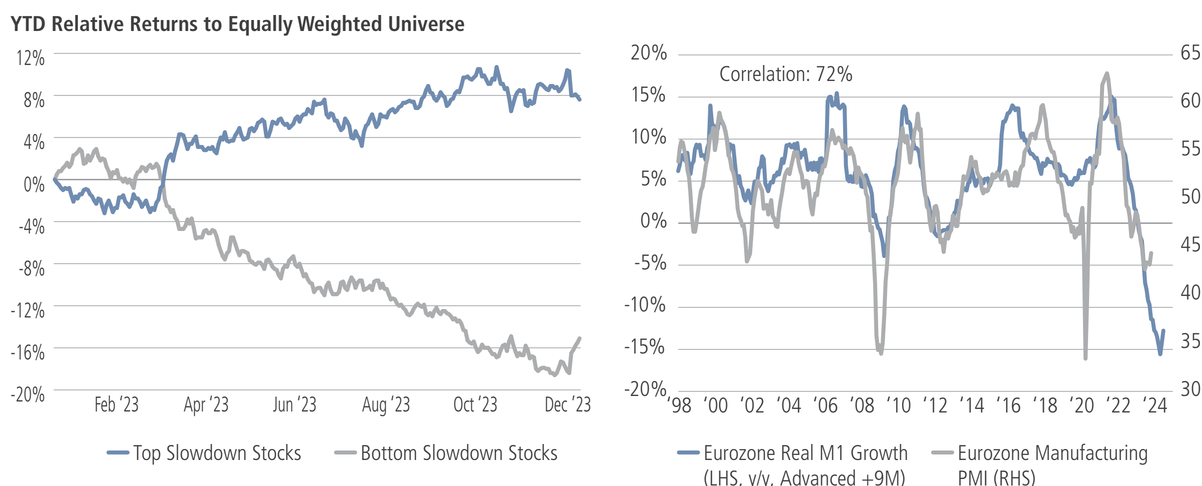
[35] Source: Neuberger Berman Research and FactSet. Data as of December 15, 2023.

What Lies Beneath the European Rally

Receding fears of a hard landing, mixed with hopes of significant interest rate cuts in 2024, have vaulted the STOXX Europe 16% year to date.[36] However, we think bullish enthusiasm will fade as European equities reconnect with the gravity of steadily deteriorating economic fundamentals.

First, consider the contours of the recent rally: As shown in the left chart of figure 7, an equally weighted basket of 50 stocks with large-cap, high-quality, high-momentum and growth tilts—factors that we find tend to outperform when growth *decelerates* and investors seek to lower overall risk—has outperformed the broader equally weighted universe by 8% year-to-date; meanwhile, an opposite basket tilted toward smaller-cap, low-quality, low-momentum and value—factors that we believe tend to outperform when growth *accelerates*—has steadily underperformed by 16%.[37] The market has spoken—and the message, in our view, isn't entirely encouraging.

FIGURE 7: RECENT MARKET DYNAMICS AND FALLING MONEY SUPPLY COULD BODE ILL FOR EUROPEAN EQUITIES



Source: Left chart, FactSet, BofA. Data as of December 15, 2023; right chart, FactSet. Data as of November 30, 2023. **Past performance is not indicative of future results.**

Note: In the left chart, the basket of "top slowdown stocks" is comprised of 50 equally weighted stocks that are most tilted toward specific factors that have historically performed well in ***decelerating*** *economic growth environments; likewise, the "bottom slowdown stocks" include 50 equally weighted names most tilted toward factors that have historically performed well in* ***accelerating*** *economic growth environments. Both baskets are plotted relative to an equally weighted universe of more than 760 stocks broadly representing the European equity market.*

Second, we believe the full impact of recent monetary tightening is yet to be fully felt. For context, since the early 1970s (when the official data began), there has never been a greater or faster reduction in the growth of M1 money supply.[38] As shown in the right chart of figure 7, the current trajectory of M1 growth—which tends to lead manufacturing PMI by about nine months—could be signaling a weakening economy.

Next, higher interest rates continue to put pressure on household borrowing costs, now the highest since the European debt crisis 12 years ago.[39] As a result, demand for consumer loans and mortgages has fallen for the last four quarters.[40] Corporations appear no

[36] Source: FactSet. Data as of December 15, 2023.
[37] Source: BofA and FactSet. Data as of December 15, 2023.
[38] Source: FactSet. Data as of November 30, 2023.
[39] Source: FactSet. Data as of November 30, 2023.
[40] Source: FactSet. Data as of November 30, 2023.

better off: Bank financing represents a full 70% of all corporate borrowing[41] in the Euro bloc (versus around 21% in the U.S.). As a direct consequence of higher interest rates, we fear companies will cut back on capex, and sales growth will slow.

The European construction sector's outlook also appears to us to be worsening. Residential building permits have plunged by 20%,[42] foretelling potentially weakening activity in this important sector. Furthermore, the IMF estimates that Europe's fiscal impulse—the change in the government budget deficit as a percentage of GDP—will be negative next year, suggesting that fiscal policy could be a drag on growth in 2024. Meanwhile, the European Industrial Production Index has contracted by a remarkable 6% over the past 12 months.[43]

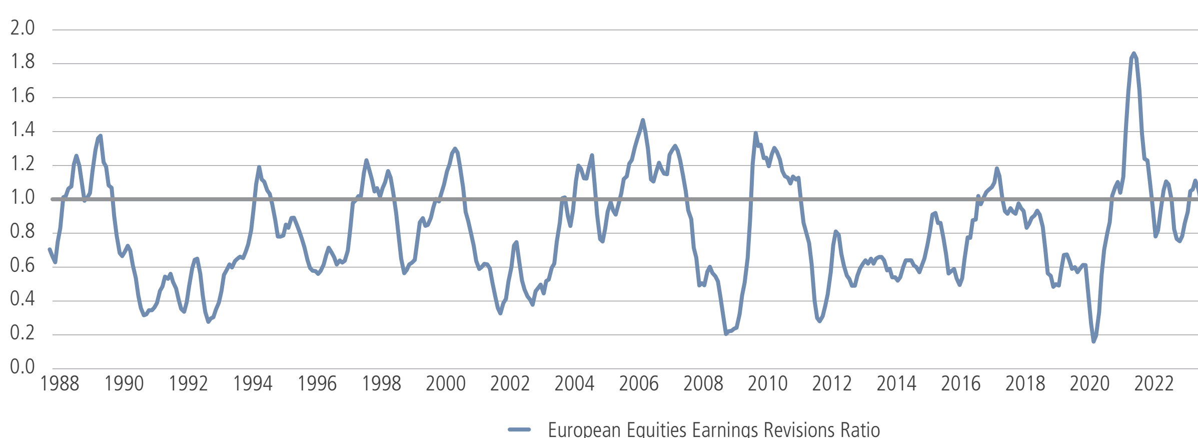
As for whether recession is truly on the horizon, labor markets often tell the tale. We believe rising unemployment across several important European economies—Germany, Italy and the Netherlands—has started to flash recessionary signals, even though the eurozone's overall jobless rate has held steady thus far.

While recent disinflation in energy-linked consumption categories has been an unqualified positive for the economy, services inflation—primarily driven by wages—remains elevated, growing at an above-target 4% year-over-year.[44] At the same time, we expect real wage growth in the eurozone is on the cusp of turning positive, which could continue to prop up services inflation.

Bulls point to the aggregate European household excess savings of about 1.1 trillion euros as a potential driver of consumer strength next year.[45] Yet unlike in the U.S., where excess savings are being depleted, low consumer confidence may be curbing spending in the eurozone. At this juncture, we believe Europe's high and rising excess household savings is more a symptom of a worsening labor market rather than a ready source for above-trend consumer spending in 2024.

Finally, within the STOXX Europe 600 index, the signs of cyclical economic deterioration are both broadening and deepening. One key metric—the Earnings Revision Ratio—has fallen below 1.0, a level that effectively separates optimism from pessimism (see figure 8).[46] Other metrics including the Sales Revision Ratio, the Capex Revision Ratio and the Price Target Revision Ratio have followed suit.

FIGURE 8: IN EUROPE, NEGATIVE EARNINGS REVISIONS NOW EXCEED POSITIVE ONES



Source: BofA European Equity Quant Strategy and FactSet. Data as of December 5, 2023.
Note: A Revision Ratio measures the number of stocks for which the consensus estimate has risen versus the number for which it has fallen. A reading above 1.0 implies more upward revisions to the consensus estimate than down, and vice versa. **Past performance is not indicative of future results.**

Given this potentially challenging backdrop, we think it is premature to overweight Europe in a global portfolio. Looking Ahead to

[41] Source: Deutsche Bank, IHS Markit. Data as of September 29, 2023.
[42] Source: FactSet. Data as of July 31, 2023.
[43] Source: FactSet. Data as of September 29, 2023.
[44] Source: FactSet. Data as of November 30, 2023.
[45] Source: Neuberger Berman Research and FactSet. Data as of September 30, 2023.
[46] Source: BofA. Data as of December 5, 2023.

Looking Ahead to 2024

What could turn us bullish—and risk-seeking—in the new year?

We are keeping a close eye on four crucial indicators:

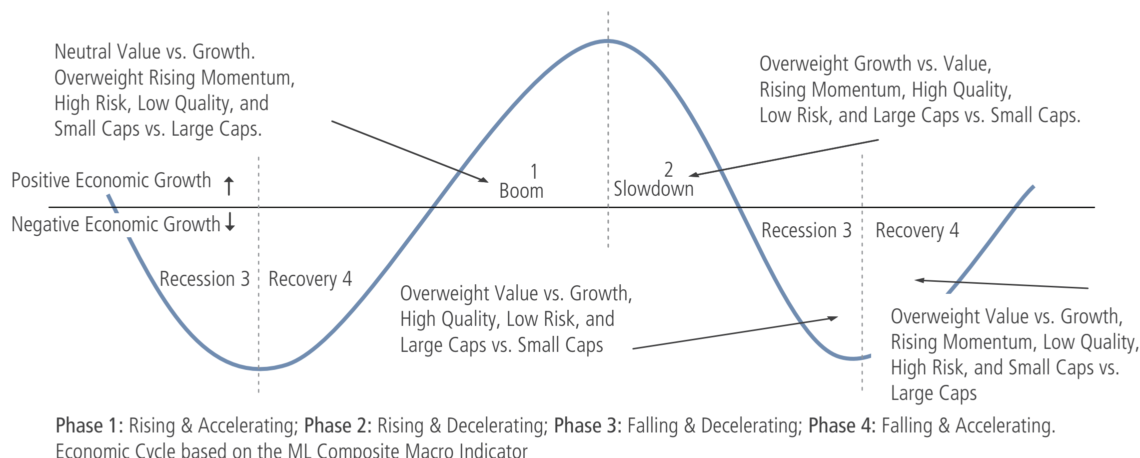
- *Interest rates.* If the Fed follows through on its projected cuts, thereby lowering the cost of capital across the economy, stocks could have more room to run.
- *The Kansas City Fed's Labor Market Conditions Index.* This aggregate of 24 labor-market indicators has been falling for more than 21 months—a sustained turnaround could be a welcome sign.[47]
- *Commercial loan growth.* Thawing credit markets could imply that a sustainable economic recovery is in the works.
- *The U.S. dollar.* A secular decline in the greenback could be a harbinger of a broader, global economic recovery—and a tailwind for equities.

In 2024, we believe the relative weight of the Magnificent Seven—more than most other considerations—could well determine the success of active management. The challenge for portfolio managers will be to nimbly calibrate the active weights of these stocks—no mean feat if volatility continues to persist.

Against this challenging backdrop, we continue to emphasize quality equity portfolios with low Beta and minimal sensitivity to the underlying business cycle. However, should Goldilocks prevail and rate cuts materialize without reigniting inflation, we recommend emphasizing value and smaller-cap holdings to increase cyclical exposure.

Appendix

A1: DIFFERENT ASSET CLASSES TEND TO SHINE AT DIFFERENT POINTS IN THE ECONOMIC CYCLE



Phase 1: Rising & Accelerating; **Phase 2:** Rising & Decelerating; **Phase 3:** Falling & Decelerating; **Phase 4:** Falling & Accelerating.
Economic Cycle based on the ML Composite Macro Indicator

For illustrative purposes only. Source: BofA European Equity Quant Strategy.

[47] Source: FactSet. Data as of November 30, 2023.

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Index Definitions

The MSCI ACWI captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. DM countries include: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, the U.K. and the U.S. EM countries include: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and United Arab Emirates.

The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years).

The S&P 500 Index consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

The STOXX Europe 600, also called STOXX 600, SXXP, is a stock index of European stocks designed by STOXX Ltd. This index has a fixed number of 600 components representing large, mid and small capitalization companies among 17 European countries, covering approximately 90% of the free-float market capitalization of the European stock market (not limited to the eurozone). The countries that make up the index are the United Kingdom (composing around 22.3% of the index), France (composing around 16.6% of the index), Switzerland (composing around 14.9% of the index) and Germany (composing around 14.1% of the index), as well as Austria, Belgium, Denmark, Finland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Spain and Sweden.

The European Industrial Production Index is a measure of output of the industrial sector of the economy. The industrial sector includes manufacturing, mining and utilities.

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FIRM HEADQUARTERS

New York
+1 800 223 6448

REGIONAL HEADQUARTERS

Hong Kong
+852 3664 8800

London
+44 20 3214 9000

Shanghai
+86 21 5203 7700

Tokyo
+81 3 5218 1930

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NEUBERGER | BERMAN

Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com

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