POSITIONING FOR AN UNCERTAIN WORLD

Global Investment Calls features our asset allocation recommendations for global stock / bond portfolios, our updated probability forecasts for DM and EM equity markets, and a quantitative assessment of the factors driving global portfolio returns.

October 2023

Time to diversify: The late cycle playbook

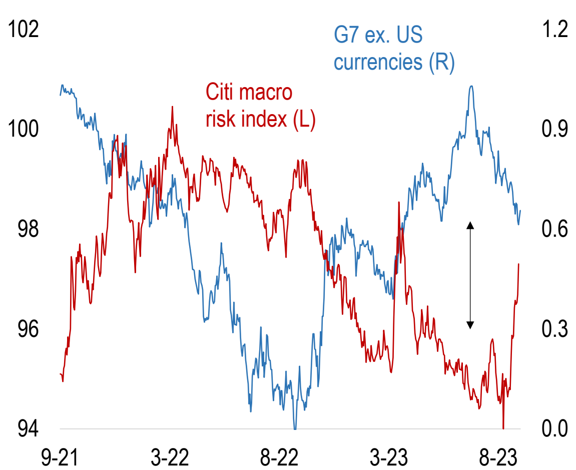
At cycle's end – DM stocks greatly benefited from bullish investor sentiment during Q2 and much of Q3, amid growing optimism that G7 central banks would achieve a 'soft landing'. Yet as we can see in F1, this optimism is giving way to risk aversion amid a toxic cocktail of soaring long-term yields, a $20 jump in crude oil prices, and significant USD appreciation.

Besides worsening global growth prospects, this disruptive trifecta is directly lowering DM stocks. We can see this in F2, which isolates the contribution of selected macro drivers to DM equity returns since July. Rising yields and the dollar have lowered the MSCI World by a combined 5.5%, with the drag amplified by a normalization in investor sentiment.

The key question, in our view, is whether these adverse shocks will trigger a long-anticipated downturn, or if DMs will achieve a soft landing. While timing regime shifts is exceptionally hard, we believe all major DMs except for Japan are now in the final stage of their expansionary cycles – making them vulnerable to rising borrowing costs or a sudden loss in purchasing power.

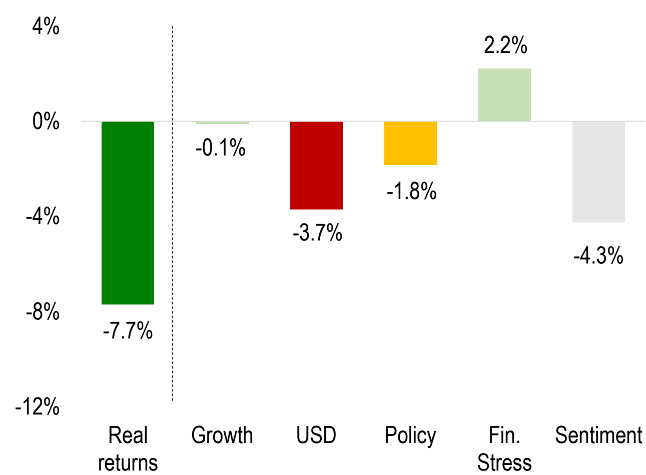
A typical 'late cycle' regime – as last observed in 2007 – is characterized by slowing yet still positive growth, high real rates, and a less hawkish tone by central bankers following aggressive hikes. This is the case for most DMs today, with leading indicators like an inverted yield curve or very low consumer sentiment (F3) pointing to weak growth in 2024.

F1: Global macro optimism is fading fast...
Global risk aversion vs. G7 ex. US currencies



Note: Chart compares the evolution of G7 ex. US currencies (CPI-adjusted) agsint Citi's long-term macro risk index, a measure of risk aversion in global financial markets. Source: J.P. Morgan, Citi.

F2: ...exerting a sizeable drag on equities
Drivers decomp. - DM stocks (07/23 - 09/23)



Note: Contribution of selected drivers to real returns on the MSCI World between July and September 2023. 'Policy' captures actual and expected changes in policy rates, money supply and corporate policy (for Japan). Source: Numera Analytics.

T1: Late cycle performance Quarter ahead of recessions	Excess returns (vs. US stocks)			
	Offshore stocks	EM stocks	DM bonds	EM bonds
Early 90s recession ('91)	2.6%	7.5%	9.0%	-
Dot-com crisis ('01)	1.3%	13%	9.3%	12%
Great Recession ('08)	1.4%	1.2%	11%	5.1%

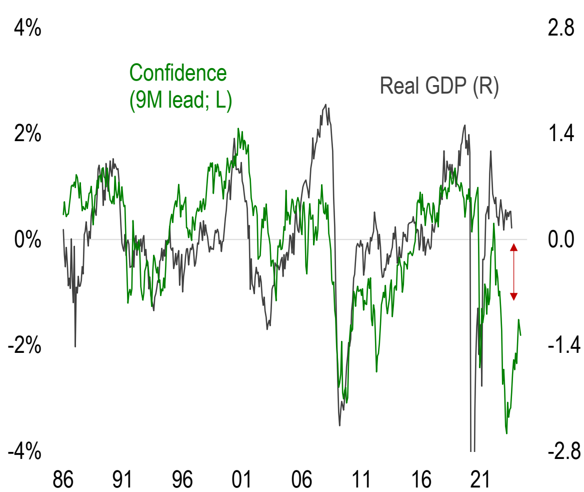
Note: Table compares cumulative USD returns on major asset classes relative to the S&P 500 in the 3 months ahead of official NBER recessions. Source: Numera Analytics on MSCI, ICE BofAML data.

How do stocks and bonds perform in this final stage of the cycle? T1 compares returns on major asset classes versus US stocks in the quarter ahead of the 1990, 2001 and 2008 recessions. As it turns out, there are a number of recurring patterns, with US equities typically underperforming most other major asset classes.

The most important feature for portfolio construction is that bonds outperform, which is not the case during overheating. The main reason is that policy rates are close to their peak, which alongside weaker growth expectations start to drive down long-term rates. This is consistent with our updated GAA model, which now signals a mildly conservative (45/55) tactical tilt after suggesting a neutral stance throughout the third quarter (T3, F7).

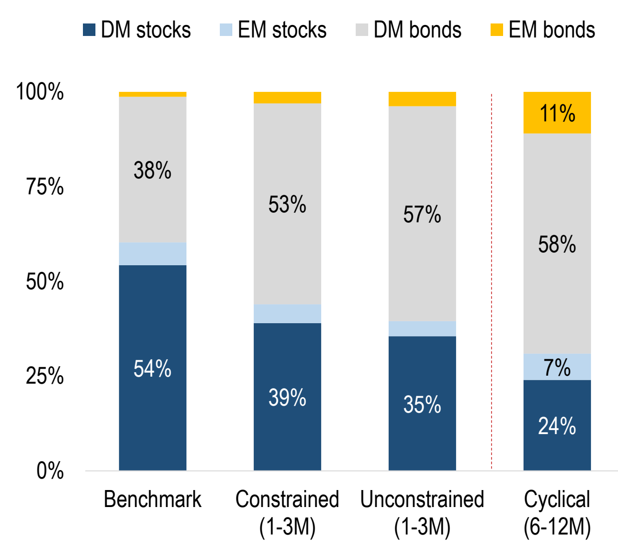
This may seem surprising given ongoing concerns over the US fiscal deficit and upcoming interest payments, which are lifting the risk premium on long-term US Treasuries. While fiscal woes create near-term risks, our structural models suggest US Treasuries are trading well below 'fair' value. This makes for an attractive entry point, especially if slowing activity boosts flight-to-safety demand and encourages a rotation away from overvalued US equity sectors.

F3: DMs nearing the end of growth cycle
G7 consumer confidence vs. real GDP



Note: Chart compares cyclical fluctuations in real GDP in G7 countries against 9-month prior changes in consumer confidence. Source: Numera Analytics.

F4: Fixed income increasingly attractive
Benchmark vs. optimal portfolio weights



Note: Optimal weights maximize risk-adjusted returns over a 3 and 12-month holding period, subject to asset constraints (see T3). Source: Numera Analytics.

T2: Asset performance USD total returns (%)	Returns by asset class Balanced (60/40)	DM stocks	EM stocks	DM bonds	EM bonds
Last month	-4.2%	-5.3%	-5.7%	-2.9%	-4.4%
YTD	4.1%	10%	-0.5%	-5.1%	-1.4%
Last 12M	8.6%	16%	5.1%	-1.1%	6.3%

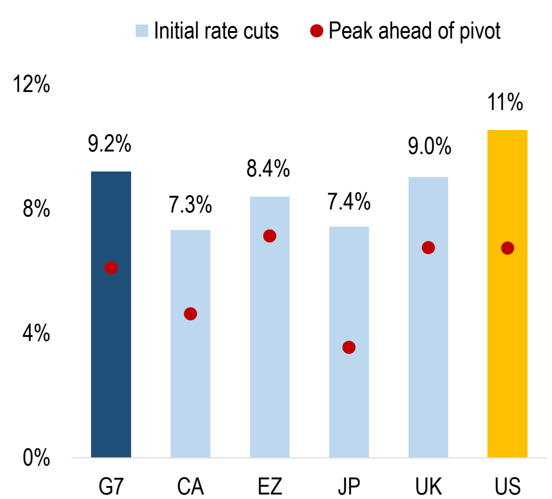
Note: Nominal asset returns through October 6, 2023. Source: MSCI, ICE BofAML; Numera calculations.

The relative appeal of DM bonds is even higher on 6-12M holdings, reflecting a high probability of cuts by G7 central banks, especially by the Fed and the BoC. Indeed, notice from F5 that DM sovereign bond returns are much higher at the start of easing cycles than when policy rates peak, particularly if economies simultaneously experience a 'hard' landing (a topic we'll explore in this month's *Global Macro Strategist*).

Besides the stock-bond question, offshore and EM stocks also outperform late in the cycle, benefiting from a weaker dollar. This is not the case today, as resilient US growth and expectations of a delayed Fed pivot have lifted the DXY 6.5% since mid-July. While US growth will likely decelerate by year-end, we expect the dollar to remain elevated in response to rising financial stress. As we can see in T3, this weakens the tactical appeal of offshore rotation.

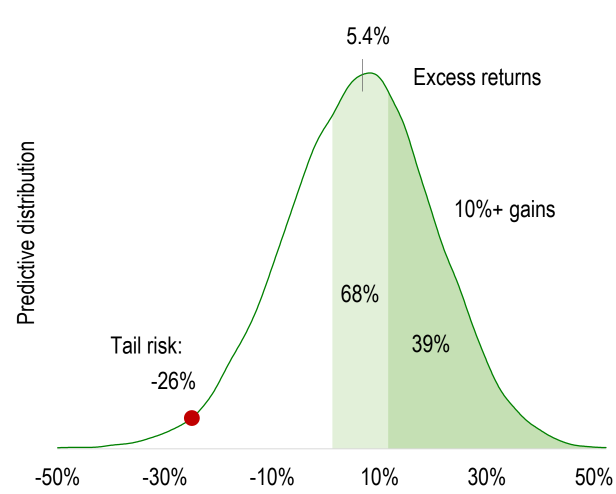
While we favour US over offshore stocks in the near-term, we find considerable opportunities for diversification at the 6-12M horizon. We are currently OW Japan, the UK and Australia, and UW the Euro area (T4). Japan is particularly attractive, owing to supportive corporate policy and a high probability of JPY appreciation. A long-short trade between Japan and the EZ (up 2.6% since we first suggested it in late June) retains significant 'alpha' potential (F6).

F5: Bonds are most attractive after pivot
DM bond returns by policy stance (1990-22)



Note: Chart compares average returns on DM sovereign bonds in the 12M after policy rates peak and central banks pivot. Source: Numera Analytics.

F6: Some DM stocks still offer high 'alpha'
Japan vs. Eurozone stocks - 12M ahead



Note: 12M probability forecast for a long-short pair trade between JP and EZ stocks. Shaded areas denote the probability that: a) Japan outperforms, and b) that the trade delivers excess returns of more than 10%. Source: Numera Analytics.

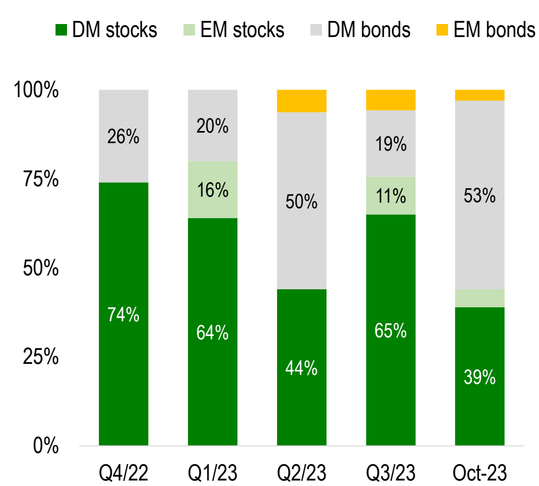
T3: Asset allocation[a] Optimal weights[b] (%)	Benchmark	Tactical (1-3M)		Cyclical (6-12M)	
		Constrained[c]	Unconstrained	Constrained	Unconstrained
DM stocks	54%	39%	35%	24%	11%
United States	36%	31%	35%	16%	9%
DM ex. US	18%	8%	0%	8%	2%
EM stocks	6%	5%	4%	7%	7%
DM bonds	38%	53%	57%	53%	72%
United States	33%	53%	57%	53%	72%
DM ex. US	5%	0%	0%	0%	0%
EM bonds	1%	3%	4%	11%	10%
Stocks	60%	44%	39%	31%	18%
Bonds	40%	56%	61%	64%	82%
United States	69%	84%	92%	69%	81%
DM ex. US	23%	8%	0%	8%	2%
EMs	7%	8%	8%	18%	17%

a. Benchmark weights match the iShares core growth asset allocation ETF (AOR), a balanced global stock-bond portfolio.

b. Optimal weights maximize risk-adjusted returns across stocks and bonds over a given holding period. Contact us for details on model construction.

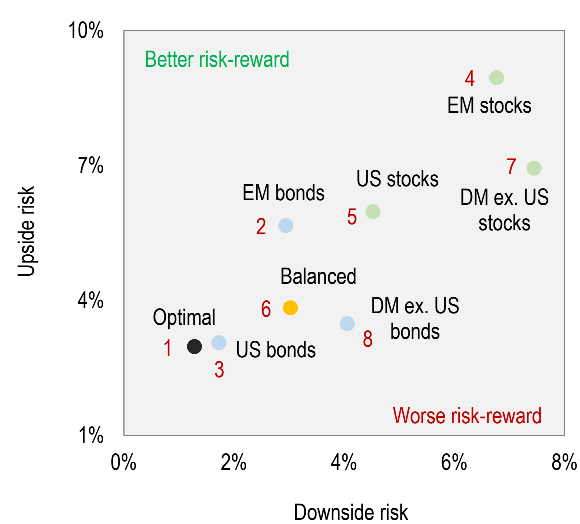
c. Weights constrained to +/-20% of benchmark for US stocks and bonds, and +/-10% for all other asset classes.

F7: Tactical global asset allocation
Optimal portfolio weights (constrained)



Note: Chart tracks optimal weights for a global stock/bond portfolio. Weights are chosen to maximize risk-adjusted returns over a 3-month holding period, subject to asset constraints (see T3). Source: Numera Analytics.

F8: Cyclical global asset allocation
12M risk-reward comparison by asset



Note: Chart compares ratio of upside to downside risk for major global asset classes over a 12M holding period. Source: Numera Analytics.

Cyclical Asset Allocation (6-12M)

Overweight	Neutral	Underweight
🟢	🟡	🔴

T4: Positioning by asset 6-12M holdings	Asset allocation[1]	Country rotation[2]	Key macro factors
DM stocks	🔴	-	Near end of growth cycle (F3); expect higher financial stress
United States	🔴	🟡	Significant downside now that consumers depleted savings
DM ex. US	🔴	🟡	Weak growth prospects, high probability of stronger USD
Australia	-	🟢	CN policy easing, improved confidence as inflation slows
Canada	-	🟡	Economy showing signs of weakness; faster BoC pivot
Europe	-	🟡	Rapidly slowing activity, high core inflation limits policy support
Eurozone	-	🔴	Stocks trading at a premium, ECB hikes amplify downside
Switzerland	-	🟡	High defensives weight limits downside risk vs. rest of Europe
United Kingdom	-	🟢	Attractive valuations, more aggressive BoE pivot than ECB
Japan	-	🟢	Supportive corporate policy, wider YCC band to lift JPY
EM equities	🟡	-	Widening EM-DM growth premium, higher liquidity support
EM Asia	-	🟡	We are neutral, but cross-country diversification encouraged
China	-	🟡	Policy support and cheap valuations, but risk of capital flight
India	-	🟢	Upgrading to OW amid strong demand from foreign investors
South Korea	-	🔴	Slowing global demand for hardware, reaccelerating inflation
Taiwan	-	🔴	CN policy support, but AI optimism has inflated valuations
EM EMEA	-	🟢	High commodity inflation should support EM EMEA returns
Latin America	-	🟡	Cheap valuations, CN + regional policy easing
Brazil	-	🟢	Low valuations, China policy easing, BCB easing cycle
Mexico	-	🔴	Overvalued MXN, exposure to US manufacturing downturn
DM bonds	🟢	-	DM bond yields are too high versus macro fundamentals
United States	🟢	-	High probability of rate cuts in H1/24 as economy stagnates
DM ex. US	🔴	-	Higher core inflation than in the US limits likelihood of pivot
EM bonds	🟢	-	Widening EM-DM growth premium, faster EM policy easing

1. Positioning relative to 60/40 global benchmark. See T3 for the recommended portfolio weights.

2. OW/N/UW relative to DM and EM equity benchmarks. See T5 for the recommended country weights.

T5: Country rotation 6-12M holdings	Market weights	Position	Optimal weights[a]		Risk-reward[b]	
			Constrained	Unconstrained	Upside	Downside
United States	70%		67%	82%	7.1%	-3.8%
DM ex. US	30%		33%	18%	6.3%	-4.8%
Australia	2%		4%	3%	10%	-5.0%
Canada	3%		2%	0%	6.5%	-6.2%
Europe	18%		16%	7%	6.5%	-6.3%
Eurozone	9%		7%	1%	6.3%	-7.5%
France	3%		4%	1%	6.7%	-6.0%
Germany	2%		1%	0%	7.9%	-8.3%
Italy	1%		1%	0%	6.9%	-8.2%
Netherlands	1%		0%	0%	4.9%	-11%
Spain	1%		0%	0%	5.8%	-10%
Switzerland	3%		2%	1%	6.0%	-5.4%
United Kingdom	4%		8%	5%	8.8%	-6.1%
Japan	6%		12%	8%	7.8%	-3.6%
EM Asia	78%		72%	67%	7.6%	-5.1%
China	30%		35%	28%	13%	-8.8%
India	15%		21%	30%	6.9%	-4.3%
South Korea	13%		6%	9%	8.8%	-5.8%
Taiwan	16%		8%	0%	7.2%	-6.3%
EM EMEA	13%		17%	20%	9.2%	-4.9%
South Africa	3%		2%	0%	10%	-7.4%
Latin America	10%		11%	13%	11%	-4.7%
Brazil	6%		9%	12%	15%	-6.2%
Mexico	3%		2%	0%	8.6%	-6.1%
Chile	1%		1%	1%	7.5%	-4.5%

a. Optimal weights maximize risk-adjusted returns across DM and EM equities respectively. Contact us for details on model construction.

b. Upside (downside) risk is the probability of positive (negative) returns times expected gains (losses) over a 12M holding period.

Top Conviction Calls & Scorecard:

Global Investment Calls Asset class	Action	Open date	Horizon	Trailing stop-loss[1]	P&L	Report
BR LC bonds (unhedged)	Long	24-Jan-23	6-12M	16%	16%	PDF
PE LC bonds (unhedged)	Long	25-Apr-23	6-12M	6.0%	6.0%	-
Mexico / EM stocks	UW	25-Apr-23	6-12M	3.0%	8.9%	PDF
MX staples / MX stocks	OW	2-May-23	6-12M	4.9%	8.6%	PDF
Brent crude oil options	Call option	14-May-23	12M	67%	67%	PDF
JGBs / US Treasuries (h)	UW	18-May-23	6-12M	-1.7%	-1.4%	PDF
EM / DM ex. US stocks	OW	13-Jun-23	6-12M	-4.1%	0.4%	PDF
Japan vs. EZ stocks	Long JP	26-Jun-23	6-12M	-1.0%	2.6%	PDF
India / EM stocks	UW	14-Jul-23	6-12M	-7.4%	-6.2%	PDF
EUR / AUD	Long AUD	26-Jul-23	6-12M	-5.7%	-1.3%	PDF
Global semiconductors	Short	15-Aug-23	6-12M	-0.1%	8.6%	PDF
Germany stocks	Short	22-Aug-23	6-12M	-0.6%	6.4%	PDF
MXN / USD	Short MXN	29-Aug-23	6-12M	5.0%	8.6%	PDF
UK / Eurozone stocks	Long UK	6-Sep-23	6-12M	0.6%	3.7%	PDF
Brazil / EM stocks	OW	27-Sep-23	6-12M	-6.4%	-3.2%	PDF

1. Stop-loss threshold matches the expected loss over the remaining holding period, relative to the current P&L.

Benchmarks:

- **DM stocks**: United States: S&P 500 TR, DM ex. US: MSCI World excl. USA index and country breakdown.
- **EM stocks**: MSCI emerging markets USD index and country breakdown.
- **DM bonds**: United States: ICE BofAML US Treasury TR (all maturities); DM ex. US: ICE BofAML Global Government excl. US TR USD (all maturities).
- **EM bonds**: ICE BofAML EM external sovereign index TR USD.