POSITIONING FOR AN UNCERTAIN WORLD

US Investment Calls features our asset allocation recommendations for US stock / bond portfolios, updated probability forecasts for major equity styles, sovereign and corporate debt, and a quantitative assessment of the factors driving US portfolio returns.

October 2023

Is it time to overweigh sovereign debt?

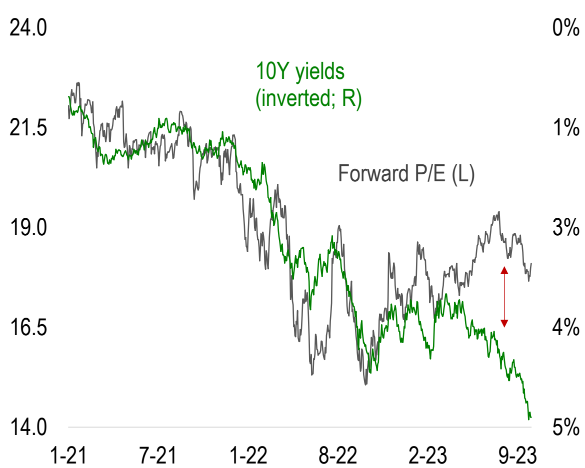
A good entry point – September proved, once again, a challenging month for US stock-bond portfolios. While August losses essentially reflected expectations of higher policy rates, investor sentiment weakened noticeably last month in response to a combination of soaring long-term Treasury yields, high oil prices, and USD appreciation.

Of these three shocks, the surge in yields is proving particularly disruptive to 60/40 portfolios, by simultaneously lowering bond prices and compressing stock valuations (although soft landing optimism continues to limit the drag; F1). In setting portfolio strategy, it is therefore critical to understand whether the spike is excessive, or justified by macro fundamentals.

Our research suggests that 80% of the jump in 10Y Treasuries since late August reflects a widening of the 'term premium' – the extra compensation required by investors to hold long-term bonds until maturity. Were it for expectations of policy rates, growth and inflation alone, 10Y yields would be trading at around 3.5%, implying a risk premium of over 100 bps.

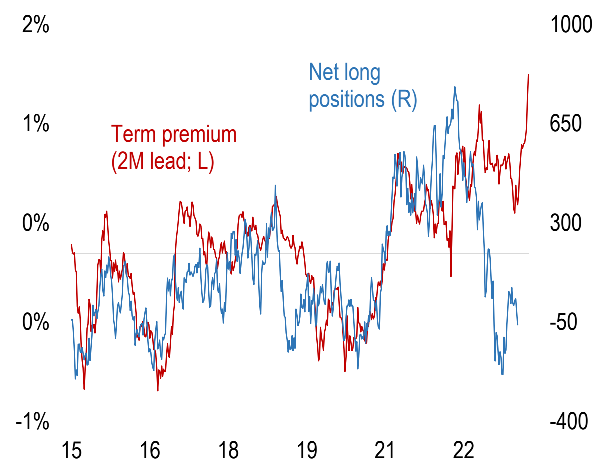
As we can see in F2, this is the first time in a decade the term premium exceeds 1%. The last time this happened was during the 2013 debt ceiling crisis, when bondholders demanded extra insurance amid political gridlock. The ongoing surge also has a fiscal backdrop, reflecting concerns over the government's ability to meet soaring interest payments.

F1: High yields finally lowering valuations
S&P 500 forward P/E vs. long-term yields



Note: Chart compares the 12M forward price-to-earnings (PE) ratio for the S&P 500 against 10Y US Treasury yields. Source: Numera Analytics.

F2: Treasury risk premia widening sharply
10Y term premium vs. speculative purchases



Note: Chart compares the term premium on 10Y yields against net long positions by asset managers and leveraged funds on 10Y Treasury futures. premium is the extra compensation to hold bonds until maturity. Source: Numera Analytics.

T1: S&P 500 outlook 12M returns by source	Real returns - 12M ahead (%)			
	Real returns	Real earnings	Valuations	Dividends
Baseline	3.3%	-2.6%	4.3%	1.6%
Positive returns prob.	61%	38%	66%	100%
Left-tail risk	-27%	-22%	-25%	1.2%

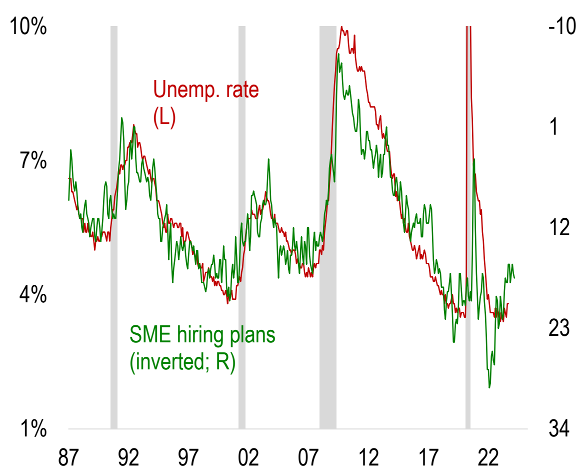
Note: 12M probability forecast for real total returns for the S&P 500. Right-hand columns break down the contribution of real earnings per share, valuations (price-to-earnings) and dividends to projected total real returns. Source: Numera Analytics.

Crucially, spikes in the risk premium are less persistent than changes in growth expectations or the Fed's policy stance. Historically, when the term premium exceeds 1%, sovereign bonds post 7% returns on average over the next 12M, partly owing to greater speculative demand by investors (blue line in F2). This fact alone makes for an attractive entry point, irrespective of the speed of a Fed pivot, or whether the US economy avoids a hard landing.

As we discussed in our latest *Global Asset Allocation* report, however, there are now multiple signs the US and other major DMs are in the final stage of their expansionary cycle. While job creation remains exceptionally strong, leading indicators like SME hiring expectations point to a marked slowdown in activity in the near-term (F3).

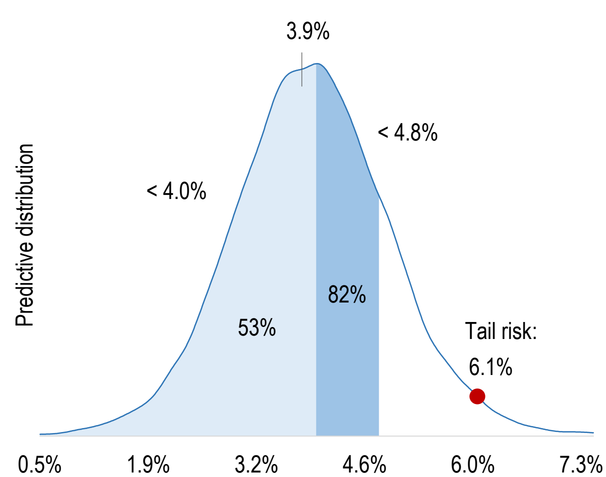
This further improves the hedging appeal of Treasuries, as weaker growth would boost 'flight-to-safety' demand and downgrade policy rate expectations. We now find an 80%+ chance that 10Y yields weaken 6-12M out (F4), signaling a much higher weighting on Treasury debt than in standard 60/40 portfolios (T2, F5). Conversely, notice from T2 that we now suggest a lower corporate debt exposure, increasingly vulnerable to widening spreads as credit tightens.

F3: Economy approaching turning point
Unemployment rate vs. SME hiring plans



Note: Chart compares the unemployment rate against 6M prior changes in hiring plans by SMEs (inverted). Shaded areas denote NBER recession dates. Source: BLS, NFIB Small Business Survey; Numera calculations.

F4: Yields to normalize as activity slows
12M probability forecast - 10Y Treasury yields



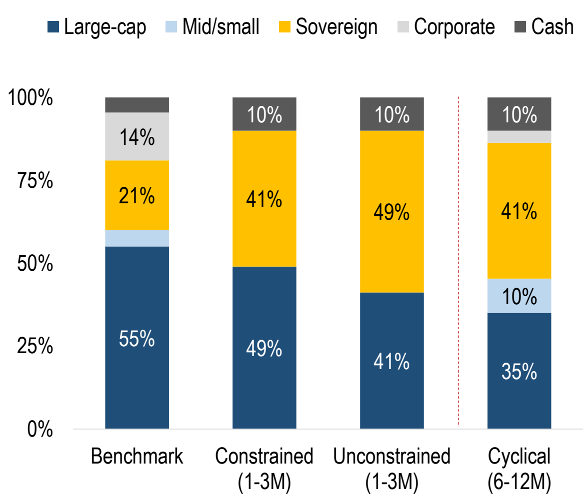
Note: 12M probability forecast for 10Y US Treasury yields. Shaded areas denote the probability that yields trade below 4.8% (their YTD peak) and 4.0% by this time next year. Source: Numera Analytics.

T2: Asset allocation[a] Optimal weights (%)	Benchmark	Tactical (1-3M)		Cyclical (6-12M)	
		Constrained[b]	Unconstrained	Constrained[b]	Unconstrained
Large-cap stocks	55%	49%	41%	35%	11%
Growth	30%	28%	22%	19%	6%
Value	25%	21%	19%	16%	6%
Mid-cap stocks	3%	0%	0%	0%	0%
Small-cap stocks	1%	0%	0%	10%	20%
Sovereign bonds	21%	41%	49%	41%	59%
Corporate bonds	14%	0%	0%	4%	0%
Investment-grade	12%	0%	0%	4%	0%
High yield	2%	0%	0%	0%	0%
Money market	5%	10%	10%	10%	10%
Stocks	60%	49%	41%	45%	31%
Bonds	40%	51%	59%	55%	69%

a. Benchmark weights match the average allocation of balanced (60/40) US multi-asset funds. Optimal weights maximize risk-adjusted returns across stocks and bonds over a given holding period. Contact us for details on model construction.

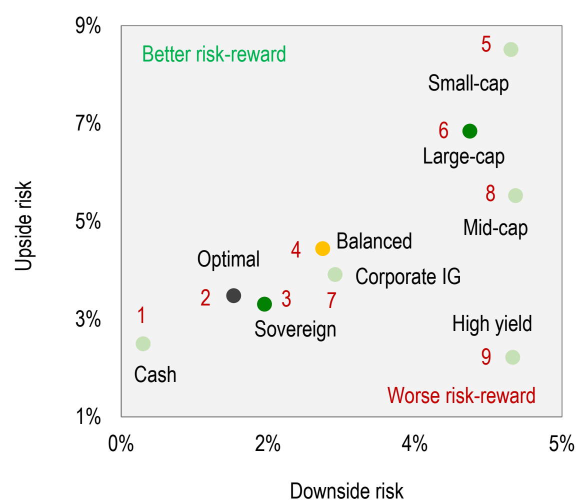
b. Weights constrained to +/-20% of benchmark for large-cap stocks and sovereign bonds, and +/-10% for other asset classes.

F5: Portfolio allocation by holding period
Benchmark vs. optimal portfolio weights



Note: Chart compares benchmark against optimal weights in a global stock-bond portfolio. Optimal weights maximize risk-adjusted returns over a 3M holding period. See T2 for detailed breakdown. Source: Numera Analytics.

F6: Cyclical US asset allocation
12M risk-reward comparison by asset



Note: Chart compares ratio of upside to downside risk across US assets. Upside is probability of positive returns times expected gains. Source: Numera Analytics.

Top Conviction Calls & Scorecard:

US Investment Calls Asset class	Action	Open date	Horizon	Trailing stop-loss[1]	P&L	Report
Building prods / industrials	UW	1-Mar-23	6-12M	-5.8%	-3.0%	PDF
Commercial MBS (CMBS)	Short	3-Apr-23	6-12M	-0.6%	2.4%	PDF
REITs	Short	12-Apr-23	6-12M	10.3%	16%	PDF
Software / hardware	Long	25-May-23	6-12M	0.7%	3.6%	PDF
Mid-cap internet stocks	Long	25-May-23	<6M	4.0%	7.1%	PDF
Health care services	OW	7-Jun-23	6-12M	-0.8%	4.0%	PDF
Regional / large banks	Long	28-Jun-23	<6M	-10%	-0.9%	PDF
Spec. chemicals / fertilizers	OW	12-Jul-23	<6M	-11%	-0.8%	PDF
Small-cap stocks	Long	18-Aug-23	1-3M	-5%	-1.2%	PDF
High yield / Treasury bonds	OW	23-Aug-23	1-3M	-1%	1.3%	PDF
Pharma & biotech	Long	31-Aug-23	6-12M	-1%	2.4%	PDF
Media & entertainment	OW	31-Aug-23	6-12M	-3%	5.0%	PDF
Homebuilding	Short	21-Sep-23	6-12M	0%	6.6%	PDF
E-commerce	OW	26-Sep-23	6-12M	-4%	0.6%	PDF
Refineries	UW	4-Oct-23	6-12M	-1%	8.0%	PDF

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

Benchmarks:

- **Stocks**: Large-cap: S&P 500 (growth + value); Mid-cap: S&P midCap 400; Small-cap: Russell 2000
- **Bonds**: ICE BofAML US Treasury, US Corporate and US High Yield; Money market: 3-month T-bill