CITY OF LONDON
Investment Management Company Limited

Cross-Asset Quarterly Outlook

September 2023*

Overview

Growing Headwinds for Buoyant Equities

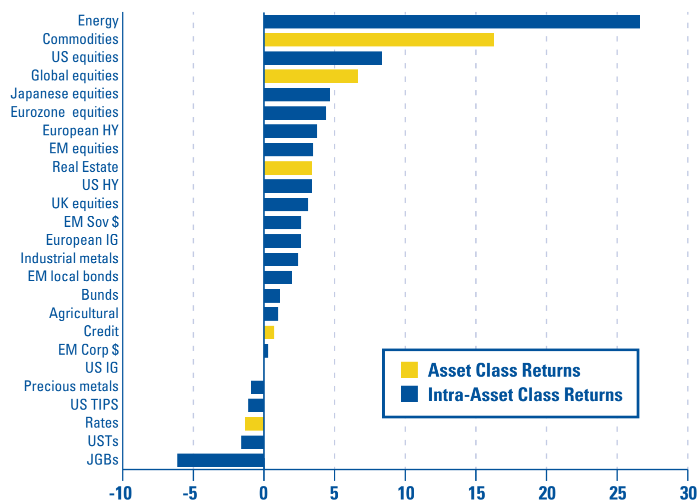
- *Global growth decelerated further in recent months, but the current level of activity remains close to trend.*
- *Global equities continued to outperform fixed income, while commodities were the best performing asset class since the last Outlook.*
- *Current valuations favour fixed income relative to equities, while industrial metal commodities offer an attractive entry-point for longer-term demand.*
- *We upgrade commodities to overweight and reduce rates to underweight. We remain overweight credit and neutral equities. Our intra-asset class allocations continue to favour higher-quality duration assets in anticipation of a peak in the Fed's hiking cycle.*

Since the last Cross-Asset Quarterly, global fixed income underperformed global equities and commodities. We continue to believe that fixed income looks attractive at current levels. However, the combination of central bank hikes, elevated inflation, and the absence of a US recession year-to-date have been medium-term headwinds for bonds. In addition, the recent optimism towards generative AI developments have also contributed to equity strength (led by IT and the US market). Commodities were the best performing asset class (led by crude oil) following a further extension of the OPEC+ cuts.

The recent global dataflow is still indicative of a relatively resilient economic environment. The Global Composite PMI fell to 50.6 in August, which is still consistent with trend-like growth and supporting equities relative to bonds. However, our asset allocation continues to maintain a neutral equity stance given our expectations for further pressure on earnings. The European growth outlook is starting to show weakness with the August Eurozone composite PMI in contractionary territory at 47.0. China's economic activity has also disappointed this year; however, we note some recent improvement in the manufacturing sector. Finally, the US economy has been resilient, but will likely slow as past monetary policy tightening continues to work through the economy. Overall, we expect a further deceleration in economic activity over the next six to twelve months.

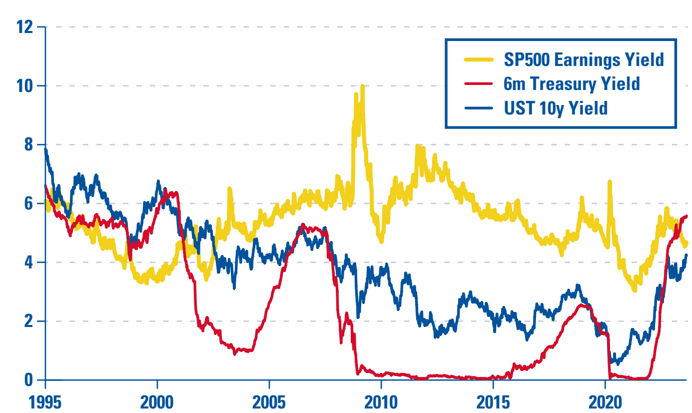
The key short-term risk for inflation and bonds is the recent oil price spike. OPEC+ supply cuts have helped push Brent crude prices back above $90 for the first time since 2022. Should prices continue to rise, headline inflationary pressures will likely intensify again in major developed market economies and keep central bank policy tight. Even accounting for these risks, core inflation measures remain on a disinflationary trend as activity slows, while the current level of developed bond yields appears attractive in absolute and relative terms. Indeed, the US 10y bond yield relative to the US equity earnings yield is now at a high from before the Global Financial Crisis (GFC) as shown in Chart 2. From a cross-asset perspective, the relative valuation for equities versus bonds is unattractive, and equities will need robust earnings growth over the coming quarters to justify further outperformance relative to fixed income.

Chart 1: Asset Returns, end May-end Aug, %



Source: Bloomberg

Chart 2: Yields, %



Source: Bloomberg

**The publication reflects asset performance up to August 31, 2023, and macro events and data releases up to September 8, 2023, unless indicated otherwise.*

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

Since the last Cross-Asset Quarterly, our overall asset allocation continues to favour higher-duration assets in anticipation of a peak in the Fed hiking cycle. In our recent allocation, we add some asset class risk exposure via commodities, moving our allocation to *overweight* (funded by Rates). We make the following changes to our **Asset Allocation** this quarter:

- We remain *neutral* on **equities**. Our current activity indicators continue to justify further equity strength. However, we expect these signals to fade over the coming months. Intra-equities, we continue to favour EM and the UK versus underweight in the eurozone.
- In **rates**, we downgrade to *underweight* to fund our upgrade to commodities. US duration remains attractive at current levels (expressed via US investment grade credit and US TIPS) and we upgrade German Bunds to neutral. However, we reduced exposure to EM local bonds given a less attractive EM-US yield spread and we remain *underweight* Japanese Government Bonds (JGBs). The overall changes within rates shift our exposure to higher-quality fixed income.
- We stay *overweight* **credit**, expressed primarily via global investment grade credit. We are positioned for HY-IG spread widening and remain *underweight* high-yield (HY) in both the US and Europe.
- Our **real estate** allocation remains *neutral*. We continue to see attractive valuations in REITs relative to equities, but unattractive value relative to fixed income.
- In **commodities**, we upgrade to *overweight*. Within commodities, we upgrade industrial metals to *overweight* to reflect our more constructive long-term view on copper. Short-term risks remain given sluggish demand in China, but we think there is sufficient pessimism priced into the market already. While we remain neutral in energy, the recent extension of cuts from OPEC+ push the risks to upside.

Equities

Neutral

An economic slowdown remains a possibility, but the strength of some underlying narratives muddies the water.

	3Y history	Latest	
Global P/E		18.4	Aug
DM P/E		19.1	Aug
US P/E		22.9	Aug
Europe P/E		12.7	Aug
Japan P/E		16.8	Aug
EM P/E		14.2	Aug

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

Global equities, as measured by the MSCI ACWI, returned 6.6% in the three-month period June – August. The index has risen in recent months despite tighter monetary policy. The US was the major contributor to this growth with a small number of mega-cap stocks being the main driver.

Signs of disinflation and speculation about generative AI growth were two positive factors contributing to the strength of global equity markets. Both developments justify a higher weighting to the 'soft-landing' scenario. However, we expect earnings to be weighed down by the long and variable lags from restrictive monetary policy. At the same time, inflation must fall further before the Fed and other developed market central banks can consider rate cuts.

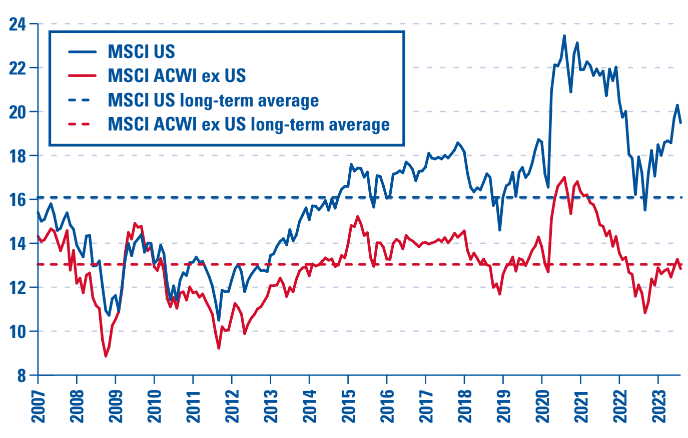
Overall valuation measures remain rich for the global MSCI ACWI Index at a 12m forward PE of 16.3x. The MSCI ACWI ex-US Index continues to offer more value at 12.8x. Our country allocations represent a balance between contrasting economic scenarios with a greater weight to a growth and earnings slowdown. We favour exposure to semiconductors within Technology, given a positive view on structural demand linked to generative AI growth. In addition, we continue to hold commodity exposure where we see attractive value and scope for re-rating. There have been no view changes since our last Outlook, but our biases have shifted within our country allocation.

Market Strategy: Our highest conviction *overweight* is to Emerging Markets (EM). EM central banks acted more swiftly to the rise in post-pandemic inflation, giving some key markets more flexibility to begin rate cuts. Taiwan and Korea should benefit from a rebound in the semiconductor sector. There remain risks for EM assets (e.g. US-China geopolitical tensions); however, Emerging Market equities offer attractive value and exposure to key long-term themes (e.g. AI and electrification). We are also *overweight* the UK due to attractive valuations (the 12m forward PE is 10.6x), a comparatively high weighting to energy exposure, which is well positioned to benefit from the recent rebound in crude oil prices.

We remain *neutral* in Japan despite their equity market having performed well, having been buoyed by corporate governance reforms. We have an upward bias for Japanese equities, but its sectoral composition is not favourable. Higher local rates could spur Yen strength and weigh on exporters, while the country's dependence on oil imports may prove unhelpful if energy prices continue to rise. We are also neutral in the US, where the market remains richly priced (the 12m forward PE is 19.5x) and anticipate a better entry point in the future. Earnings forecasts for 2023 are flat, and most of the upward movement in recent quarters was from re-rating rather than earnings growth. Several historically reliable leading indicators suggest that a US recession is likely, but the US labour market remains strong. Resilience in some economic data indicates that a soft landing is possible. Still, we believe the equity market is currently pricing in an overly optimistic scenario.

We are *underweight* in the EU, where several indicators signal a period of economic weakness. Increasingly, the cyclical and value companies representing the largest weight in the European index face headwinds as rates approach a local peak and energy prices look to have bottomed. We expect that the current earnings projections will likely be revised downward.

Chart 3: 12m Forward P/E Ratio



Source: Bloomberg

Rates

Underweight (↓)

Trim EM local exposure due to a tighter EM-US spread.

	3Y history	Latest	
Global Govt Yield		3.2	Aug
UST 10Y Yield		4.1	Aug
TIPS 10Y Real		1.8	Aug
Bund 10Y Yield		2.5	Aug
Italy 10Y Yield		4.1	Aug
JGB 10Y Yield		0.7	Aug
EM Local Yield		4.2	Aug

Source: Bloomberg Barclays Indices. Yield in %.

Government bond yields in most developed markets (DM) have risen to multi-year highs in recent weeks. This can be attributed to multiple factors, including central banks being more hawkish than previously expected, a growing concern that inflation may prove more resilient, the supply of bonds – particularly Treasuries – being elevated, the downgrade of US government debt by Fitch, the continued strength of the US labour market, and the upward bias to Japan's Yield Curve Control (YCC) pushing the global term premia higher.

Despite these headwinds, we remain positive on government bonds.

- Yields are now noticeably higher than in recent years, with the US 10y reaching 4.36% in August. Nominal yields are also now higher than the dividend yield on the S&P 500 (Chart 2). Inflation-protected bonds are also offering higher real yields.
- Historically, bonds have produced positive total returns during periods of equity market stress. This relationship is not a given – as 2022 demonstrated, but with higher yields we think the risk distribution is turning more favourable for bonds, particularly in an economic slowdown scenario. The fact that policy rates have risen so much affords central banks more leeway to cut, should they need to stimulate the economy.
- Although there is a risk that inflation does not return to target in some DM economies, we are now at the point where the Fed is believed to be at, or near, its terminal rate, as is the ECB. Although "higher for longer" has become a relatively anticipated outcome, we believe that the balance of probabilities is beginning to weigh on the side of more material rate cuts, even if there is a further hike before then.

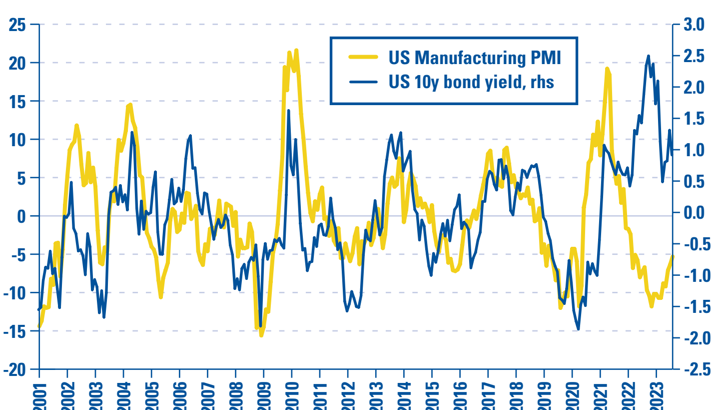
Market Strategy:

Nominal DM bonds (US neutral, EZ upgraded to neutral, JP underweight). Our nominal DM bond view remains unchanged. US Treasuries remain our preferred market, given attractive valuations and expectations for US rates to peak this year. While we expect positive returns from US bonds, we express this view via US IG (see Credit section). As a result, the US nominal bond view remains *neutral*. We upgrade our view of German bunds to neutral, given that the ECB is now close to its terminal rate. We stay *underweight* Japanese government bonds given that the YCC band is likely to be adjusted up in future, resulting in higher local rates in Japan.

US TIPS (OW). We continue to favour US inflation-protected bonds in our allocation. US TIPS will generate positive returns in a mild or deep recession scenario. In the tail-risk event where long-end inflation rises (i.e., a stagflation scenario), US inflation-protected bonds should outperform other bond markets.

EM local bonds (OW): We have reduced our overweight EM local bonds. With some EM central banks having started to cut rates and the US Fed potentially having one more hike to implement, the yield spread between EM and the US has narrowed. However, the USD remains rich on long-term valuation measures, which offers support to our small *overweight* position.

Chart 4: 12m Change in US 10Y Treasury Yield and Manufacturing PMI, ppts



Source: Bloomberg

Credit

Overweight

Defaults are likely to rise further due to tighter monetary policy and slower growth.

	3Y history	Latest	
Global IG OAS		1.3	Aug
US IG OAS		1.2	Aug
US HY OAS		3.7	Aug
Euro IG OAS		1.6	Aug
Euro HY OAS		4.4	Aug
EM Sov $ OAS		3.8	Aug
EM Corp $ OAS		3.1	Aug

Source: Bloomberg Barclays Indices. Yield in %.

Credit has provided a positive return in the first eight months of the year. The high-yield indices have outperformed investment grade bonds year-to-date in both the US and Europe. The same is true in the most recent quarter. US investment grade debt returns were flat over the past three months as government bond yields rose. This rise in yields has led to the carry offered by credit being higher than it has been for years and has contributed to positive returns. Currently US high-yield debt is yielding 8.40%, while US investment grade is yielding 5.68%.

Coincident indicators such as the ISM Manufacturing PMI suggest that high-yield is priced for a more optimistic growth scenario. There is also evidence that defaults are beginning to inch up. Recent data show the uptick in bankruptcy filings has not been reflected in credit spreads, unlike during the previous 20 years. In addition, chart 5 shows how spreads have not reacted to the tightening in lending standards being implemented by banks.

There are several leading indicators (with reliable track records) that suggest that we are moving towards an economic slowdown. Central banks have raised policy rates significantly, and we may yet see the long and varied lagged effect of this monetary tightening impede the economy. We nudged up our probability of a soft landing in recent months, but a recession, especially a relatively mild one, remains a definite possibility.

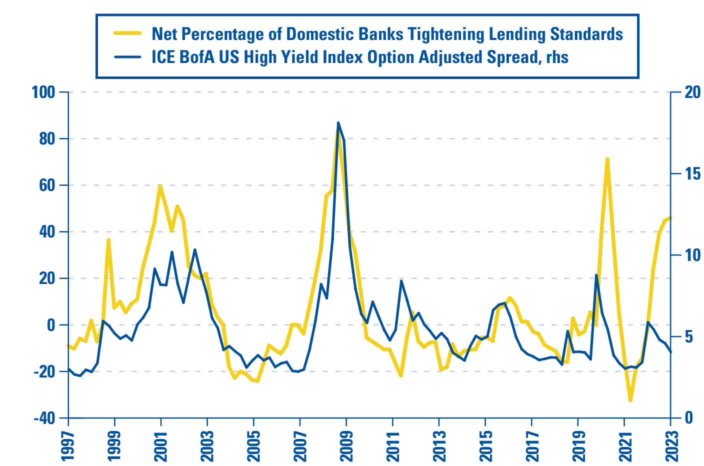
Market Strategy: Despite the attractive return, we do not think that the 366bps HY spread in the US (chart 6) is sufficient for the level of risk that we think HY debt represents. HY spreads have scope to widen if DM growth continues to moderate or morph into a recession.

US (OW IG, UW HY): We have a strong preference for investment grade relative to HY credit, believing that the risks are not reflected in HY prices. In addition, we believe the Fed is closer to its terminal rate, which should provide support to higher-duration assets such as IG bonds.

EU (OW IG, UW HY): As with the US, the HY-IG spread appears mispriced in comparison to our cyclical indicators. The European economy also looks vulnerable to a recession based on recent business surveys.

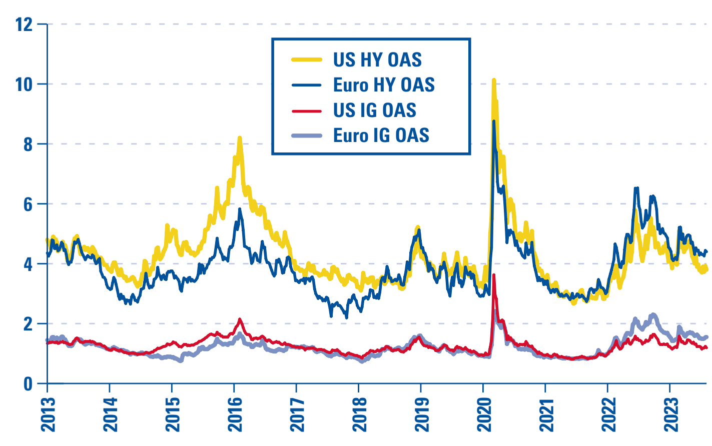
EM (NW $ Sovereign and NW $ Corporate): EM hard-currency bonds produced positive returns since our last outlook. The EM Sovereign spread and the EM Corporate spread are 371bps and 312bps, respectively, which are both close to their 10y average. We maintain our neutral stance on EM hard currency bonds.

Chart 5: HY Spreads and Lending Standards



Source: FRED, St. Louis Federal Reserve

Chart 6: HY/IG Credit Spreads, OAS



Source: Bloomberg

Real Estate

Neutral

Real estate valuations against fixed income have deteriorated.

	3Y history	Latest	
Net TR index*		3.4	Aug
EPS, % yoy		-7.6	Aug
Dividend yield, %		4.3	Aug

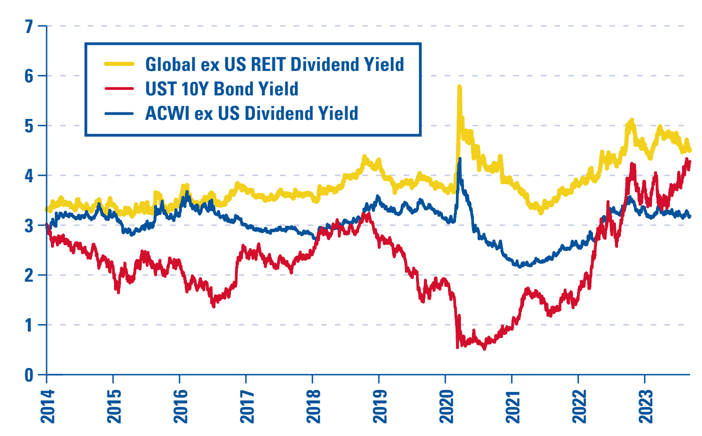
*Source: Bloomberg. 3M return is shown in "Latest". *FTSE EPRA/NAREIT Global Index.*

Global real estate was the third best-performing asset class in the three months to end-August, reversing its fortunes of previous quarters. The pro-cyclical nature of real estate equities meant it benefited from the improving market sentiment over a US 'soft landing', while hopes around property-related stimulus in China created volatility in July.

Nonetheless, conditions in the direct real estate market continue to deteriorate. Investment volumes fell by 54% yoy in Q2, making H1 the weakest period in a decade. Reflecting caution among investors, the capital bid-ask gap is still wide. Within sectors, the office sector is under the most pressure, with global net absorption turning negative in Q2. Sentiment in logistics and residential is more upbeat due to nearshoring trends and an undersupply.

Meanwhile, real estate stock valuations have become more stretched against US bond yields, given the sharp rise in the latter. Real estate maintains its value against equities (see Chart 7).

Chart 7: Yields, %



Source: Bloomberg

Market Strategy: The eventual peak in monetary tightening is a positive for real estate valuations. However, valuations have deteriorated over the past three months. Combined with a soft macro backdrop, we maintain our *neutral* allocation.

Commodities

Overweight (↑)

Despite the headwind of slower global growth, low inventories and building momentum in the decarbonisation trend will support industrial metal prices.

	3Y history	Latest	
Commodities*		16.3	Aug
Brent Oil		19.5	Aug
Copper		4.1	Aug
Aluminum		-1.7	Aug
Gold		-1.1	Aug
Corn		-22.4	Aug
Soybeans		4.6	Aug

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

Commodities were the best-performing asset class in June-August, driven by a rebound in energy prices as the supply picture tightened following deepening OPEC+ cuts. An expected global slowdown does not make for a supportive backdrop for commodities; however, with tentative signs that China's downturn may have troughed, the outlook has improved in recent months. Also, with the Fed approaching the end of its tightening cycle, the softer US dollar could lift commodity prices.

In the oil market, the extension of OPEC+ cuts until the end of 2023 suggests a tighter market. While not incorporating the latest OPEC+ decision, the EIA projects the global oil balance to remain in a deficit until the end of the year. As such, oil prices will likely be buoyed over the coming months, but the rally looks overbought. In industrial metals, we are optimistic about copper's medium-term prospects due to the decarbonisation trend. While global growth faces headwinds, low visible metals inventory should keep a floor under prices. Also, heightened polarity in speculative copper positioning highlights the lack of consensus on the direction of prices. For gold, valuations are too stretched to justify a change in position ahead of peak policy rates. Turning to agriculture, the high likelihood of an El Niño event this year implies a risk to crop yields and, therefore, rising prices, especially as inventories are low.

Market Strategy: While not all the stars are aligned for higher commodity prices, we have become more positive on the asset class. With copper a major beneficiary of the decarbonisation trend, we upgrade our allocation to industrial metals to *overweight*.

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-August 2023 unless otherwise stated)*

	ASSET ALLOCATION							PERFORMANCE					End May-End Aug	BENCHMARK INDEX & WEIGHTS	
	-3	-2	-1	0	+1	+2	+3	5Y	3Y	1Y	2022	Ytd			
EQUITIES				■				**43.3**	**23.3**	**14.0**	**-18.4**	**14.8**	**6.6**	**MSCI ACWI**	**50%**
US				■				64.6	30.9	15.2	-19.8	18.7	8.4	MSCI USA	25%
Eurozone		■						22.8	22.3	29.8	-17.9	15.8	4.4	MSCI EMU	7%
UK					■			18.1	34.9	14.8	-4.8	7.7	3.1	MSCI UK	3%
Japan				■				16.5	12.1	15.3	-16.6	13.6	4.6	MSCI Japan	5%
EM					■			5.0	-4.1	1.3	-20.1	4.6	3.5	MSCI EM	10%
RATES			■					**-10.5**	**-21.0**	**-1.1**	**-17.5**	**-0.5**	**-1.3**	**Bloomberg Barclays Global Treasury Total Return Index Value Unhedged**	**27%**
USTs				■				1.0	-14.5	-2.1	-12.5	0.7	-1.6	Bloomberg Barclays US Treasury Total Return Unhedged USD	10%
US TIPS					■			12.0	-4.4	-3.7	-11.8	1.1	-1.1	Bloomberg Barclays US Treasury Inflation-Linked Bond Index	3%
Bunds				■				-19.0	-25.3	2.2	-22.9	3.3	1.1	Bloomberg Barclays Euro Aggregate Treasury Germany TR Index Unhedged USD	3%
JGBs			■					-26.5	-30.9	-7.4	-17.5	-9.1	-6.1	Bloomberg Barclays Asian-Pacific Japan Treasury TR Index Unhedged USD	5%
EM Local					■			7.3	-6.1	8.9	-10.2	5.9	1.9	Bloomberg Barclays EM Local Currency Liquid Govt TR Index Unhedged USD	6%
CREDIT					■			**1.7**	**-13.4**	**3.1**	**-16.7**	**3.5**	**0.7**	**Bloomberg Barclays Global Aggregate Credit Total Return Index Value Unhedged USD**	**13%**
US IG							■	7.2	-12.0	0.9	-15.8	2.8	0.0	Bloomberg Barclays US Corporate Statistics Index	4%
US HY	■							17.7	5.5	7.2	-11.2	7.1	3.4	Bloomberg Barclays US Corporate High Yield Statistics Index	3%
European IG					■			-10.7	-17.9	9.1	-19.0	5.2	2.6	Bloomberg Barclays EuroAgg Corporate Statistics Index USD	2%
European HY			■					0.5	-7.1	15.0	-16.1	7.7	3.8	Bloomberg Barclays Pan-European High Yield (Euro) Index Statistics USD	1%
EM Sov $				■				1.5	-13.5	5.5	-17.4	4.2	2.6	Bloomberg Barclays Emerging Markets Sovereign TR Index Value Unhedged USD	2%
EM Corp $				■				4.0	-12.5	2.6	-14.9	2.1	0.3	Bloomberg Barclays Emerging Markets Corporates TR Index Value Unhedged USD	1%
REAL ESTATE				■				**-4.8**	**1.6**	**-5.1**	**-24.2**	**0.7**	**3.4**	**FTSE EPRA/NAREIT Global Index Net TRI USD**	**5%**
COMMODITIES					■			**30.9**	**100.9**	**-1.8**	**26.0**	**3.0**	**16.3**	**S&P GSCI Total Return Index**	**5%**
Energy				■				18.3	159.7	-4.1	42.3	5.6	26.6	S&P GSCI Energy Total Return Index	2%
Industrial metals					■			24.2	24.4	0.3	-7.6	-6.7	2.4	S&P GSCI Industrial Metals Total Return Index	1%
Precious metals				■				54.0	-4.9	15.0	-0.4	5.9	-0.9	S&P GSCI Precious Metals Index Total Return Index	1%
Agricultural				■				48.3	65.6	-5.4	12.1	-4.5	1.0	S&P GSCI Agriculture Index Total Return Index	1%

Source: Bloomberg, CLIM

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Investment Management Company Limited

Contacts

Macroeconomic Analysis

Justin Kariya, London Office
Phone: 011 44 207 711 1558
E-Mail: justin.kariya@citlon.co.uk

Tom Traill, London Office
Phone: 011 44 207 860 8316
E-mail: tom.traill@citlon.co.uk

Yasemin Engin, London Office
Phone: 011 44 207 711 1551
E-Mail: yasemin.engin@citlon.co.uk

London Office
77 Gracechurch Street
London EC3V 0AS
United Kingdom
Phone: 011 44 20 7711 0771
Fax: 011 44 20 7711 0774
E-Mail: info@citlon.co.uk

Philadelphia Office
17 East Market Street
West Chester, PA 19382
United States
Phone: 610 380 2110
Fax: 610 380 2116
E-Mail: info@citlon.com

Singapore Office
20 Collyer Quay
10-04
Singapore 049319
Phone: 011 65 6236 9136
Fax: 011 65 6532 3997

Website

www.citlon.com
www.citlon.co.uk