CITY OF LONDON
Investment Management Company Limited

Developed Markets Quarterly Outlook

August 2024*

Overview

What's changed, and what hasn't?

Global equities have come under pressure in recent weeks as macro and political drivers create market volatility. Overall, we assess the macro backdrop as mixed with pockets of strength in areas such as semiconductor demand to power Artificial Intelligence (AI) growth. However, the US labour market shows signs of softening, prompting an increase in our recession probability to 30% over the next 6-12 months. Our asset allocation continues to balance some pro-cyclical and defensive exposure. We are slightly increasing the latter by upgrading Switzerland to overweight and downgrading Canada to neutral.

Since mid-July, global equities (ACWI) declined and have seen a sharp rise in volatility. The market peak (July 16th) coincided with former President Trump's improvement in polls and a potential political change. The mid-July market dynamic was more consistent with a rotation away from large-cap technology stocks (in favour of small-cap and value stocks) rather than a broad market sell-off. This dynamic shifted following the July 31st central bank meetings, and broad-based selling pressure intensified after the recent US payrolls report. The Bank of Japan hiked their target rate against consensus expectations, triggering a 'carry trade unwind', driving a sharp Yen appreciation and a significant decline in Japanese stocks. The Federal Reserve's July meeting was more benign, but the FOMC failed to use the opportunity to ease policy and postponed their decision to the September meeting. Finally, the US payrolls report showed an unexpected 0.2% point rise in the unemployment rate (to 4.3%), triggering the 'Sahm rule', which has historically signalled when the US economy is in a recession. Does the recent price action and the rising unemployment rate indicate we are in a recession and bear market? We think the signs are more mixed at this juncture. We review what has changed over the quarter and what has not changed in recent months.

What has changed? The global growth backdrop remains above trend based on coincident indicators such as the global PMI composite index. However, growth has started decelerating for the first time this year (Chart 1). The recovery in China and Europe has stalled, and strong US growth appears to be transitioning to trend growth. The most recent Atlanta Fed GDP Nowcast estimate has fallen to a growth rate closer to 2%. The slowing labour market may be an early warning signal that US growth will decelerate further. We are adjusting our recession probability higher to 30% over the next 6-12 months. Still, we emphasize that our baseline view remains a more benign growth slowdown over the next year. Our broad set of leading indicators does not currently signal a sharp deterioration in global growth.

The rates outlook has also shifted slightly. We expected rate cuts this year, but the softer inflation and labour market data have intensified the pressure on the Fed to cut rates at the next meeting in September. The 10-year Treasury yield is now below 4%. Historically, the implication for stocks depends more on the growth backdrop and not just interest rates. We do not see a strong case for being heavily exposed to defensives relative to cyclicals or vice versa. Still, the combination of slower growth and lower rates favours an upgrade to more counter-cyclical sectors, given that defensive stocks have historically performed better in a lower rates environment (Chart 2). We upgraded our Switzerland allocation due to its higher weighting to defensive sectors.

In politics, the upcoming US election may result in some shifts in the US. The race remains close between both candidates (based on RealClearPolitics.com betting odds). It is too early to position aggressively for a particular election outcome. Still, markets have to price the possibility of a Trump victory that could see trade tariffs rise. US-China trade tensions are not a new theme and were a mainstay of the Biden administration. Higher tariffs for traditional allies such as Europe could be a new market headwind under a second Trump term.

Global Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
US	–			■		
Canada	↓			■		
Eurozone	–		■			
Switzerland	↑				■	
UK	–		■			
Japan	–			■		
Australia	–		■			
EM	–					■

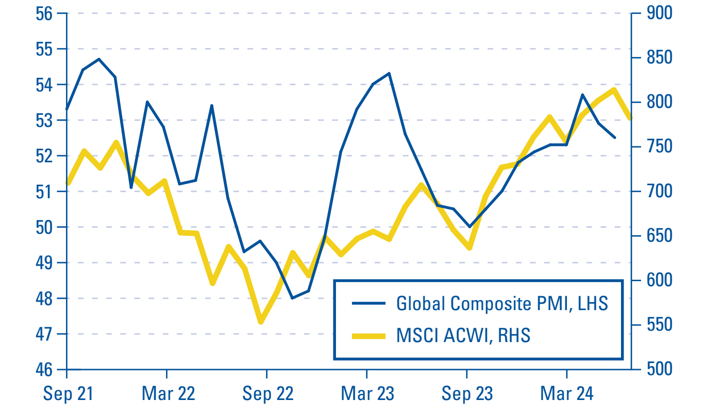
International Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
Canada	↓			■		
Eurozone	–		■			
Switzerland	↑				■	
UK	–		■			
Japan	–			■		
Australia	–		■			
EM	–					■

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

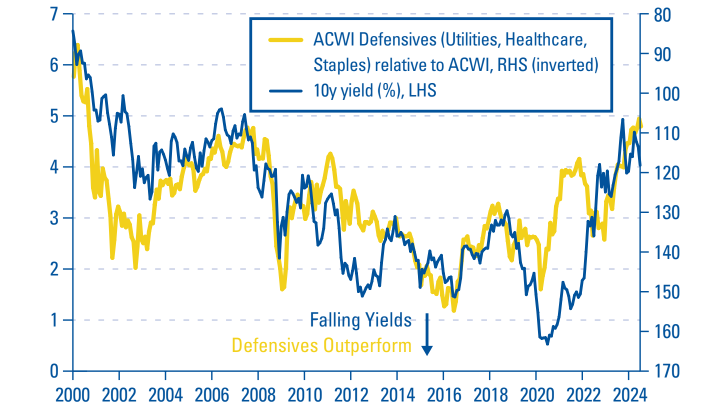
**This publication reflects asset performance up to 31 July, 2024, and macro events and data releases up to 7 August, 2024, unless indicated otherwise.*

Chart 1: The Global Composite PMI Index and Global Equities (ACWI)



Source: Bloomberg

Chart 2: ACWI Defensive Sectors (vs ACWI) and US 10-year Yield



Source: Bloomberg

What has not changed? Artificial Intelligence (AI) remains a structural growth theme. There remain question marks on how some companies will profit from AI and what earnings forecasts and valuation multiples are reasonable for the most optimistically priced US tech stocks. However, there is clear evidence of growth in tech hardware/semiconductor demand and data centres required to power AI. Global semiconductor sales and Taiwan/South Korea exports are rising to meet growing demand (Chart 3). Guidance from large US tech firms suggests these trends will persist for some time. As a result, any weakness in the tech cycle is likely to be shallow relative to past downturns. We continue to see value in EM due to its significant exposure to these themes.

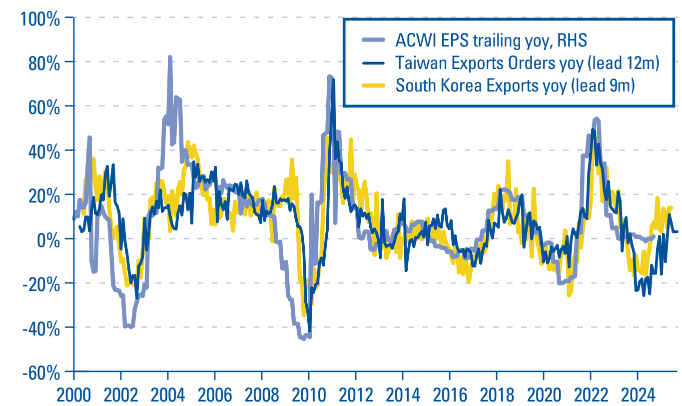
Meanwhile, the US dollar remains expensive on standard valuation metrics, and the long-term trend is likely lower, given that its current Real Effective Exchange Rate (REER) is close to previous historical peaks (Chart 4). An imminent reversal in the multi-year dollar appreciation trend is difficult to time. The dollar could see bouts of strength due to global growth concerns or new tariffs. Still, it is notable that the nominal trade-weighted dollar (JPMQUSD Index) has depreciated over 1% since early July despite a rise in Trump's election chances and rising US recession fears. Any fading of 'US exceptionalism' and lower US rates will likely lead to a weaker greenback.

Market Strategy: Our asset allocation favours a balance between cyclical and defensive beta. Since our last quarterly, we have marginally upgraded our recession risk expectations. As a result, we are adding more defensive exposure (via Switzerland) to our allocation while maintaining exposure to AI (via EM). We made the following changes to our country allocation:

- Upgrade **Switzerland** to *overweight*. The MSCI Switzerland Index premium relative to ACWI has eroded close to zero, which presents a compelling value opportunity. The Swiss index contains the highest weighting to defensive sectors such as healthcare and consumer staples, which historically outperform in an environment of slower growth and lower rates.

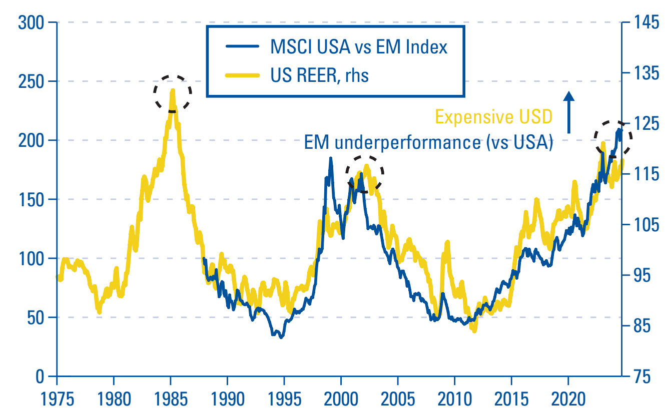
- Downgrade **Canada** to *neutral*. Canada still presents pockets of value. Its financial sector trades at historically depressed levels and geopolitical risks may support its energy sector. However, Canada is not insulated from slower growth in the US (its largest trade partner). A deceleration in global activity is also a risk for energy demand.

Chart 3: Taiwan Export Order, South Korea Exports, and ACWI Trailing Earnings (yoy)



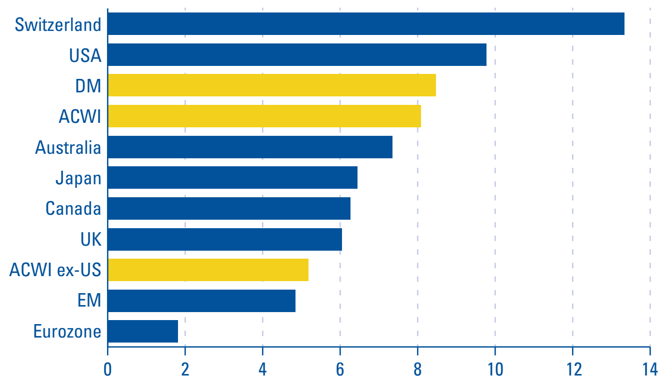
Source: Bloomberg

Chart 4: US Dollar Real Effective Exchange Rate (REER) and MSCI USA Index vs. MSCI EM Index



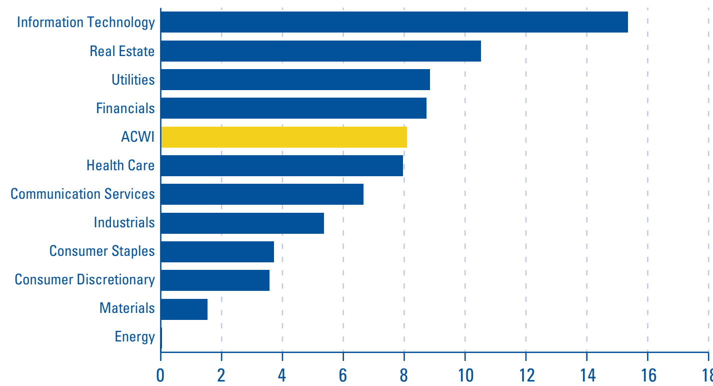
Source: Bloomberg

MSCI ACWI, Net Total USD Return, May-Jul, %



Source: Bloomberg

MSCI ACWI Sectors, Net Total USD Return, May-Jul, %



Source: Bloomberg

United States

NW (Global Index)

	3Y history	Latest	
GDP, % qoq saar		2.8	Q2
PMI, index		46.8	Jul
CPI, % yoy		3.0	Jun
Policy rate, %		5.38	Jul
MSCI USA*		1.7%	Jul
EPS, % yoy		3.5	Jul
Trailing P/E		26.3	Jul

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- US economic data has begun to soften, falling closer to trend growth. Labour market data has weakened, potentially signalling lower growth ahead. The November election is also a source of uncertainty. Recent inflation prints have fallen faster than expectations, providing greater confidence that the Fed will begin cutting rates in September. The weaker employment and inflation data suggests the Fed may now be behind the curve.
- Earnings expectations remain positive in the US but have seen downward revisions recently. The US has remained among the strongest markets with solid earnings growth from mega-cap stocks. However, multiples in some sectors of the US market have expanded to unattractive levels.
- Historically the US tends to outperform in a slower growth environment given its positive correlation to lower rates, and it has a smaller weighting to highly cyclical sectors compared to other DM markets. However, the reliability of this signal is less clear going into the next recession given the long US equity positioning is one of the most crowded trades. We remain *neutral*.

Eurozone

UW (Global and Global ex-US index)

	3Y history	Latest	
GDP, % yoy		0.6	Q2
PMI, index		45.8	Jul
CPI, % yoy		2.6	Jul
Policy rate, %		4.25	Jul
MSCI Eurozone*		-6.3%	Jul
EPS, % yoy		1.3	Jul
Trailing P/E		16.3	Jul

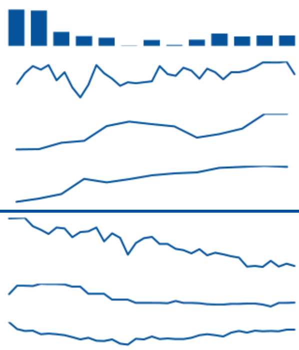
**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- A recovery in European activity data appears to be reversing based on the latest business surveys. We continue to see downside risks for earnings. Moderating inflation and weaker growth support further ECB rate cuts, in line with other DM ex Japan central banks.
- Europe's equity market has historically been more pro-cyclical, benefiting from higher global growth and rates. As global data decelerates and rates fall, we expect the Eurozone to underperform. The upcoming US election may also add a new headwind if Trump is elected and implements tariffs on European goods.
- Valuation measures continue to signal value in Europe. However, Eurozone equities lack a positive catalyst, with global growth decelerating and domestic politics (e.g. French elections) likely resulting in more gridlock rather than structural reform. We remain *underweight*.

Emerging Markets

OW (Global and Global ex-US index)



	3Y history	Latest	
GDP, % yoy		4.8	Q1
PMI, index		50.7	Jul
CPI, % yoy		7.9	Jun
Policy rate, %		6.54	Jul
MSCI EM*		-3.3%	Jul
EPS, % yoy		-9.3	Jul
Trailing P/E		15.7	Jul

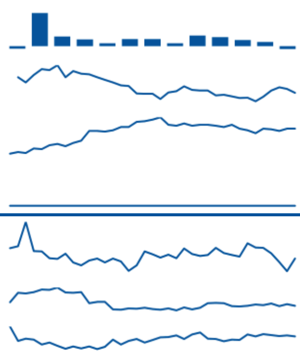
**US$ total return relative to MSCI ACWI. Latest is three-month return. Economic indicators are GDP-weighted with the exception of PMI, which is value-added-weighted.*

Source: Bloomberg

- Emerging Markets (EM) offer exposure to advanced manufacturing and AI-related technologies at more appealing valuations than their DM counterparts. Taiwan and Korea are integral to manufacturing cutting-edge semiconductors and high band width memory (HBM) and are well-positioned to benefit from the rebound in the semiconductor cycle.
- The dollar remains richly priced on some standard valuation measures, and while FX valuations are not typically a reliable short-term predictor of FX moves, they signal that the risks are more asymmetrical to the downside for the USD over the long run. Should the dollar weaken, history suggests that EM equities and currencies will be significant beneficiaries.
- Relative to other markets, expected earnings for EM are strong (+20% over 2024-25). Despite solid earnings expectations, the current 12m forward P/E ratio for the MSCI EM Index is only 12x, below its five-year average. The combination of robust earnings growth and attractive value suggests that the market is ripe for a re-rating. We remain *overweight*.

Japan

NW (Global and Global ex-US index)



	3Y history	Latest	
GDP, % yoy		-0.7	Q1
PMI, index		49.1	Jul
CPI, % yoy		2.8	Jun
Policy rate, %		-0.10	Jul
MSCI Japan*		-1.6%	Jul
EPS, % yoy		2.4	Jul
Trailing P/E		17.4	Jul

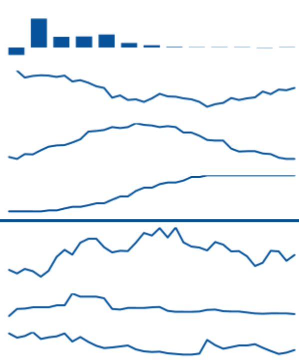
**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- The Bank of Japan's policy tightening contrasts with other developed market central banks. As a result, the Yen weakness that previously benefited Japanese exporters has started reversing, with Japanese equities suffering accordingly.
- The ongoing corporate governance reforms seek to unlock shareholder value, and if firms continue to be successful, then a higher multiple is justified. There are promising signs, with the number of companies that have published their initiatives rising.
- Recent repricing has meant that the Japanese index is beginning to trade at more attractive valuations, though further downside risks remain if the Yen continues to strengthen and global growth decelerates. We remain *neutral*, but our view would likely shift more positive once Yen strength abates.

United Kingdom

UW (Global and Global ex-US index)



	3Y history	Latest	
GDP, % yoy		0.3	Q1
PMI, index		52.1	Jul
CPI, % yoy		2.0	Jun
Policy rate, %		5.25	Jul
MSCI UK*		-2.0%	Jul
EPS, % yoy		-15.6	Jul
Trailing P/E		14.5	Jul

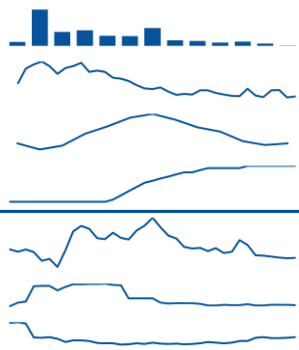
**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- Higher global rates have historically favoured the more value-oriented UK large-cap stocks. As global rates decline, we expect this trend will not support UK large-cap equities. The UK also has a comparatively high weight in the energy sector, and although the Middle East tensions could cause an oil price spike, any weakness in global economic growth could offset this.
- The new Labour government has been welcomed by the market given that the scale of their victory provides some stability relative to the previous government uncertainty. UK small and mid-cap firms will likely benefit from some improvement in domestic business sentiment.
- The UK remains cheaply valued, but its multiple is consistent with lower earnings expectations for large-cap firms. We see better value in the small-cap space, but for the overall index, we remain *underweight*.

Australia

UW (Global and Global ex-US index)



	3Y history	Latest	
GDP, % yoy		1.1	Q1
PMI, index		47.5	Jul
CPI, % yoy		3.8	Jun
Policy rate, %		4.35	Jul
MSCI Australia*		-0.7%	Jul
EPS, % yoy		-10.1	Jul
Trailing P/E		19.1	Jul

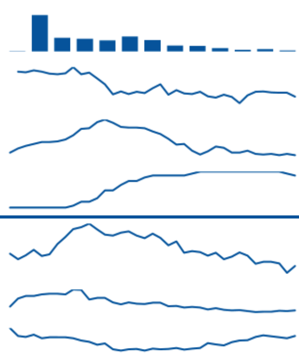
**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- The MSCI Australia Index has become more richly valued on a forward P/E multiple, primarily driven by downward revisions to expected earnings. Earnings are forecast to grow less than 3% over 2024-25, and the market is trading at a 17x forward P/E ratio.
- Australia is typically a beneficiary of positive sentiment towards China. Chinese economic growth and demand for Australia's primary exports (i.e., industrial commodities) have historically propelled the Australian commodity and financial sectors. China's economic growth is expected to remain steady at "around 5%" and shrink over time. The Chinese equity market may recover from factors that are less directly tied to the traditional economic engines (e.g., compelling valuations and direct policy support). Given this dynamic, we think EM offers a better value opportunity.
- MSCI Australia is unattractively valued. We maintain an *underweight* allocation.

Canada

NW (Global and Global ex-US index) ↓



	3Y history	Latest	
GDP, % yoy		0.5	Q1
PMI, index		47.8	Jul
CPI, % yoy		2.7	Jun
Policy rate, %		4.50	Jul
MSCI Canada*		-1.8%	Jul
EPS, % yoy		-8.0	Jul
Trailing P/E		17.9	Jul

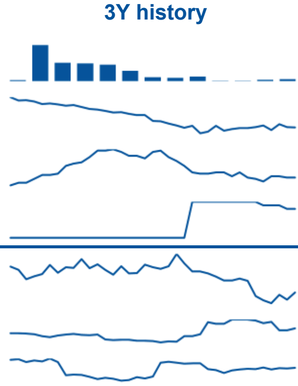
**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- Canadian equities have a larger weight to the energy sector relative to ACWI and, despite ongoing geopolitical risks emanating from the Middle East and Russia, oil prices have failed to rise materially. OPEC spare capacity and the potential for weaker global demand should act to limit any potential geo political shocks.
- Financials also have a high weight in the Canadian index, and the sector continues to screen cheap. Although further cuts from the Bank of Canada should reduce the default risk on the highly leveraged households, it will also act to reduce Bank net interest margins.
- Canadian equities are trading in line with their five-year average discount to ACWI, at a 12-month forward P/E ratio of 14x. Earnings growth is expected to be 5% in 2024, which appears consistent with its discount to ACWI. We now have less conviction for Canada to outperform and reduce our position to *neutral*.

Switzerland

OW (Global and Global ex-US index) ↑



	3Y history	Latest	
GDP, % yoy		0.8	Q1
PMI, index		43.5	Jul
CPI, % yoy		1.3	Jul
Policy rate, %		1.25	Jul
MSCI Switzerland*		5.2%	Jul
EPS, % yoy		28.4	Jul
Trailing P/E		20.2	Jul

**US$ total return relative to MSCI ACWI. Latest is three-month return.*

Source: Bloomberg

- The decline in global and US rates historically favours lower yielding currencies such as CHF. Current softer economic conditions have also historically been favourable for MSCI Switzerland Index.
- The MSCI Switzerland Index outperformed in recent months despite its two largest sectors (consumer staples and healthcare) underperforming in USD terms. If global growth continues to weaken then the defensive Swiss index will likely continue to outperform.
- Earnings growth expectations for 2024-25 are strong around 12%. Despite recent strength, the index premium to ACWI is depressed relative to its 5-year range, providing a compelling value opportunity. The entry point is particularly attractive as its large defensive sectors tend to outperform in slower growth and lower rate environments. We increase our allocation to a small *overweight*.

GLOBAL EQUITY - KEY ECONOMIC AND FINANCIAL INDICATORS

		Macroeconomic Data													Market Performance				Forecast†	
		% change on year ago				Latest 12 months														
	Developed Market	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2024F**	Trade Balance	Current Account Balance	Foreign Reserves 2024 Latest	Foreign Reserves 2023 Year Ago	Currency vs $ 2024 Latest	Currency vs $ 2023 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US$	Change since 12/31/23 US$	Change since 12/31/23 Local	2024 P/E Forecast	3 month Currency vs $ +/-
		%	%	%	%		$ Bns	$ Bns	$ Bns	$ Bns			%		Jul. 31, 2024	Jul. 31, 2024	%	%		
Overweight	EM****	4.8	n.a.	3.8	7.9	-4.1	723.2	484.1	7866.19	7595.91	1735.93	1677.77	6.54	n.a.	10.07	575.50	7.81	11.67	13.1	n.a.
Overweight	SWITZERLAND	0.8	2.0	-3.1	1.3	0.5	57.4	68.5	791.62	808.19	0.86	0.88	-0.75	AAA	2.24	19310.21	6.66	11.55	19.4	-
Neutral	CANADA	1.1	1.7	0.8	2.7	-1.4	0.6	-16.9	94.96	86.47	1.37	1.34	4.29	AAA	2.71	8322.94	6.71	11.80	15.6	+
Neutral	DENMARK	1.2	-5.5	3.4	1.8	2.0	32.9	41.9	97.77	89.78	6.85	6.81	3.35	AAA	0.84	72394.15	18.61	21.20	29.7	-
Neutral	HONG KONG	3.3	1.6	1.8	1.5	-2.0	-50.5	119.3	417.08	420.87	7.79	7.81	4.18	AA+	0.39	50542.71	-10.45	-10.41	12.2	-
Neutral	ISRAEL	-1.2	14.4	-26.8	2.9	-7.2	-29.5	66.7	205.85	197.36	3.78	3.72	4.47	A+	0.17	166.83	11.96	14.53	11.3	+
Neutral	JAPAN	-0.7	-2.9	-7.3	2.8	-4.2	-37.3	173.5	1100.69	1126.10	147.09	143.31	0.08	A+	5.31	8946.81	12.43	19.99	16.2	-
Neutral	NEW ZEALAND	0.3	0.8	-3.1	3.3	-2.4	-5.7	-16.9	14.49	9.93	0.60	0.60	5.13	AA+	0.04	607.93	0.53	7.17	37.3	-
Neutral	NORWAY	1.1	0.8	2.1	2.6	14.0	73.5	81.6	75.05	70.72	10.86	10.28	4.71	AAA	0.13	10102.15	-0.94	6.66	10.1	+
Neutral	SINGAPORE	2.9	0.2	-3.9	2.4	0.1	189.5	102.7	355.75	311.75	1.33	1.35	3.58	AAA	0.31	1289.11	12.27	13.75	13.3	-
Neutral	SWEDEN	0.7	2.8	-2.8	2.6	-0.8	7.0	38.9	41.82	40.26	10.55	10.72	3.50	AAA	0.72	33506.88	3.96	10.56	17.3	+
Neutral	UNITED STATES	3.1	2.8	1.6	3.0	-6.5	-807.6	-818.8	35.24	36.64	1.00	1.00	n.a.	AA+	64.50	15653.76	16.05	16.05	23.2	uc
Underweight	EUROZONE	0.6	1.2	-2.9	2.6	-3.0	0.3	2.8	304.35	300.61	1.09	1.09	0.76	n.a.	7.50	458.58	6.56	8.77	13.6	+
Underweight	UK	0.3	2.8	0.4	2.0	-3.6	-39.1	-111.6	102.15	106.04	1.27	1.27	4.98	AA	3.43	8810.13	11.40	10.57	12.3	+
Underweight	AUSTRALIA	1.1	0.4	0.5	3.8	-0.5	60.5	-3.4	37.64	36.91	0.66	0.65	3.50	AAA	1.68	5676.80	4.14	8.82	18.1	+

*Note: All data shown are as at August 8, 2024 unless otherwise stated. S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast. ***MSCI All Country World Index Daily Total Return Net. ****IP data from CPB; Currency level from MSCI EM Currency Index; GDP, CPI, budget and interest rate data from Bloomberg.*

†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results.

Source: Bloomberg, CLIM

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