Cross-Asset Quarterly Outlook

December 2023*

Overview

Walking on Thin Ice

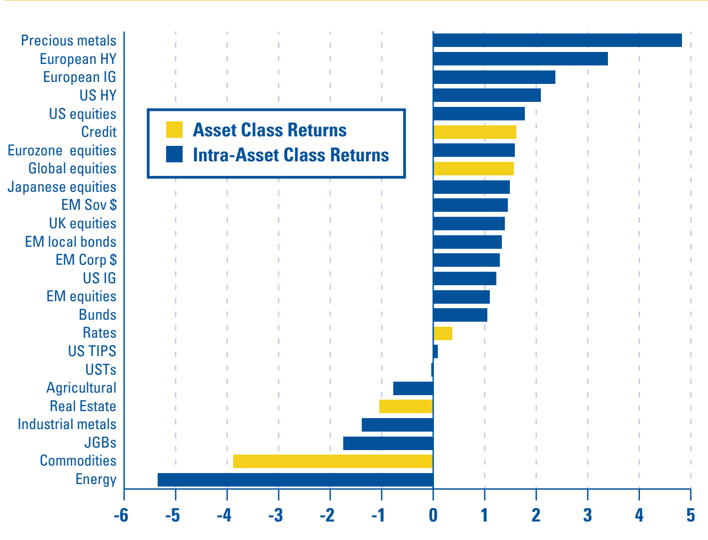
- *Soft landing expectations have grown going into year-end, and the Fed has likely completed its rate hiking cycle.*
- *Global equities and high-yield bonds benefit from these developments; however, forward-looking indicators continue to signal caution towards the cycle in 2024.*
- *Our asset allocation reflects a balance between a soft landing and mild recession scenario, but our bias continues to lean towards an economic slowdown favouring higher-quality assets.*
- *We upgraded our US government bonds allocation to over weight and reduced our EM local bonds allocation to neutral.*

Since our last Cross-Asset Quarterly, pro-cyclical assets (global equities and global high-yield bonds) have been supported by growing expectations for a soft landing scenario. Despite a further decline in the Global PMI composite index to a below-trend level of 50, markets have been comforted by resilient US growth and further disinflation. Both allow the Fed to signal a potential end to its rate-hiking cycle, resulting in looser financial conditions and stronger global equity performance.

While we still consider a soft landing a possible outcome in 2024, our baseline view remains below-trend growth in 2024. Current pricing is overly optimistic in our view. Admittedly, inflation is moderating, and the recent US 3Q GDP print of 5.2% qoq annualised growth does not indicate an imminent recession. In addition, there is precedent for avoiding a recession following a Fed hiking cycle. For example, Alan Greenspan's mid-1990s policy tightening avoided a recession. However, our leading indicators continue to signal caution as long and variable lags feed through the US economy following 525bps Fed tightening. Also, excess pandemic savings and loose fiscal policy are expected to become less supportive factors over 2024. Outside of the US, the eurozone is experiencing a slowdown and is potentially on track for a recession. In China, growth remains on target for 5% in 2023, but long-term structural challenges remain a headwind.

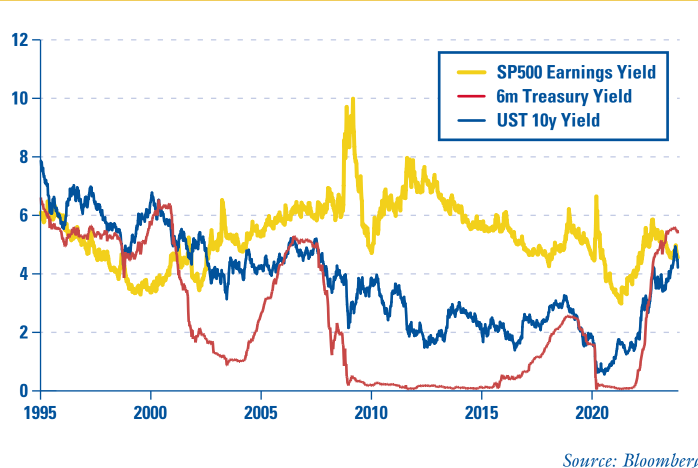
Pockets of resilience in the global economy may continue supporting earnings in the first half of 2024. We have, therefore, refrained from an equity underweight in 2023. However, fixed-income valuations continue to improve relative to equities. For example, the US equities' earning yield relative to the 10-year US Treasuries is now negative for the first time since 2002. The global equities earnings yield is also becoming less attractive versus bonds, but international equity valuations look more appealing than the US market. If our broad macro momentum signals turn negative in 2024, we will likely move equities to underweight relative to government bonds. We stay neutral equities but express a more defensive allocation via underweight in high-yield bonds versus higher-quality duration assets.

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



Source: Bloomberg

Chart 2: Yields, %



Source: Bloomberg

**The publication reflects asset performance up to November 30, 2023, and macro events and data releases up to December 6, 2023, unless indicated otherwise.*

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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

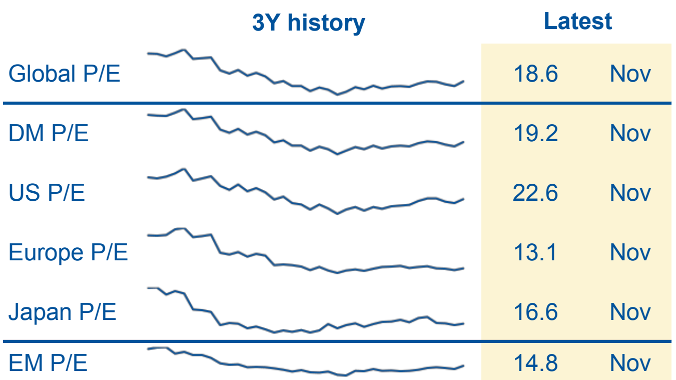
Our overall asset allocation reflects a wide distribution of potential scenarios in 2024. A soft landing (favouring more pro-cyclical assets) and a mild recession (favouring more defensive assets) remain possible outcomes in 2024. Our bias leans more towards a slowdown in earnings favouring higher-quality duration. Still, we also acknowledge that the recent data may continue to feed near-term expectations for a 'goldilocks' scenario of trend growth and further disinflation, keeping us neutral equities. Our recent **Asset Allocation** changes this quarter reflect marginal adjustments in favour of higher-quality duration:

- We remain *neutral* on **equities**. A fall in DM bond yields provides renewed support for global equities and Megacap technology stocks, while US earnings growth remains resilient. However, we are cautious about elevated valuation measures, which suggest limited upside should a material slowdown occur in 2024. Intra-equities, we continue to favour EM and the UK versus underweight in the eurozone.
- In **rates**, we remain *underweight* but reduce the size. The position reflects our Japanese government bond (JGB) underweight. While DM rates have likely peaked following the recent Fed and ECB pause, we continue to look for some normalisation in the Bank of Japan's loose monetary policy. Outside of Japan, we are overweight DM government bonds. We remain overweight US duration and increase our allocation to US Treasuries (UST). EM local bonds are downgraded to neutral, given that the spread to USTs has become less attractive.
- We downgrade **credit** to *neutral*. We shifted some of our US investment grade (IG) credit overweight to US government bonds, given that spreads are tight. However, we remain overweight IG where fundamentals remain positive. Global HY remains underweight as we look for some spread widening in 2024.
- 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 stay *overweight*. Within commodities, we continue to see long-term value in industrial metals. We remain neutral in energy and precious metals.

Equities

Neutral

Stay OW EM and UK versus UW in the Eurozone.



	3Y history	Latest	
Global P/E		18.6	Nov
DM P/E		19.2	Nov
US P/E		22.6	Nov
Europe P/E		13.1	Nov
Japan P/E		16.6	Nov
EM P/E		14.8	Nov

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

Global equities outperformed most asset classes in the past three months. The combination of lower rates, resilient US growth, and still buoyant earnings expectations were all helpful factors contributing to recent performance. These factors may further support equities over the short term if inflation continues to fall closer to target and the market prices further rate cuts. However, we think market pricing is moving closer to a soft landing view when late-cycle risks remain.

The MSCI ACWI earnings are expected to deliver 11% growth in 2024. However, revisions will likely trend lower as long as variable monetary lags apply pressure to activity and corporate profits. Tighter credit conditions, an inverted yield curve, and a rising US unemployment rate are warning signals that investors should not be overly complacent. In absolute terms, equities can still produce positive returns if the US avoids a recession and the Fed begins considering rate cuts. However, equities will struggle to outperform fixed income if global growth continues to fall below trend. Indeed, the SP500 earnings yield is now lower than the US 10-year Treasury bond for the first time since 2002.

Market Strategy: The MSCI ACWI Index 12m forward PE remains elevated at 16x – largely thanks to a handful of American tech stocks – and is vulnerable to further shocks from tighter financial conditions or elevated geopolitical risks. Despite our expectations for a global slowdown in 2024, investors can still find strategic value within international equities. Indeed, the ACWI ex-USA Index is trading at a forward P/E of 13x, below its historical average. Within equities, we have not made any allocation changes since the last Quarterly Outlook.

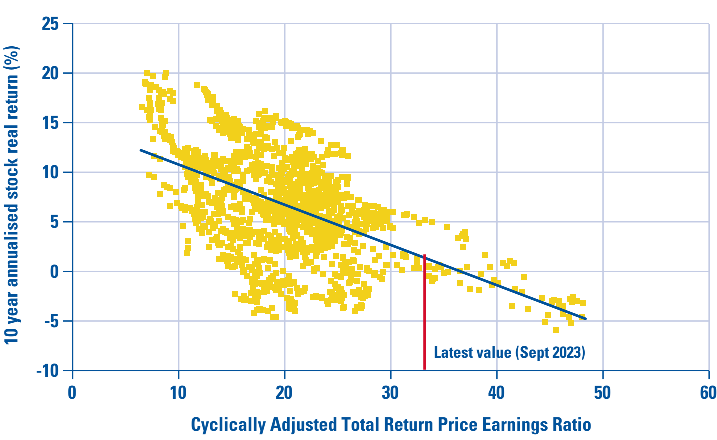
We keep our *overweight* in EM. EM earnings remain strong for 2024 in anticipation of a cyclical bottom in China's earnings and semiconductor sales, while our valuation measures continue to signal an opportunity for re-rating if positive earnings are delivered next year. Short-term headwinds remain with US rates and the USD trading at elevated levels. But we expect these drivers to move in favour of EM assets.

We stay *overweight* in the **UK**. The price of brent crude has moderated, and our baseline view does not anticipate a repeat of 2022 price rises. However, the tail risk of escalation in the Middle East or the Ukraine-Russia conflict will likely keep some risk premium in oil prices, supporting Energy stocks.

We remain *neutral* in the **US** and **Japan**. The US economy remains resilient, and the equity index includes world-class companies linked to strategic growth areas in technology - still, the US market trades at a far higher multiple than other markets. In Japan, improving corporate governance is a longer-term positive, but Japanese exporters may struggle to maintain strength if the cycle turns less favourably and the JPY strengthens.

We maintain our *underweight* to the **Eurozone**. Recent data continues to signal further negative pressure on earnings. Valuations have cheapened, but we expect further weakness if global growth slows. Higher energy prices remain a risk for the Eurozone.

Chart 3: Real Stock Returns Tend to be Lower from a High Starting Valuation



Source: Schiller, Yale

Rates

Underweight

Upgrade UST exposure to overweight and downgrade EM local exposure to neutral.

	3Y history	Latest	
Global Govt Yield		3.3	Nov
UST 10Y Yield		4.3	Nov
TIPS 10Y Real		2.1	Nov
Bund 10Y Yield		2.4	Nov
Italy 10Y Yield		4.2	Nov
JGB 10Y Yield		0.7	Nov
EM Local Yield		4.3	Nov

Source: Bloomberg Barclays Indices. Yield in %.

The last three months have seen two sides to the bond market – yields rose sharply through September, with the US 10-year briefly breaking 5% in October. This weakness was primarily driven by concerns over the ongoing level of government borrowing and the fear of prolonged inflation and further policy tightening. However, recent weeks have seen yields fall markedly. Additional signs of disinflation and growing expectations that the Federal Reserve and other major central banks (except Japan) are done hiking have supported a rally in fixed income.

Our duration view remains positive for several reasons. First, although no Fed official has explicitly ruled out further rate hikes, several more hawkish FOMC members have suggested that the current policy level may be sufficient to bring inflation back to target. Inflation remains above target but is heading in the right direction. Second, despite the recent decline in DM yields, bond valuations remain attractive, particularly compared to equities. Finally, the bond-equity correlation has turned positive post-pandemic. Historically, this is not unusual in periods of high inflation. However, if we see a material slowdown and further disinflation, the correlation will likely turn negative, leaving higher-quality bonds well-placed to outperform.

Market Strategy:

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

We upgrade our view on US Treasuries to *overweight* due to a growing conviction that the Fed has finished hiking while offering comparative security in a global slowdown. We remain neutral in Europe, where a recession seems comparatively more likely, but yields are lower, offering less value. In Japan, we remain underweight. The Bank of Japan is at a different stage of the monetary cycle due to its late exit from ultra-loose monetary policy. The current level of Japanese government bond (JGB) yields implies that risks are asymmetrically skewed towards higher rates, making Japan the least attractive government bond market.

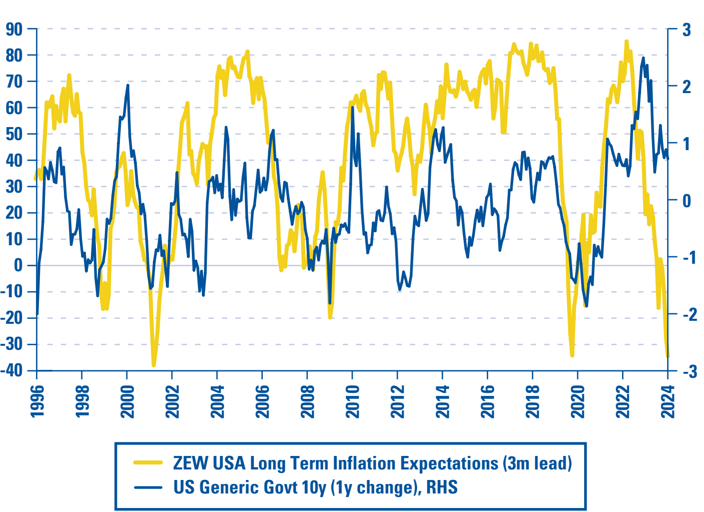
US TIPS (OW):

We remain *overweight* inflation-protected bonds. US TIPS currently offer a real yield of over 2%, levels that had not been seen for over a decade. Like nominal bonds, inflation-linked bonds should fare relatively well in a lower growth environment next year but will likely underperform nominals as inflation moderates. US TIPS offer more value for alternative scenarios that lift inflation expectations while negatively impacting growth. For example, ongoing geopolitical events such as the Ukraine-Russia war and the Israel-Hamas conflict could feed into greater oil price volatility, resulting in a repricing in breakeven inflation.

EM local bonds (downgrade to neutral):

Due to their earlier policy tightening, EM centrals have been able to start cutting rates ahead of DM. These actions have supported EM local bonds this year. However, the EM local index spread relative to US Treasuries no longer offers an attractive premium. Also, EM central banks may struggle to accelerate rate cuts beyond current expectations if global financial conditions tighten, which historically triggers capital outflows. Given these factors, we reduced our EM local allocation to *neutral*.

Chart 4: Lower Inflation is Supportive for DM Bonds.



Source: Bloomberg

Credit

Neutral (↓)

Maintain global IG OW vs HY UW, but shift some IG exposure to government bonds given tight spreads.

	3Y history	Latest	
Global IG OAS		1.2	Nov
US IG OAS		1.0	Nov
US HY OAS		3.7	Nov
Euro IG OAS		1.5	Nov
Euro HY OAS		4.3	Nov
EM Sov $ OAS		3.8	Nov
EM Corp $ OAS		2.9	Nov

Source: Bloomberg Barclays Indices. Yield in %.

Credit was the best performing of the major asset classes in the past three months (Sep-Nov), returning 1.6%. Global high yield (HY) bonds led this space due to attractive yields, and further spread compression. Default rates in 2023 are tracking close to the historical average. Also, many companies could refinance during the pandemic for relatively long periods at low rates, providing some stability for credit spreads. Overall, HY spreads are tight despite our earlier expectations for some widening.

Lower-quality credit will likely come under some pressure in 2024. Default rates are more likely to pick up next year as the pace of growth (particularly in the US) begins to slow below trend. Even if rates fall in the coming quarters, HY issuers will come under increasing pressure when refinancing their debt at higher rates. In addition, credit spreads typically correlate closely with equity volatility (as measured by the VIX), which is unusually low at a level of 13 versus a long-term average close to 20. A normalisation in market volatility will reduce the attractiveness of spread products, which should result in some risk premium being priced back into global HY spreads.

Global investment Grade (IG) spreads have also tightened in response to lower market volatility. However, the higher duration of IG bonds has been punished this year due to the sharp rise in DM bond yields in response to policy tightening. The Fed has likely completed its hiking cycle, which will provide more support for higher-duration assets, including IG bonds. We remain *overweight* given the relative safety of IG within the credit space, attractive yields (vs equities), and scope for higher-duration assets to outperform in anticipation of Fed rate cuts next year. However, given that IG spreads have tightened to recent lows, we have started to shift some of our overweight exposure to government bonds. This shift has resulted in our overall Credit allocation moving to neutral from overweight.

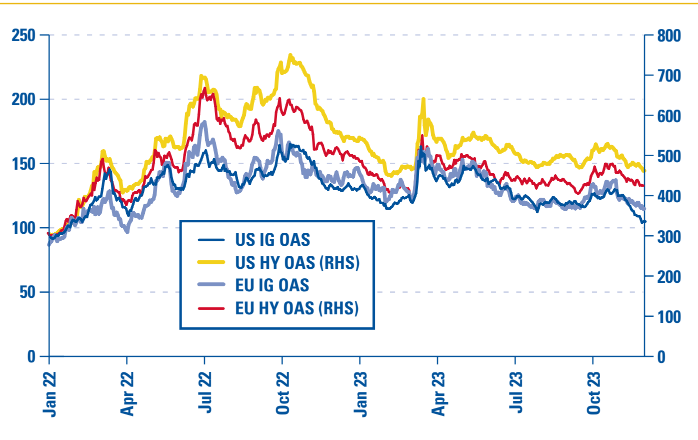
Market Strategy: Our allocations favour IG credit relative to HY credit.

US (OW IG, UW HY): We remain *overweight* IG credit, albeit slightly less overweight than previously. We expect IG to outperform as a Fed peak is historically followed by a rally in higher-quality fixed income assets. The US HY's absolute yield remains appealing, but economic conditions will eventually move against lower-quality debt. Based on our estimates, the current level of spreads is more closely aligned with a soft landing scenario.

EU (OW IG, UW HY): European corporates are in a similar position to US ones, except the economic outlook looks weaker and a recession more likely. As with the US, we remain *overweight* IG credit and *underweight* HY.

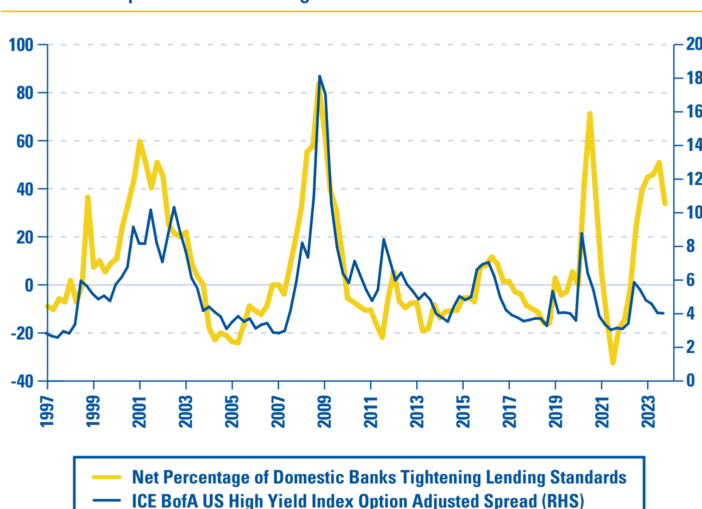
EM (NW $ Sovereign and NW $ Corporate): EM hard-currency bonds produced positive returns since our last outlook. The EM Sovereign spread and the EM Corporate spread are 377bps and 290bps respectively. We maintain our *neutral* allocation on EM hard currency bonds.

Chart 5: US and EU Corporate OAS (bps)



Source: Bloomberg

Chart 6: HY Spreads Remain Tight

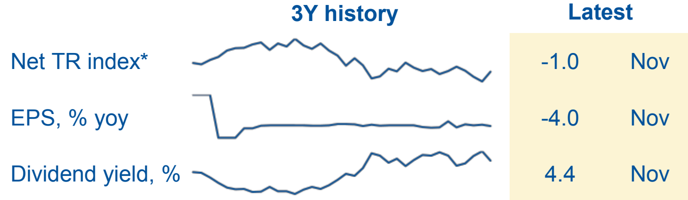


Source: FRED, St Louis Federal Reserve

Real Estate

Neutral

A global slowdown and unattractive value relative to fixed income support a neutral real estate allocation..



	3Y history	Latest	
Net TR index*		-1.0	Nov
EPS, % yoy		-4.0	Nov
Dividend yield, %		4.4	Nov

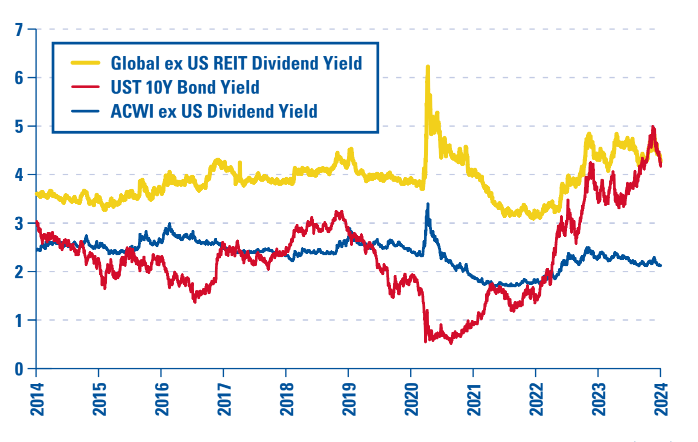
*Source: Bloomberg. 3M return is shown in "Latest". *FTSE EPRA/NAREIT Global Index.*

Global real estate was one of the weakest asset classes in the three months to end-November on the back of monetary tightening and lingering growth concerns. The impact of past rate hikes will take time to feed through into activity while keeping the cost of capital high. Poor sentiment is reflected in the wide bid-ask spreads. Global direct investment volumes declined by 46% yoy in Q3, while cross-border transactions were 56% lower on the year.

Nonetheless, real estate stocks are well placed beyond the near term once the economic cycle turns more positive. For a start, substantial dry powder is waiting for the right opportunities. At a sectoral level, nearshoring and demographics will continue to support the industrial and residential sectors respectively. Elsewhere, the office sector is likely to lag, given large supply pipelines and economic softness, while the retail sector shows tentative signs of a recovery.

Global real estate stock valuations continued to deteriorate against US bond yields while maintaining value against equities (see Chart 7). The eventual peak in the Fed's tightening cycle and expectations of an economic slowdown should cap US bond yields, providing some reprieve for real estate pricing.

Chart 7: Yields, %



Source: Bloomberg

Market Strategy: A peak in bond yields and an improvement in the economic cycle will strengthen the case for real estate. Until then, we keep our *neutral* allocation.

Commodities

Overweight

Weak sentiment and strong long-term demand provide a favourable backdrop for industrial metals.

	3Y history	Latest	
Commodities*		-3.9	Nov
Brent Oil		-4.6	Nov
Copper		0.5	Nov
Aluminum		-0.7	Nov
Gold		5.0	Nov
Corn		0.2	Nov
Soybeans		-1.3	Nov

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

Commodities were the worst-performing asset class in September-November. Precious metals were the only sub-asset class to record positive returns, as gold prices rallied amid heightened geopolitical risk and a softening US dollar. While our base case of sluggish global growth is typically an unsupportive environment for commodities, our assumption for peak rates and a weaker US dollar provides some support. Moreover, there could be less downside for commodities as the drop in commodity prices year-to-date compared to other asset classes suggests that the asset class is already pricing in a material slowdown. Additionally, commodities like oil offer some value as a geopolitical hedge.

In the oil market, the EIA projects the global oil balance to be in a small surplus on average in 2024, leaving prices treading water. The limited surplus means the market is vulnerable to an escalation in the Israel-Hamas war and further OPEC+ cuts. Turning to industrial metals, a soft macro backdrop and ample supply will likely keep prices range-bound for the next year. However, we still hold an optimistic medium-term view on copper due to demand from the energy transition. The resilience of gold prices in the face of rising US Treasury yields has indicated that they continue to screen expensive. While current prices do not offer an attractive entry point, allocation to gold could be increased ahead of a Fed easing cycle should prices soften from their current high. Agricultural prices are skewed to the upside due to El Niño-related risks to supply.

Market Strategy: A likely global slowdown suggests limited upside for commodities; however, supply risks (oil, agricultural) and decarbonisation trends (copper) should keep a floor under prices. We maintain our *overweight* to industrial metals.

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-November 2023 unless otherwise stated)*

	ASSET ALLOCATION							PERFORMANCE						BENCHMARK INDEX & WEIGHTS	
	-3	-2	-1	0	+1	+2	+3	5Y	3Y	1Y	2022	Ytd	End Sep-End Nov		
EQUITIES				■				**54.4**	**18.1**	**12.0**	**-18.4**	**16.6**	**1.6**	**MSCI ACWI**	**50%**
US				■				76.0	27.5	13.7	-19.8	20.8	1.8	MSCI USA	25%
Eurozone		■						38.6	14.4	17.6	-17.9	17.6	1.6	MSCI EMU	7%
UK					■			28.4	29.8	8.7	-4.8	9.2	1.4	MSCI UK	3%
Japan				■				24.9	1.8	15.6	-16.6	15.3	1.5	MSCI Japan	5%
EM					■			12.3	-11.6	4.2	-20.1	5.7	1.1	MSCI EM	10%
RATES			■					**-8.7**	**-21.9**	**0.6**	**-17.5**	**-0.1**	**0.4**	**Bloomberg Barclays Global Treasury Total Return Index Value Unhedged**	**27%**
USTs					■			1.5	-14.1	0.1	-12.5	0.7	0.0	Bloomberg Barclays US Treasury Total Return Unhedged USD	10%
US TIPS					■			14.3	-4.4	0.1	-11.8	1.2	0.1	Bloomberg Barclays US Treasury Inflation-Linked Bond Index	3%
Bunds				■				-16.1	-25.5	3.5	-22.9	4.4	1.0	Bloomberg Barclays Euro Aggregate Treasury Germany TR Index Unhedged USD	3%
JGBs			■					-26.3	-33.4	-6.8	-17.5	-10.7	-1.7	Bloomberg Barclays Asian-Pacific Japan Treasury TR Index Unhedged USD	5%
EM Local				■				6.1	-8.4	9.8	-10.2	7.3	1.3	Bloomberg Barclays EM Local Currency Liquid Govt TR Index Unhedged USD	6%
CREDIT				■				**5.9**	**-13.9**	**5.4**	**-16.7**	**5.1**	**1.6**	**Bloomberg Barclays Global Aggregate Credit Total Return Index Value Unhedged USD**	**13%**
US IG						■		10.7	-12.9	3.6	-15.8	4.0	1.2	Bloomberg Barclays US Corporate Statistics Index	4%
US HY	■							22.5	4.2	8.7	-11.2	9.4	2.1	Bloomberg Barclays US Corporate High Yield Statistics Index	3%
European IG					■			-5.0	-17.7	9.6	-19.0	7.7	2.4	Bloomberg Barclays EuroAgg Corporate Statistics Index USD	2%
European HY			■					10.1	-7.5	14.6	-16.1	11.4	3.4	Bloomberg Barclays Pan-European High Yield (Euro) Index Statistics USD	1%
EM Sov $				■				3.1	-13.3	5.8	-17.4	5.7	1.4	Bloomberg Barclays Emerging Markets Sovereign TR Index Value Unhedged USD	2%
EM Corp $				■				5.7	-13.3	5.5	-14.9	3.4	1.3	Bloomberg Barclays Emerging Markets Corporates TR Index Value Unhedged USD	1%
REAL ESTATE				■				**-3.5**	**-5.0**	**-2.9**	**-24.2**	**-0.3**	**-1.0**	**FTSE EPRA/NAREIT Global Index Net TRI USD**	**5%**
COMMODITIES					■			**44.9**	**85.5**	**-2.4**	**26.0**	**-1.0**	**-3.9**	**S&P GSCI Total Return Index**	**5%**
Energy				■				40.6	143.1	-3.4	42.3	0.0	-5.4	S&P GSCI Energy Total Return Index	2%
Industrial metals					■			24.4	9.9	-7.3	-7.6	-8.0	-1.4	S&P GSCI Industrial Metals Total Return Index	1%
Precious metals				■				59.5	12.7	16.3	-0.4	11.0	4.8	S&P GSCI Precious Metals Index Total Return Index	1%
Agricultural				■				48.3	46.3	-3.7	12.1	-5.2	-0.8	S&P GSCI Agriculture Index Total Return Index	1%

Source: Bloomberg, CLIM

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