CITY OF LONDON
Investment Management Company Limited

Cross-Asset Quarterly Outlook

March 2024*

Overview

Balancing the Short and Medium-term Signals

- *Recent activity data sends a more supportive short-term signal for global equities relative to the bonds.*
- *However, we continue to hold a more cautious 12-month outlook, favouring fixed income relative to equities as growth and inflation slow, and valuations for global equities are less compelling.*
- *Intra-equities, the environment is more supportive for Emerging Markets (EM) due to robust advanced semiconductor demand. We add to our OW exposure (funded by a downgrade to the UK).*
- *We increased our US TIPS exposure in fixed income given the attractive real yield. We reduced our OW exposure to IG bonds as spread levels have tightened closer to previous cyclical lows.*

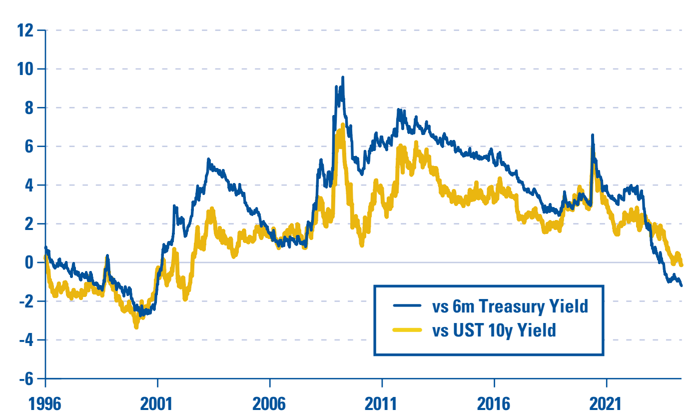
The global economic backdrop has started the year relatively strong. The global composite PMI index has risen this year to an expansionary 52.1 level, and the improvement has been broad based. The US, Europe, and China composite PMIs rose over the past six months. Historically, positive macro momentum tends to be associated with short-term strength in equities. As a result, we believe an overly bearish stance towards equities is premature.

However, our more cautious outlook is unchanged. Valuations are unattractive for equities and high-yield (HY) credit, and there remain lingering signs of late-cycle risks that argue for maintaining our neutral equity stance. On valuations, the MSCI All Country World Index (ACWI) forward P/E is currently 18x (above its 10-year average of 16x), and the US equity earnings yield spread to the 10y US Treasury yield remains around the tightest levels since the early 2000s (chart 1). In HY credit, the Bloomberg US HY Index trades at a spread of 315bps, close to the previous cyclical lows. This spread tightening contrasts with rising corporate default rates. There is a risk that we are underestimating the resilience of the business cycle; however, there is also evidence that markets are already priced for the optimistic scenario.

Regarding late-cycle risks, monetary lags are still feeding through the economy, and fiscal policy and excess pandemic savings should become less supportive. Also, we note that the US unemployment rate has risen over the past year, and the unemployment rate is below previous troughs. Historically, the unemployment rate is either rising or falling. Post-WWII it has never stayed flat for an extended period. Rising unemployment typically precedes a recession, and equity markets, on average, peak about six months before the onset of a recession based on data since the 1960s. Every cycle is unique, and this time may be different, but we believe a neutral equity exposure remains appropriate despite recent activity data improvement.

With this backdrop in mind, we still see opportunities. The growth in Artificial Intelligence (AI) is a structural trend, and investors should look for reasonably priced assets to gain exposure. We increased our overweight to EM equities, which include key semiconductor stocks in Taiwan and South Korea. EM earnings growth is expected to outpace DM this year, and valuations remain modest at a 12x multiple. In fixed income, US TIPS look attractive with the real yield currently trading around 1.83%. Inflation has moderated from elevated levels over the past year, and we do not expect a sharp reacceleration. Still, the 10y breakeven is around the middle of its historical range at 2.32%. It offers reasonably priced protection against two potential risks: 1) a further escalation in the Middle East region resulting in higher oil prices, and 2) the re-election of Donald Trump. The latter risk may cause markets to doubt the credibility of the Fed's 2% inflation target if the fiscal deficit widens further and the Fed's independence is challenged.

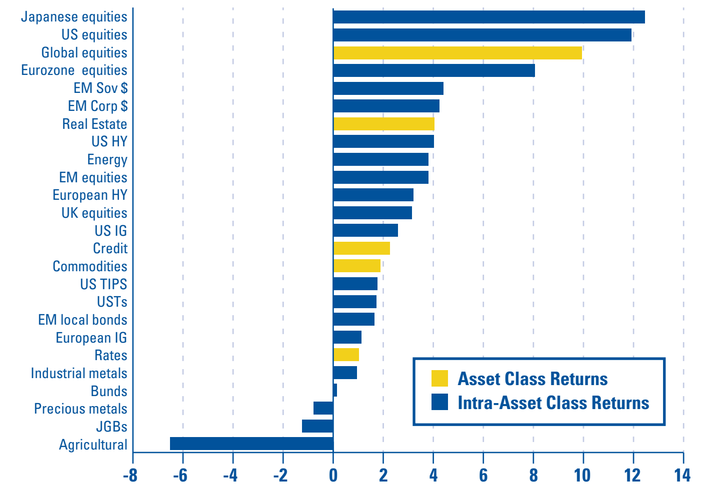
Chart 1: S&P 500 Earnings Yield Spread, % pts



Source: Bloomberg

**The publication reflects asset performance up to February 29, 2024, and macro events and data releases up to March 6, 2024, unless indicated otherwise.*

Chart 2: Asset Returns, Dec-Feb, %



Source: Bloomberg

Asset Allocation

	Chg	-3	-2	-1	0	+1	+2	+3
EQUITIES	-				■			
RATES	↑					■		
CREDIT	↓			■				
REAL ESTATE	-				■			
COMMODITIES	-					■		

	Chg	-3	-2	-1	0	+1	+2	+3
US equities	-				■			
Eurozone equities	-		■					
UK equities	↓				■			
Japan equities	-				■			
EM equities	↑						■	
USTs	-					■		
TIPS	↑						■	
Bunds	-				■			
JGBs	-			■				
EM local bonds	-				■			
US IG credit	↓					■		
US HY credit	-	■						
European IG credit	-					■		
European HY credit	-			■				
EM Sov $ credit	-				■			
EM Corp $ credit	-				■			
Energy	-				■			
Industrial metals	-					■		
Precious metals	-				■			
Agricultural	-				■			

Note: Up/down arrows indicate a positive or negative change in our asset allocation compared to the previous quarter. A dash indicates no change.

Source: CLIM

Market Strategy

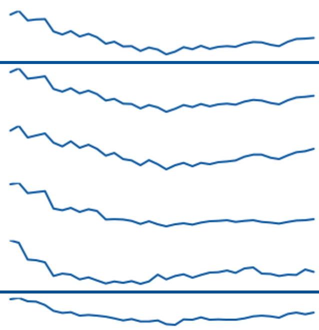
This year's bias still leans in favour of bonds over equities as we expect growth to trend lower. However, the recent strength in activity and earnings data continues to signal a positive equity stance over a short-term horizon. Balancing these two timeframes, we still favour a neutral equity stance and await more confirmation from our macro momentum indicators before downgrading our allocation to equities relative to bonds. Our allocations this quarter focus on intra-asset class opportunities:

- We remain *neutral* on **equities**. Intra-equities, we favour adding exposure to our existing EM *overweight* and moving the UK down to *neutral*. EM earnings growth is expected to be strong due to the demand for advanced chips. The UK market's valuation multiple remains low compared to peers. We are less confident that a catalyst will emerge this year to shift its underperformance trend.
- In **rates**, we move *overweight*, funded by a reduction in credit. We add exposure to our existing *overweight* in US inflation-linked bonds. US real yields have risen, providing a more attractive entry point. In addition, long-term inflation expectations are moderately priced and may increase this year if some of our risk scenarios materialise (e.g. Trump re-election or Middle East escalation). JGBs remain *underweight* as we expect further policy normalisation from the BoJ.
- We downgrade **credit** to *underweight*. This shift results from reducing our US IG *overweight* position while our global HY positions remain *underweight*. IG and HY credit have tightened to unattractive levels. A catalyst for spread widening is not imminent, and we remain *overweight* global IG. Still, we are gradually shifting our long exposure towards more attractive yields in government bonds.
- Our **real estate** allocation remains *neutral*. While the asset class offers some long-term value, fixed income provides better opportunities.
- In **commodities**, we stay *overweight*, continuing to favour industrial metals. We remain *neutral* in energy and precious metals.

Equities

Neutral

Valuations are rich in some areas, but EM offers opportunities.



	3Y history	Latest	
Global P/E		19.9	Feb
DM P/E		20.8	Feb
US P/E		24.9	Feb
Europe P/E		14.2	Feb
Japan P/E		17.3	Feb
EM P/E		15.3	Feb

Source: Bloomberg, MSCI. Trailing P/E ratios are shown.

Equities have outperformed recently, with AI stocks continuing to perform strongly. There is a growing consensus that the global economy is improving, which has lifted investor sentiment. Similarly, policy rates are expected to have peaked. In the short term, rising PMIs traditionally bode well for equities relative to bonds.

However, valuations have become very elevated in some areas of the market, most noticeably in the tech sector, and the index has become unusually concentrated. These measures have historically preceded weak equity returns. However, AI/tech sector earnings have been robust and forward expectations remain high.

Global equities are expected to see earnings rise by 10.4% during 2024, but revisions are more likely to be lower rather than higher. Several indicators still suggest potential economic trouble ahead, and the full impact of the policy tightening cycle has not yet been fully realised based on recent research by the Chicago Federal Reserve. In the US, excess pandemic savings are expected to be depleted by year-end. A slowing economy remains a possibility. Equities have strong momentum, and the macroeconomic environment currently appears supportive. Still, they will struggle, in absolute and relative terms (compared to fixed income) if the economy slows materially.

Market Strategy: MSCI ACWI is trading at a 12m forward P/E ratio of 18x, slightly above its five-year average. This is primarily due to the US tech sector, which is trading at 29x (MSCI US Tech Index) – and its recent performance means that it occupies a significant weight in the index. Beyond the US, valuations are more reasonable, with the MSCI ACWI ex-US Index trading in line with its historical average (around 14x). Since the last Quarterly Outlook, we have made two changes to our allocations, removing our UK overweight, and upgrading our EM position to a larger overweight.

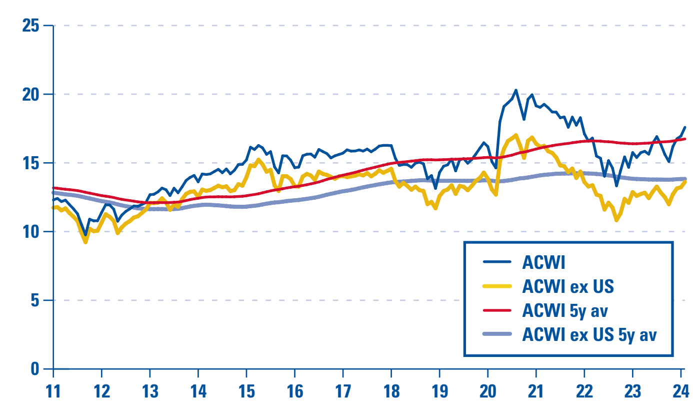
We reduce our UK position to *neutral* despite the market trading at cheap valuations. The UK could benefit from an oil price spike but stronger-than-expected US shale production limits the upside potential from an oil-shock scenario.

We increased our *overweight* to EM equities. The MSCI EM Index has attractive earnings prospects that will benefit from growing demand for advanced semiconductors. Also, EMs offer exposure to the tech sector at more compelling valuations than the US. Finally, more meaningful stimulus from policymakers in China may lift depressed sentiment.

We remain *underweight* in the Eurozone. Europe's economic outlook is weak, and its earnings risk being downgraded further. However, its valuations have cheapened, and growth, although still soft, might be stabilising at a weaker growth rate.

We stay *neutral* Japan and the US. In Japan, corporate reforms remain supportive and could unlock further value. On a more cautious note, our bias towards global economic weakness and lower US rates is historically a headwind for Japan. The US market has persistent positive momentum and tends to outperform in a below-trend growth environment. However, the US is the most crowded position, trading at a premium to its peers and historical norms.

Chart 3: Valuations are More Attractive Outside the US, 12m Forward P/E Ratios



Source: Bloomberg

Rates

Overweight (↑)

Historically, government bonds rally following peaks in global policy rates.

	3Y history	Latest	
Global Govt Yield		3.2	Feb
UST 10Y Yield		4.3	Feb
TIPS 10Y Real		1.9	Feb
Bund 10Y Yield		2.4	Feb
Italy 10Y Yield		3.8	Feb
JGB 10Y Yield		0.7	Feb
EM Local Yield		4.0	Feb

Source: Bloomberg Barclays Indices. Yield in %.

The last two months of 2023 saw yields fall sharply, with a growing belief that central banks were done tightening and that rate cuts were imminent. At the end of the year, the market was pricing in six cuts in 2024. However, the first two months of 2024 have seen yields retracing, with rate cut expectations falling back to three for the year (as of end-Feb) – in line with the Fed's December dot plot. Japan remains the outlier among developed markets, with expectations that the Bank of Japan will slowly look to exit their negative interest rates policy and yield curve control.

Inflation has continued to fall back towards 2%. However, an above consensus data print in the US's January data has stoked fears that inflation's return to target may not be smooth. The ongoing supply-chain disruptions in the Middle East have also contributed to some risk that goods disinflation may turn inflationary this year. While the path to 2% inflation may be slow, we do not expect another sharp rise in inflation similar to 2021-22. The rise in yields makes bonds increasingly attractive relative to equities whose valuations look stretched in some areas. Although no recession is increasingly the consensus expectation, a material slowdown remains possible, and government bonds should benefit in such a scenario.

Market Strategy:

Nominal DM bonds (US overweight, EZ neutral, JP underweight)

We remain *overweight* US Treasuries with the view that further policy tightening is unlikely, and yields will likely fall when the Fed cuts rates. There are concerns about the US fiscal deficit and the growing cost of interest, though this is not exclusive to the US. Furthermore, the dollar-denominated assets will likely attract inflows should global growth slow. In Europe, many of the same forces are at work, although the economy looks closer to a recession. European yields are significantly lower, offering less potential upside; therefore, we stay neutral. Japan is the exception, with the central bank likely to hike as they seek to end their loose monetary policy. We remain *underweight*.

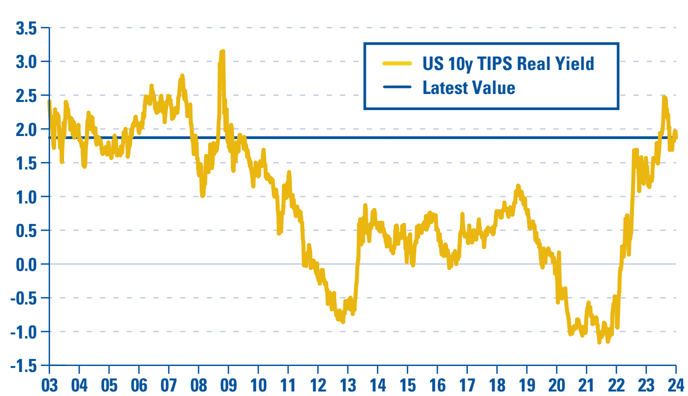
US TIPS (overweight)

US TIPS currently offers a real yield of 1.83%, an attractive level relative to the past ten years. As with conventional bonds, they are likely to appreciate if the central bank starts to cut rates or if there are clearer signs of a slowdown. Currently, they are trading with a 10-year breakeven inflation rate of 2.32%, so US TIPS will underperform US nominal bonds if inflation is consistently on target. However, if inflation proves more stubborn or geopolitical tensions push up oil prices, then inflation-linked bonds should outperform. While not our baseline view, the credibility of the Fed's long-run inflation target could be tested under a second Trump presidency, and TIPS should offer some protection from this tail risk. We have increased our *overweight*.

EM local bonds (neutral)

EM central banks have, in some cases, already started to cut rates. As a result, the index spread relative to US treasuries has diminished. EMs are also vulnerable to outflows if economic conditions weaken. This could mean that central banks are limited in their ability to accelerate rate cuts ahead of expectations for fear of weakening their currencies. The long-term trend in the USD is likely weaker given the current rich valuations, which historically support EM local assets, but the path will likely be gradual. We remain *neutral* on EM local bonds.

Chart 4: TIPS Real Yields are Attractive



Source: FRED, St Louis Federal Reserve

Credit

Underweight (↓)

Global investment grade (IG) and high-yield (HY) spreads are unattractive following recent tightening.

	3Y history	Latest	
Global IG OAS		1.1	Feb
US IG OAS		1.0	Feb
US HY OAS		3.1	Feb
Euro IG OAS		1.2	Feb
Euro HY OAS		3.4	Feb
EM Sov $ OAS		3.5	Feb
EM Corp $ OAS		2.4	Feb

Source: Bloomberg Barclays Indices. Yield in %.

Corporate bonds returned 2.3% over the past three months as spreads tightened. HY credit performed better than IG over the period, as the global economy proved resilient. Corporate bond yields remain attractive, and the growing belief in a soft landing justifies narrower spreads. However, HY borrowers are vulnerable if the economy slows and default rates rise further. In addition, credit spreads are traditionally correlated with equity market volatility, which has been unusually low and may be ripe for an increase to more typical levels. Lower levels of credit issuance have also played a role in the narrowing of spreads, but these conditions may not last.

Default rates remain below average but have been trending up for the past two years. There is evidence suggesting that companies took advantage of the low rates to fix their costs and, in some cases, to increase their duration, potentially blunting some of the impact of the recent rate hikes. Borrowers, particularly lower-rated borrowers, will likely come under pressure in the coming months as they seek to refinance at higher rates. They will face further pressures if economic growth slows. The incremental impact of the past tightening is likely to continue in the coming months.

Most central banks (Japan is the major exception) will likely begin to cut rates at some point this year. The fact that inflation has been trending towards target has contributed to this expectation. The latest upside surprise to inflation adds to uncertainty, but it did not change the market's view that the tightening cycle has peaked. IG debt's higher duration (than HY) was a handicap as global rates rose. However, higher duration typically benefits as rates fall. We still favour some IG exposure, but narrower spreads improve the attractiveness of government debt.

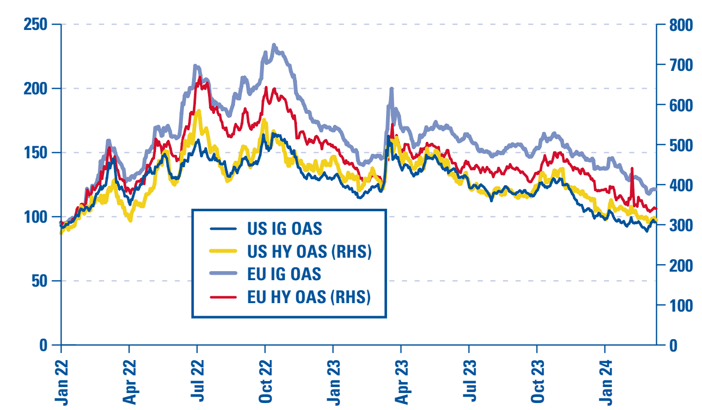
Market Strategy: Overall, we reduce our credit position to a small *underweight*. We remain *overweight* investment grade credit in the US and Europe. However, we do not believe HY spreads adequately compensate investors for rising default rates, and a potential deterioration in the macro environment.

US (OW IG, UW HY) We remain *overweight* IG, as a Fed rate peak is historically followed by a rally in higher-quality fixed income assets. We have scaled back our overweight, primarily to reflect that IG spreads have narrowed to less compelling levels relative to government bonds. HY spreads are also close to cyclical lows, and default rates are rising. If economic conditions deteriorate or companies are forced to refinance at higher rates, default rates should rise further. Current spreads do not offer sufficient cushion for this scenario. We are *underweight* HY.

EU (OW IG, UW HY) European corporates are subject to similar global factors as the US, and HY offers limited compensation for rising European default rates. As with the US, we remain *overweight* IG and *underweight* HY.

EM (NW $ Sovereign and NW $ Corporate) We maintain our *neutral* allocation to EM hard currency bonds. A peak in the Fed rate and the USD should favour EM hard currency bonds. However, spreads are less compelling for EM Corporates and EM Sovereigns.

Chart 5: US and EU Corporate Option-Adjusted Spreads (bps)



Source: Bloomberg

Real Estate

Neutral

Valuations are still unattractive against Treasuries, keeping us on the sidelines until the easing cycle begins.

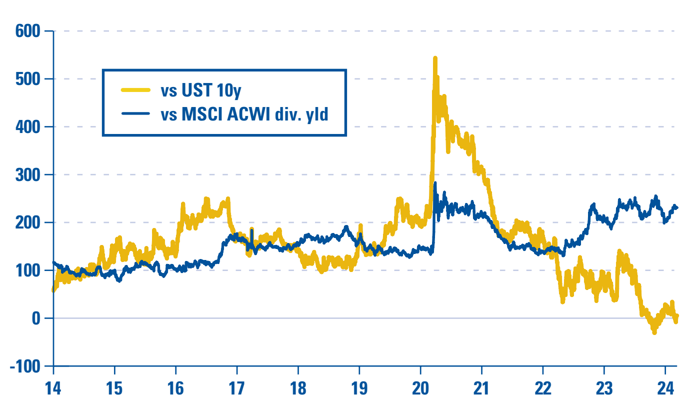
	3Y history	Latest	
Net TR index*		4.0	Feb
EPS, % yoy		25.0	Feb
Dividend yield, %		4.3	Feb

*Source: Bloomberg. 3M return is shown in "Latest". *FTSE EPRA/NAREIT Global Index.*

Global real estate was the second-best performer in the three months to end-February as equities rebounded in response to optimism over a likely Fed cutting cycle. Lower rates should benefit real estate given its quasi-duration status, but the direct market will likely continue to face uncertainty. The lack of investor appetite for real estate is reflected in the wide bid-ask spreads. Additionally, the RICS Global Commercial Property Sentiment Index remained in negative territory at the end of 2023, while global direct investment volumes fell by 23% yoy in Q4. As a result, 2023 saw the lowest level of direct investment in over ten years.

Global real estate stock valuations remain unattractive against US bond yields while maintaining some value against equities (see Chart 6). Fed easing and the accompanying fall in bond yields should improve real estate valuations. The abundance of dry powder will help with transactions.

Chart 6: Global REIT Yield Spread, Bps



Source: Bloomberg

At a sectoral level, industrial, residential, and alternatives will fare better than offices, where supply pipelines are set to remain elevated in Europe and Asia Pacific. The retail sector recovery has yet to pick up pace.

Market Strategy: Monetary policy easing should help improve real estate stock valuations, supported by substantial dry powder. However, at this juncture, we keep our *neutral* allocation.

Commodities

Overweight

While neutral for most commodities, copper is a bright spot given its link to the decarbonisation trend.

	3Y history	Latest	
Commodities*		1.9	Feb
Brent Oil		1.0	Feb
Copper		0.3	Feb
Aluminum		1.6	Feb
Gold		0.4	Feb
Corn		-10.0	Feb
Soybeans		-16.0	Feb

*Source: Bloomberg. 3M return is shown in "Latest". *S&P GSCI Total Return Index.*

Commodities as an asset class were the middle of the pack over December-February, returning 1.9%. Energy drove most of the gains, followed by a small increase in industrial metals. The prospect of Fed rate cuts and an accompanying softer US dollar should be a boon for commodities, which have historically generated positive returns ahead of and during Fed easing cycles. However, our optimism is tempered by a maturing growth cycle, tepid economic momentum in China and the lagged impact of prior tightening, meaning a soft-landing scenario is far from guaranteed.

In the oil market, the global market balance is set to be finely balanced as soft demand is offset by low supply. The extension of OPEC+ cuts into Q2 should put a floor under prices, but also highlight concerns over demand. Recent tensions in the Middle East have only led to a small geopolitical risk premium, as ample OPEC+ spare capacity suggests barrels could be returned quickly to the market in the event of a supply shortage. Supply balances appear tight for industrial metals, while Chinese visible stocks are low. Ongoing Chinese stimulus should support prices in the face of a global slowdown. We maintain our constructive view on copper given the demand from decarbonisation. Turning to precious metals, gold is often a beneficiary of a Fed-driven fall in real rates. However, gold looks expensive, so we prefer fixed income, which provides a regular coupon, unlike gold. Nonetheless, the risk of the US fiscal deficit widening further and ongoing support from central bank buying warrants revisiting our allocation in the coming quarters. Finally, except for sugar, agricultural prices look set to struggle amid ample supply.

Market Strategy: The risk of a slowdown means we don't have a strong conviction for the overall commodity complex. An exception is industrial metals, where we maintain our *overweight* allocation, given our optimism over copper prices.

Any forward looking statements or forecasts are based on assumptions and actual results may vary from any such statements or forecasts.

KEY ASSET ALLOCATION INDICATORS *(All data shown are as at end-February 2024 unless otherwise stated)*

	ASSET ALLOCATION							PERFORMANCE						BENCHMARK INDEX & WEIGHTS	
	-3	-2	-1	0	+1	+2	+3	5Y	3Y	1Y	2023	Ytd	End Dec-End Feb		
EQUITIES				■				**64.8**	**21.8**	**23.1**	**22.2**	**4.9**	**9.9**	**MSCI ACWI**	**50%**
US				■				93.9	35.0	30.1	26.5	6.9	11.9	MSCI USA	25%
Eurozone		■						43.2	16.9	14.8	22.9	3.4	8.1	MSCI EMU	7%
UK				■				24.3	22.9	5.5	14.1	-1.3	3.1	MSCI UK	3%
Japan				■				41.9	9.4	26.9	20.3	7.8	12.5	MSCI Japan	5%
EM						■		9.8	-17.7	8.7	9.8	-0.1	3.8	MSCI EM	10%
RATES					■			**-10.4**	**-19.5**	**1.5**	**4.2**	**-3.1**	**1.0**	**Bloomberg Barclays Global Treasury Total Return Index Value Unhedged**	**27%**
USTs					■			0.8	-10.0	2.3	4.1	-1.6	1.7	Bloomberg Barclays US Treasury Total Return Unhedged USD	10%
US TIPS						■		14.2	-2.6	2.5	3.9	-0.9	1.8	Bloomberg Barclays US Treasury Inflation-Linked Bond Index	3%
Bunds				■				-17.2	-24.7	5.7	9.3	-4.3	0.1	Bloomberg Barclays Euro Aggregate Treasury Germany TR Index Unhedged USD	3%
JGBs			■					-29.7	-32.0	-9.7	-5.9	-6.2	-1.2	Bloomberg Barclays Asian-Pacific Japan Treasury TR Index Unhedged USD	5%
EM Local				■				2.6	-6.1	8.2	11.3	-2.0	1.6	Bloomberg Barclays EM Local Currency Liquid Govt TR Index Unhedged USD	6%
CREDIT			■					**4.4**	**-10.9**	**6.8**	**9.6**	**-1.9**	**2.3**	**Bloomberg Barclays Global Aggregate Credit Total Return Index Value Unhedged USD**	**13%**
US IG					■			9.1	-8.3	6.0	8.5	-1.7	2.6	Bloomberg Barclays US Corporate Statistics Index	4%
US HY	■							22.6	5.6	11.0	13.4	0.3	4.0	Bloomberg Barclays US Corporate High Yield Statistics Index	3%
European IG					■			-6.4	-17.4	8.8	12.0	-2.8	1.1	Bloomberg Barclays EuroAgg Corporate Statistics Index USD	2%
European HY			■					8.9	-7.6	12.3	16.1	-1.0	3.2	Bloomberg Barclays Pan-European High Yield (Euro) Index Statistics USD	1%
EM Sov $				■				1.1	-7.3	9.4	11.0	-0.6	4.4	Bloomberg Barclays Emerging Markets Sovereign TR Index Value Unhedged USD	2%
EM Corp $				■				4.9	-10.7	6.9	6.7	1.1	4.2	Bloomberg Barclays Emerging Markets Corporates TR Index Value Unhedged USD	1%
REAL ESTATE				■				**-4.2**	**-6.9**	**0.0**	**8.7**	**-4.6**	**4.0**	**FTSE EPRA/NAREIT Global Index Net TRI USD**	**5%**
COMMODITIES					■			**41.5**	**53.7**	**5.0**	**-4.3**	**5.4**	**1.9**	**S&P GSCI Total Return Index**	**5%**
Energy				■				35.5	89.2	9.6	-5.2	9.4	3.8	S&P GSCI Energy Total Return Index	2%
Industrial metals					■			20.7	-0.1	-7.5	-4.5	-2.7	0.9	S&P GSCI Industrial Metals Total Return Index	1%
Precious metals				■				46.9	13.1	11.0	11.5	-1.3	-0.8	S&P GSCI Precious Metals Index Total Return Index	1%
Agricultural				■				46.2	14.2	-8.0	-8.3	-3.4	-6.5	S&P GSCI Agriculture Index Total Return Index	1%

Source: Bloomberg, CLIM

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