Finance outlook 2024

High interest rates trigger mixed fortunes

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High interest rates trigger mixed fortunes

High interest rates will determine the success or failure of almost every part of the financial services sector in 2024.

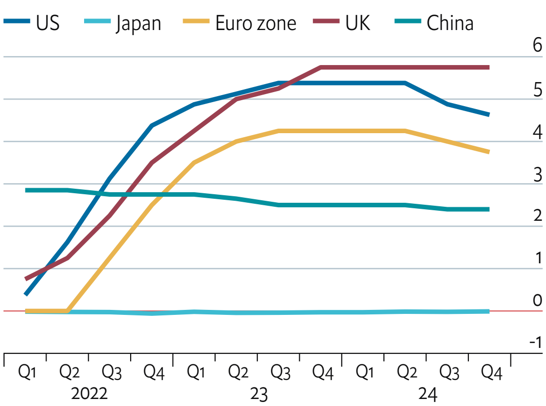
- High interest rates will persist into 2024 in most key global markets, with the exception of China and Japan. We forecast some mild ebbing of rates late in the year.
- Banks will enjoy strong net interest margins and revenue flows until margins begin to narrow mildly late in 2024.
- The interest rate environment will bolster investors in, and managers of, fixed-income funds, but hurt most property firms and funds.
- The funding freeze for start-ups may thaw in 2024, but conditions will remain difficult for young firms forced to burn through monies raised in the "easy-money" period of the late 2010s.
- Property insurers will step back from covering areas subject to weather-related risks, such as tropical storms, rainfall, floods and wildfires.

Interest rates will remain high, and margins wide, throughout much of 2024

In financial markets, the level and movement of interest rates makes the weather. As a result, high interest rates will remain the most important feature of financial markets in most major economies in 2024, even if a slight easing of monetary policy becomes possible towards the year's end.

Most central banks have lifted their base policy rates sharply since early 2022 in an effort to smother an inflationary spike (see chart). In some major markets—notably the US and the euro zone—they have also run down portfolios of bonds purchased to bolster economies amid earlier economic weakness.

Interest rates will start to fall in 2024
(%, end-period)



Source: EIU.

These actions have sharply lifted market interest rates—for example, those applied to loans and fixed-income instruments, and those on deposits and money market units.

The key exceptions are big ones: China, the world's second ranked economy, where rates have eased slightly in recent times, and Japan, the third ranked, where policy rates and most market rates have stayed close to zero. We forecast that the central banks of these two Asian giants will keep money cheap in 2024 as inflationary pressures remain weaker than elsewhere and as they aim to stabilise their currencies in ways that boost their export-oriented economies.

Those exceptions aside, rates are likely to ease only moderately in 2024. For the US and euro zone, for example, EIU believes that the Federal Reserve (Fed, the US central bank) and the European Central Bank are likely to have already brought base rates up to their peak, barring unexpected inflation-sparking events. However, we forecast that the two monetary authorities will only begin to cut rates from the second half of 2024, and then only moderately as price rises return to their 2% inflation targets.

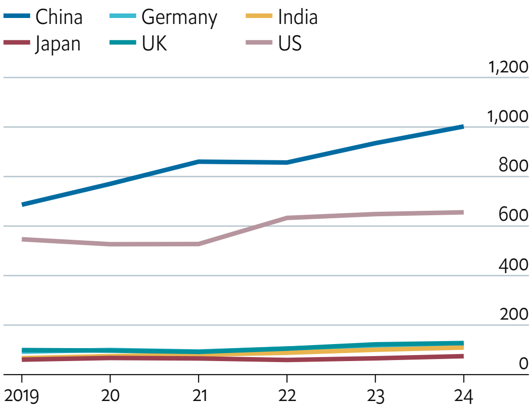
This scenario is painful for borrowers, as those with floating-rate loans must make higher periodic payments and those who must refinance existing credits will have to take on more costly financing. The impact will be especially severe for households with mortgages and highly indebted companies that do not have fixed-rate credit. By contrast, enduringly higher rates, at least for another year, benefit institutional investors like pension funds, as well as households that carry little debt. This will be especially true in 2024 as ebbing inflation means rates of returns will turn even more positive.

Banks will enjoy strong net interest margins into 2024

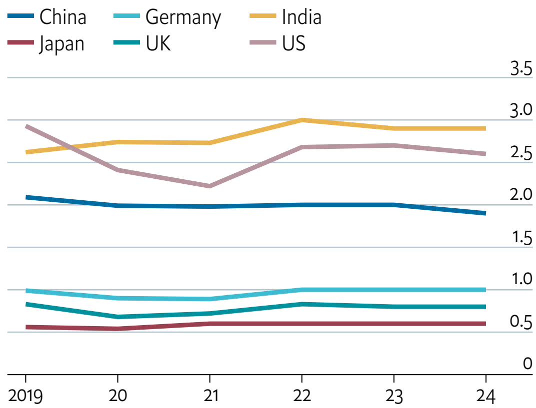
Lenders will continue to be one important beneficiary of higher interest rates. In many markets, the banking sector enjoyed record profits in 2021-22. Banks are on track to perform strongly in 2023 and are likely to enjoy a lucrative 2024 as well. Higher rates have boosted revenues for banks, which typically are quick to pass on higher rates to borrowers but slower to share them with depositors. This expands their net interest margins, which are usually their key source of revenue.

EIU forecasts that banks' net interest income in nominal US-dollar terms will rise significantly in all six major economies (see chart). Revenues on lending will rise as a result of wide interest margins, even though high rates will suppress demand for loans. The high rate environment also depresses business in areas where banks earn fees, such as mortgage loan origination and underwriting of corporate bond and share issues.

Banks' net interest income will increase...
(US$ bn)



...as will net margins
(banks' net interest income as % of assets)



Source: EIU.

This net interest margin effect will begin to wane in the second half of 2024. Depositors in many markets will continue to shift their savings to higher-yielding accounts at online banks and money market accounts, and away from low-earning accounts at big banks. We forecast that the spread will narrow slightly in 2024 in two of the six major economies—the US and China—while remaining unchanged in the other four—Germany, India, Japan and the UK.

High rates pose pitfalls for the banking industry as well. Many borrowers, both households and companies, will struggle to shoulder heavier burdens on their borrowing, and may miss repayments or default entirely. Levels of non-performing loans (NPLs) have already ticked up somewhat in most major economies, aside from China, where defaults by property developers have already triggered a crisis.

The collapse of several regional banks in the US in early 2023 highlighted another risk. The lenders affected by the run on deposits were somewhat unique in having invested heavily in safe, low-yielding bonds that lost significant market value as rates rose. They also had high levels of uninsured deposits whose owners were quick to make withdrawals at the first sign of financial trouble. Fortunately, we expect few, if any, recurrences of such panic, in part because regulators are now more alert to the danger.

High rates will bolster fixed-income asset managers but hurt property funds

Higher rates will provide a boost to returns on fixed income instruments, and thus to the asset managers who handle them for investors. For many years, investors fled bonds and similar instruments that paid only low, and sometimes negative, returns. With this situation now reversed, investors have flocked to securities and funds that pay out real, inflation-adjusted positive yields.

Although it is always risky to forecast the direction of securities markets, our scenario of a slight decline in interest rates in late 2024 may create a bull market in both stocks and bonds. Fixed-income investors will earn increasingly positive returns as inflation falls towards central bank targets. At the same time, the stabilisation of interest rates in 2024 will not tighten the financial screws further on company financing.

One asset class that is likely to suffer is property, and not just in China. Many owners of office buildings and shopping centres find themselves wrongfooted by the shift to hybrid work and e-commerce. Already heavily indebted, some will have to refinance or restructure their debts in 2024. This distress is likely to filter through to many property shares and funds, although those specialising in warehouses and infrastructure will perform better.

Capital markets will thaw, but conditions will stay icy for upstart firms

High rates have produced poor conditions for young firms seeking capital through initial public offerings (IPO) and private fundraising. Given our forecast for continued high rates in 2024, this implies that markets will remain unreceptive to upstart firms in a variety of sectors, including financial technology (fintech).

Investors able to earn a 5% yield on safe bonds or deposits will remain disinclined to channel funds towards risky ventures, even if they tout appealing innovations or business models. There are signs of a return to "animal spirits" more recently with investors flocking to firms promising generative artificial intelligence (AI) and putting money into IPOs for firms like the UK-based chip designer ARM.

Despite these green shoots, we foresee difficult fundraising conditions for fintech and other young firms in 2024. Many companies will run down funds raised in the "easy-money" period of the late

2010s and find it difficult to obtain new financing. Those that do attract fresh investors may trim their valuations, making so-called "down rounds", forcing losses on earlier backers.

Insurers will step back from weather risks

Interest rates will not drive all developments in finance in 2024. Faced with increasingly volatile weather, insurance companies around the world will decide to withdraw from risky locations where they forecast high future damage payouts. Three top insurers said recently that they would limit new homeowner policies in California, a state susceptible to drought and wildfires. Some Florida insurers have been forced into bankruptcy, and others have said that they will cease business in the state, which is a regular target of hurricanes.

Although none of the disaster events can themselves be attributed to climate change, research has increasingly quantified their rising frequency and intensity amid warmer oceans and atmosphere. The US government forecasting office says that it expects the El Niño climate cycle to continue into early 2024, producing warmer, wetter conditions in the southern US, but hotter, drier ones in northern climates, including the Canadian provinces recently plagued by wildfires.

The retreat of insurers is not due entirely to troublesome weather. Many regulators cap damage insurance premiums and set coverage requirements, making policies for storms, floods and fires less attractive for providers. Government-backed insurers can pick up some of the slack, as already occurs in US flood insurance, but it is subject to politicised setting of low policy rates, which in turn encourages homeowners to build, or rebuild, in risky locations.

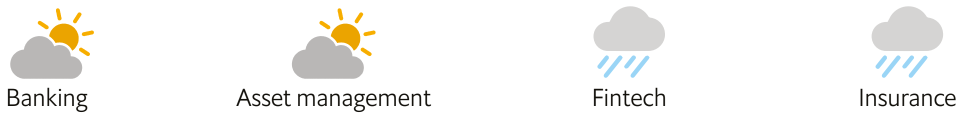
What to watch

New capital rules in the US. As part of its implementation of Basel III, the Fed and its partner agencies are likely to roll out refined capital rules for banks with over US$100bn in assets. The regulations would, by 2028, standardise approaches to credit and operational risk (instead of banks relying on internal models). They would also modify required bank capital related to securitisation exposures. Critics, who say that the rules would lead to reduced lending and weaker economic growth, have until end-November 2023 to lodge objections.

Corporate sustainability in the EU. From January 1st 2024, large, publicly listed companies in the EU will have to comply with its Corporate Sustainability Reporting Directive (CSRD) when drawing up reports due in 2025. A company is identified as a large company if it meets two of three criteria: it has more than 250 employees, more than €40m (US$42m) in turnover or more than €20m in total assets. A key requirement under CSRD is a double materiality assessment, which assesses both the impact of a company's actions on its own finances and on its wider community and environment. Smaller companies will face the same rules from 2025.

Crypto and digital currencies. Despite the lukewarm response to central-bank digital currencies (CBDCs) in China, Nigeria and the EU, governments will persist with the introduction of retail CBDCs to raise financial inclusion or wholesale CBDCs for more efficient payments. A global agreement on minimum standards for cryptocurrency governance is likely to emerge as the Financial Stability Board in the US and the IMF synthesise their concerns on financial stability and macroeconomic risks, respectively.

EIU's weather forecast for financial businesses in 2024



Source: EIU.

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