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4Q 2023

Global Asset Allocation Viewpoints

The last mile

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Key themes for 4Q 2023

- **Global growth is facing a number of headwinds.**
  The global outlook is being troubled by rising rates, oil prices and the U.S. dollar, resulting in investor risk aversion. The U.S. faces a consumer-led downturn, although corporate balance sheet strength should ensure it is only mild.

- **Inflation is decelerating, albeit slowly, and will end the year above target.**
  Global inflation continues to recede, but deep economic slowdowns will be required to reach global central bank inflation targets. Higher oil prices, if sustained, also threaten to undermine anchored inflation expectations.

- **Global monetary tightening cycles are nearing the end, but rate cuts are not imminent.**
  As long as economic growth remains above trend, inflation may resurge, forcing continued caution amongst policymakers and delaying policy rate cuts.

- **Equities face limited upside as a 2024 soft landing is already priced in.**
  Spiking bond yields are challenging the equity market's soft landing assumption. With limited prospect of an upgrade to earnings expectations, equity market returns are likely to be muted—particularly until bond yields peak.

- **The global bond sell-off is disruptive but adds much-needed income to fixed income.**
  A nuanced approach is required in fixed income. Higher for longer may extend the bond sell-off, but a modest economic downturn means credit spreads can remain fairly tight. Bonds now generate meaningful portfolio income.

- **Alternatives provide important diversification against traditional equities and fixed income.**
  Until bond yields peak, REITs may remain under pressure. Commodities' strong performance may be sustained. While the less bearish economic outlook suggests infrastructure exposure is less crucial, inflation mitigation is still required.

Investment themes

Peak central bank rates

Short, shallow U.S. downturn

Bonds are back

Inflation risks and financial market stress

Central bank tightening: The last mile

The inflation shock has dissipated significantly, mainly due to the renormalization of supply chains, but has also been helped along by higher policy rates. Inflation remains above central bank targets. However, as a deep economic downturn would likely be required to hit the bullseye, policymakers presumably believe the growth-inflation trade-off is not worth the extra mile of tightening. As such, policy rates are probably close to their peak.

That said, central bankers must remain alert to bubbling price pressures. As long as growth stays above trend, there will be a risk of inflation resurgence. So, while rate hikes are largely complete, rate cuts are not imminent. Policy loosening will only be initiated once economic growth has slowed— hopefully to just below trend, but likely into negative territory.

Short, shallow U.S. downturn

The unique support provided by policymakers during the pandemic enabled households and corporations to firm up the health of their balance sheets. They each entered 2023 with reduced interest rate sensitivity, prompting resiliency in the face of aggressive monetary tightening. But these measures have essentially acted to delay the downturn, not cancel it.

Indeed, the various fiscal support structures for households are now winding down. By early 2024, many consumers will be exposed to the full burden of higher rates. Companies, however, will remain insulated until late 2024, when the corporate debt maturity wall becomes more pressing.

Consumer spending will likely begin to weaken soon, but with still-strong corporate spending offsetting the impact, the forecasted downturn will be limited to just two quarters of modestly negative growth, with only a slight increase in unemployment—a soft recession.

Bonds are back

Central banks' reinforcement of the higher-for-longer narrative is clearly behind much of the recent upward spike in global bond yields. Yet there are additional forces at play that suggest bond yields will settle at a permanently higher level.

The U.S. fiscal deficit, already colossal, is projected to balloon in coming years, resulting in large-scale Treasury issuance, both now and in the future. And with the Bank of Japan's eventual move away from ultra-easy monetary policy drawing incremental demand away from U.S. Treasurys, the U.S. government will need to offer a higher interest rate on its bonds to attract buyers.

Higher rates imply greater volatility and lower long-term growth. But for investors, higher rates also indicate that bonds can finally be more than just a diversification tool—the "income" is back in fixed income.

Consider the potential risks

Resurgent inflation: If economic growth fails to slow, it risks igniting a resurgence in price pressures. Central banks would have to respond by resuming policy tightening, tipping economies into deep downturns. Even worse, if growth slows but rising energy prices result in a de-anchoring of inflation expectations, central banks would still need to respond to the stagflationary environment by hiking rates further.

Financial market stress: Previous bond bear markets have ended in financial turmoil. And when combined with rising oil prices and a strengthening U.S. dollar, there is an elevated risk of significant casualties across the global financial system. If bond yields continue to rise relentlessly, something will eventually break.

Equities

Reduce risk appetite and focus on U.S. large-cap and quality factor.

Position toward certainty:

- Exposure to quality within equities can potentially offer risk mitigation during pullbacks.
- Attractive international valuations suggest opportunities outside the U.S.
- U.S. large-cap offers stronger geographical revenue exposure and more attractive valuations

How to implement:

- Large-cap U.S. strategies
- Quality-biased active managers
- Well-diversified and active international managers

Fixed income

Increase exposure to high-quality credit.

High-quality, core fixed income and total return positioning:

- Core fixed income to hide out in as recession risk rises.
- Increasing duration bias across the asset class.
- Emerging market debt may offer total return potential with central bank easing.
- High yield maintains a substantial carry advantage for income-seeking investors

How to implement:

- IG credit heavy core fixed income
- Agency MBS strategies
- Active emerging market debt

Alternatives

Pursue less correlated real asset exposures.

Real assets:

- Real return-focused strategies gain attractiveness when nominal growth slows.
- Infrastructure offers more stable cash flows with potentially attractive yield.
- Real assets can help mitigate inflation risk.

How to implement:

- Diversified real asset strategies (infrastructure, natural resources)
- Private real estate markets

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Risk considerations

Investing involves risk, including possible loss of principal. Past performance is no guarantee of future results. Asset allocation and diversification do not ensure a profit or protect against a loss. Equity investments involve greater risk, including higher volatility, than fixed-income investments. Fixed-income investments are subject to interest rate risk; as interest rates rise their value will decline. International and global investing involves greater risks such as currency fluctuations, political/social instability and differing accounting standards. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. Non-investment grade securities offer a potentially higher yield but carry a greater degree of risk. Risks of preferred securities differ from risks inherent in other investments. In particular, in a bankruptcy preferred securities are senior to common stock but subordinate to other corporate debt. Emerging market debt may be subject to heightened default and liquidity risk. Risk is magnified in emerging markets, which may lack established legal, political, business, or social structures to support securities markets. Small and mid-cap stocks may have additional risks including greater price volatility. Treasury inflation-protected securities (TIPS) are a type of Treasury security issued by the U.S. government. TIPS are indexed to inflation in order to help investors from a decline in the purchasing power of their money. As inflation rises, rather than their yield increasing, TIPS instead adjust in price (principal amount) in order to maintain their real value. Inflation and other economic cycles and conditions are difficult to predict and there Is no guarantee that any inflation mitigation/protection strategy will be successful.

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