CITY OF LONDON
Investment Management Company Limited

Cross-Asset Quarterly Outlook

September 2024*

Overview

Rising risks, but it is still too early to cry wolf

- *US labour market data is signalling rising recession risks, but the broad set of economic and earnings data still indicates a more benign growth slowdown.*
- *The Fed is expected to start cutting rates this month, providing support for fixed income assets. Lower-quality credit is less likely to benefit if US growth continues to soften.*
- *Our asset allocation favours an overweight to rates and commodities versus an underweight to credit, while equities remain neutral.*
- *This quarter, we added exposure to precious metals and reduced US IG credit.*

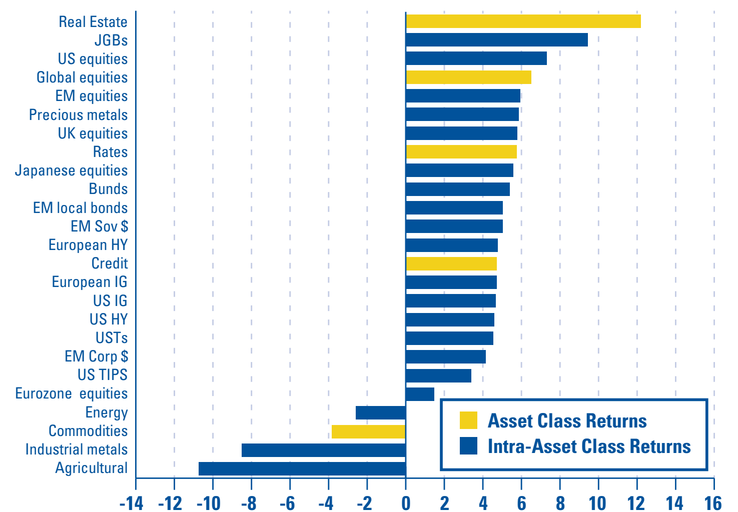
The summer of 2024 was eventful for markets. Volatility (as measured by the VIX) spiked, US recession chatter re-intensified, and AI-related stocks came under some pressure. Despite some signs of underlying weakness in the macro backdrop, global equities still reached new highs. However, the upward trend has become bumpier, and traditional safe havens (e.g. fixed income, precious metals, and the JPY) performed better in recent months (see chart 1).

Our baseline view remains a 'muddle-through' scenario with slower global growth but where the US avoids a recession over the next 6-12 months. However, the tail-risk scenario probabilities have risen. The rise in the US unemployment rate is an ominous signal that is historically associated with a US recession (see chart 2). There are some caveats to the recent rise in the unemployment rate, including an increase in labour supply rather than layoffs. Still, the reliability of the signal historically means one should not totally discount weakening labour market trends. We adjusted our recession probability upwards to 30%, and our allocations reflect a gradual shift to more defensive assets.

Lagged effects from tight monetary policy are one factor weighing on activity. Over 2022-23, the Fed increased interest rates by 525bp, and recent data indicates that tighter policy is weighing on activity, as evidenced by cooling inflation pressures and a softening labour market. Waning pandemic savings and less fiscal support may also contribute to a further deceleration in US growth. Fed rate cuts will incrementally reduce these headwinds, but the policy feedback will be lagged. Still, equity markets may react positively to Fed policy easing. Historically, US equity market performance is positive in the 3-6 months following the first rate cut if a recession is avoided (1995, 1998, and 2019), while performance was negative when the cut was associated with a recession (1990, 2001, and 2007). 2020 was an exception where there was a recession, but markets rebounded sharply following rate cuts.

On a more optimistic note, we still see evidence of strength in the tech cycle. In particular, artificial intelligence (AI) remains a structural theme. There are questions over 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 (see 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.

Chart 1: Asset Returns, Jun-Aug, %



Source: Bloomberg

**The publication reflects asset performance up to August 30, 2024, and macro events and data releases up to September 6, 2024, unless indicated otherwise.*

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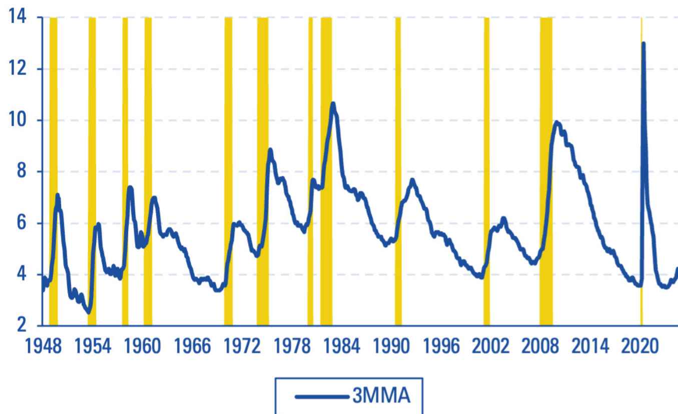
Chart 2: US Unemployment Rate (%)



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:

The macro crosscurrents favour a balance between pro-cyclical and defensive exposure. Since our last Outlook, the US labour market has exhibited further cooling, indicating a slightly higher risk of a recession. Accordingly, we are maintaining some defensive exposure via an underweight to HY credit and overweight to US Treasuries. However, our cyclical indicators still point to some support for risky assets. Earnings trends remain positive, the Fed is expected to commence an easing cycle, and structural themes (e.g. AI) still have room to grow. Therefore, our allocations maintain some pro-cyclical exposure where we see value this quarter:

- We remain *neutral* on **equities**. Global equity valuations remain unattractive, and some leading indicators are starting to signal a less bullish environment for stocks. Still, we see evidence against being underweight this quarter as stocks could continue grinding higher. Intra-equities, EM remains our preferred overweight based on solid earnings expectations driven by the demand for advanced semiconductors and high-bandwidth memory to power AI. We view recent weakness in tech hardware/semi conductor stocks as temporary.
- In **rates**, we stay *overweight*. US inflation-linked bonds are our preferred long position given attractive US real yields, and long-term inflation expectations have fallen to levels that do not reflect upside risks in our view. Nominal yields still appear attractive relative to equities. However, with +200bp of Fed cuts already priced over the next year, further US data weakness is likely required to see an additional decline in US rate expectations.
- We remain *underweight* **credit** via global HY credit while reducing our long IG exposure, given unattractive spreads.
- Our **real estate** allocation remains *neutral*. The asset class offers long-term value with lower rates, but we expect government bonds to provide better returns over the next year.
- We remain *overweight* in **commodities**, continuing to favour industrial metals. This quarter, we also added some small exposure to precious metals. Lower real rates, central bank purchases, and a weaker USD are all supportive for precious metals.

Equities

Neutral

> *Stretched global equity valuations and a mixed macro backdrop favour a balance between pro-cyclical and defensive exposure, focusing on beneficiaries of AI structural demand.*

Global Equity Indicators

	3Y history	Latest	
Global P/E		21.7	Aug
DM P/E		22.7	Aug
US P/E		26.2	Aug
Europe P/E		15.9	Aug
Japan P/E		16.5	Aug
EM P/E		15.3	Aug

Source: Bloomberg, MSCI

Chart 3: EM Asia Exports and ACWI Earnings Growth

Source: Bloomberg

Asset	View	Chg	Commentary
Global equities	0	-	Short-term indicators are supportive for global equities, with the global PMI above-trend and macro momentum still positive. Central bank cuts will also provide some support. However, in the medium term, we are more cautious as valuations are elevated, especially relative to bonds, and labour market data suggests we are late-cycle.
US equities	0	-	US earnings continue to grow strongly, but these are dominated by a handful of large tech stocks, increasing market concentration. The US tends to outperform in a slower global growth environment, but the crowded long US position keeps us cautious, as valuations look stretched.
Eurozone equities	-1	–	Risks to earnings are skewed to the downside as economic activity has started to deteriorate. As a pro-cyclical market, a global slowdown has historically resulted in Eurozone underperformance. The bloc is also vulnerable to a blanket tariff if Trump is re-elected.
UK equities	-1	–	The new Labour government and the associated improvement in business sentiment will likely benefit small and mid-cap firms. Still, falling rates do not bode well for the more value-oriented UK large-cap equities. Abating geopolitical tensions have lowered oil prices, which is a headwind given the UK's high weight in the energy sector.
Japan equities	0	-	In Japan, corporate governance reforms remain supportive and could unlock further value. On a more cautious note, recent global economic weakness and lower US rates is historically a headwind for the MSCI Japan Index. Likewise, the undervalued Yen is a risk for future local market returns, should it strengthen further.
EM equities	+2	-	EM equities offer exposure to the AI trade given the heavy presence of tech hardware and semiconductor industries in Taiwan and South Korea's stock markets. Moreover, EM valuations are much more attractive than the US. The US dollar remains expensive and is likely to trend lower in the long run, benefiting EM equities based on history.

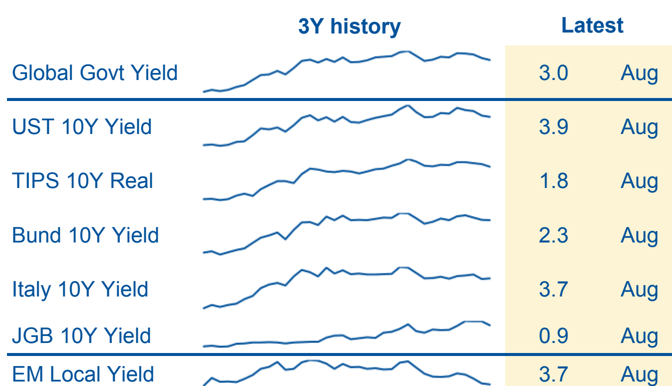
Note: Up/down arrows indicate a positive or negative change in our asset allocation compared to the previous quarter. A dash indicates no change.

Rates

Overweight

DM policy rate cuts are supporting bonds. We favour inflation-linked bonds.

Global Rates Indicators



	3Y history	Latest	
Global Govt Yield		3.0	Aug
UST 10Y Yield		3.9	Aug
TIPS 10Y Real		1.8	Aug
Bund 10Y Yield		2.3	Aug
Italy 10Y Yield		3.7	Aug
JGB 10Y Yield		0.9	Aug
EM Local Yield		3.7	Aug

Source: Bloomberg Barclays Indices, US Federal Reserve. Yield in %.

Chart 4: S&P500 Earnings Yield Spread, %pts

Source: FRED, St Louis Federal Reserve

Asset	View	Chg	Commentary
USTs	+1	-	Policy rate cuts should provide support for US government bonds. Since the late 1970s, when the Fed paused rate hikes, US yields have consistently fallen over the subsequent year. Recent inflation data has moved closer to the Fed's target, while a slowing labour market also supports the case for rate cuts. Concerns about the US fiscal deficit and the growing interest costs will remain, though this is not exclusive to the US and may not affect UST auctions for some years.
US TIPS	+2	-	US TIPS currently offer an attractive real yield, and they are likely to benefit from Fed rate cuts and slower US growth. If long-term inflation expectations rise 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.
Bunds	0	-	The ECB has started cutting rates ahead of the US, as inflation is closer to target. However, core services inflation has proven more stubborn, which has tempered expectations for aggressive rate cuts. In addition, the Bund-US spread is already tight, suggesting limited value.
JGBs	-1	-	Japan is the outlier among developed market central banks as they raise rates and end their ultra-loose monetary policy – an unattractive backdrop for fixed income. The speed of future policy tightening will be determined by inflation and wage growth trends. Sharp JPY appreciation is also complicating the policy outlook.
EM local bonds	0	-	EM central banks were earlier than their DM peers to hike rates and were also quicker to embark on rate-cutting cycles last year. These factors have set up a favourable backdrop for EM local bonds. As a result, the EM spread relative to US Treasuries has tightened, leaving limited value to extract at current levels. EMs are also vulnerable to outflows if economic conditions weaken. The long-term trend is likely a weaker USD given current rich valuations, historically supporting EM local assets, but the path will likely be gradual.

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Credit

Underweight

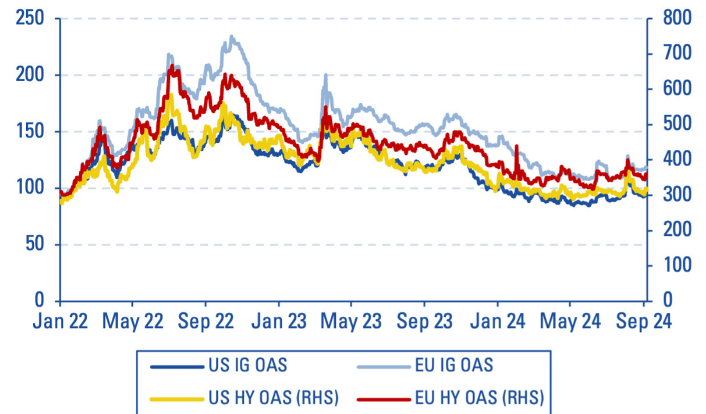
> *Global credit spreads remain tight and vulnerable to a weaker growth backdrop.*

Global Credit Indicators

	3Y history	Latest	
Global IG OAS		1.0	Aug
US IG OAS		0.9	Aug
US HY OAS		3.0	Aug
Euro IG OAS		1.2	Aug
Euro HY OAS		3.5	Aug
EM Sov $ OAS		3.2	Aug
EM Corp $ OAS		2.2	Aug

Source: Bloomberg Barclays Indices. Option-adjusted spreads in %.

Chart 5: US and EU Corporate OAS (bps)



Source: Bloomberg

Asset	View	Chg	Commentary
US IG	+1	-	US corporate spreads remain tight due to resilient US economic growth and relatively low issuance. Market volatility (proxied by the VIX) has picked up, which is typically associated with wider spreads. At current levels, IG offers a limited spread cushion relative to Treasuries, and we are gradually reducing our IG exposure in favour of government bonds and gold. However, we still favour IG relative to HY, given that the higher-duration IG index should benefit from a broader rebound in fixed income assets. Higher-quality corporate debt should perform well in a US slowdown.
US HY	-3	-	HY spreads are close to cyclical lows and are not priced for a rising trend in default rates. 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. However, default rates have fallen in recent months, which may delay the timing of HY's underperformance. Historically, a mid-cycle slowdown or a mild recession implies a material widening in HY spreads from current levels.
European IG	+1	-	We expect higher-quality fixed income to outperform if global growth softens in 2H and, therefore, maintain some exposure to EU IG. However, we are gradually reducing our exposure in favour of government debt given less attractive spreads.
European HY	-1	-	EU HY spreads have started to widen but remain tight relative to history. Unlike in the US, European HY default rises have risen steadily, and we expect the weaker economic backdrop to keep default rates elevated going into next year. We see more asymmetric risks for wider spreads.
EM Sov $ credit	0	-	Spreads have widened recently due to a rise in market volatility, but the spread levels are still tight versus history. Easier Fed policy should support US dollar debt. A more stable US dollar (which directly impacts the cost of EM dollar debt) is also supportive.
EM Corp $ credit	0	-	The EM Corporate USD spreads are narrow and do not currently offer an appealing entry point. New issuance activity has picked up from 2023 but is well below the pre-2022 levels. Default rates are tracking lower in 2024 than in 2021-23.

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Real Estate

Neutral

Valuations against government bonds are not compelling and will need to improve for a sustained upturn in the asset class.

Asset	View	Chg	Commentary
Global Real Estate	0	-	Expectations of easier Fed policy are a positive, but valuations for global real estate stocks continue to look unattractive against government bonds, albeit there has been some improvement. In contrast, the spread to global equities is stable. The yoy decline in global direct investment volumes slowed in Q2, with industrial and residential the healthiest sectors. Activity is set to improve as the bid-ask gap narrows.

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Commodities

Overweight

We turn positive on gold ahead of Fed rate cuts and strong central bank demand, while we maintain our allocation to copper to gain exposure to the shift to decarbonisation.

Asset	View	Chg	Commentary
Energy	0	-	The EIA projects the global oil market to remain in a deficit until early 2025, but concerns over global demand have weighed on prices and speculative positioning for Brent crude is negative. A second Trump presidency could be bearish (higher US production and tariffs) or bullish (tougher on Iran) for oil prices. Combined with ongoing geopolitical risks in the Middle East, we stay neutral.
Industrial Metals	+1	-	Prices across the industrial metals complex could continue to soften from weakness in China, as speculative long positioning unwinds further. However, we are still positive on the structural demand for metals from decarbonisation, with the copper market balance expected to tighten over the coming years. For aluminium, a more constructive price outlook depends on lower Chinese output.
Precious Metals	+1	↑	Gold prices reached a record high in August and the rally has further to run on the back of easier Fed policy and recovery in ETF inflows despite the pullback in Chinese physical demand. Indeed, the inverse correlation between gold prices and US real yields has been reestablished. Structurally, increased central bank buying and US fiscal deficit concerns should support gold prices. Strong demand from solar demand should keep the silver market in a deficit, boosting prices. As such, we upgrade our allocation to precious metals to overweight.
Agriculture	0	-	Global demand worries and ample inventories have resulted in bearish speculative positioning across the subsector. Even so, the worst of the price sell-off is likely behind us, with the La Niña weather phase threatening the output of some agricultural commodities

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

	ASSET ALLOCATION							PERFORMANCE						BENCHMARK INDEX & WEIGHTS	
	-3	-2	-1	0	+1	+2	+3	5Y	3Y	1Y	2023	Ytd	End Jun-End Aug		
EQUITIES				■				**77.4**	**18.3**	**23.4**	**22.2**	**16.0**	**6.5**	**MSCI ACWI**	**50%**
US				■				103.9	26.2	26.6	26.5	18.8	7.3	MSCI USA	25%
Eurozone			■					52.2	10.0	17.6	22.9	10.8	1.5	MSCI EMU	7%
UK			■					51.9	29.3	22.0	14.1	15.1	5.8	MSCI UK	3%
Japan				■				47.8	11.8	19.7	20.3	13.0	5.6	MSCI Japan	5%
EM						■		26.3	-8.9	15.1	9.8	9.5	5.9	MSCI EM	10%
RATES					■			**-12.8**	**-16.1**	**5.5**	**4.2**	**0.7**	**5.7**	**Bloomberg Barclays Global Treasury Total Return Index Value Unhedged**	**27%**
USTs					■			-3.0	-7.4	6.0	4.1	2.6	4.5	Bloomberg Barclays US Treasury Total Return Unhedged USD	10%
US TIPS						■		10.6	-3.8	6.2	3.9	3.3	3.4	Bloomberg Barclays US Treasury Inflation-Linked Bond Index	3%
Bunds				■				-16.4	-19.8	5.8	9.3	0.0	5.4	Bloomberg Barclays Euro Aggregate Treasury Germany TR Index Unhedged USD	3%
JGBs			■					-34.4	-30.1	-1.9	-5.9	-5.2	9.4	Bloomberg Barclays Asian-Pacific Japan Treasury TR Index Unhedged USD	5%
EM Local				■				2.5	-3.7	6.6	11.3	1.4	5.0	Bloomberg Barclays EM Local Currency Liquid Govt TR Index Unhedged USD	6%
CREDIT			■					**2.2**	**-7.5**	**9.6**	**9.6**	**3.4**	**4.7**	**Bloomberg Barclays Global Aggregate Credit Total Return Index Value Unhedged USD**	**13%**
US IG					■			3.4	-6.2	9.3	8.5	3.5	4.7	Bloomberg Barclays US Corporate Statistics Index	4%
US HY	■							24.4	7.8	12.6	13.4	6.3	4.6	Bloomberg Barclays US Corporate High Yield Statistics Index	3%
European IG					■			-3.2	-11.3	9.4	12.0	2.8	4.7	Bloomberg Barclays EuroAgg Corporate Statistics Index USD	2%
European HY			■					14.1	-1.4	13.7	16.1	5.5	4.8	Bloomberg Barclays Pan-European High Yield (Euro) Index Statistics USD	1%
EM Sov $				■				2.1	-4.7	13.5	11.0	6.5	5.0	Bloomberg Barclays Emerging Markets Sovereign TR Index Value Unhedged USD	2%
EM Corp $				■				4.9	-6.4	11.8	6.7	7.0	4.1	Bloomberg Barclays Emerging Markets Corporates TR Index Value Unhedged USD	1%
REAL ESTATE				■				**2.9**	**-8.8**	**16.2**	**8.7**	**7.7**	**12.2**	**FTSE EPRA/NAREIT Global Index Net TRI USD**	**5%**
COMMODITIES					■			**49.9**	**36.7**	**-2.1**	**-4.3**	**5.3**	**-3.8**	**S&P GSCI Total Return Index**	**5%**
Energy				■				40.5	59.4	-3.7	-5.2	7.2	-2.6	S&P GSCI Energy Total Return Index	2%
Industrial metals					■			40.8	-3.5	7.1	-4.5	4.6	-8.5	S&P GSCI Industrial Metals Total Return Index	1%
Precious metals					■			55.1	33.8	26.8	11.5	20.4	5.9	S&P GSCI Precious Metals Index Total Return Index	1%
Agricultural				■				51.3	1.1	-11.5	-8.3	-7.8	-10.7	S&P GSCI Agriculture Index Total Return Index	1%

Source: Bloomberg, CLIM

CITY OF LONDON
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

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