Latest Asset Allocation View

July 2024[1]

Multi-Asset Solutions Team

[1]The latest Asset allocation views publication schedule is January, April, July and October. The last update was issued in May 2024.

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Key Global Themes

1. Economic environment has supported risk assets, but for how long?

- A soft landing for the global economy has been the consensus so far, as global inflation declines, albeit slowly, with positive economic growth. This has been a Goldilocks environment for risk assets with stocks well ahead of bonds year to date.
- The European Central Bank becomes the latest developed-market central bank to break with historical trends to cut rates ahead of the US Federal Reserve (Fed), joining Canada and Switzerland with a 25 basis point cut.
- The Fed will be carefully monitoring key economic markers, while inflation will be the primary focus. Jobs data and economic growth will also be measured, as it seeks to strike a balance between cutting rates too early and waiting too long, which could necessitate deeper cuts.

2. How long before cracks appear?

- Our outlook remains generally positive—reflected in an overweight in equity versus fixed income—but we remain alert to potential—hidden—market weakness.
- A string of disappointing economic data includes the lowest job openings since 2021 and GDP growth revised lower. This signals that growth in the United States, while still positive, may be weakening.
- Valuations are elevated relative to historical levels, heightening the risk of deeper drawdowns in a slowdown. On their own, however, valuations aren't typically a good predictor of near-term market movements.

Source: Multi-Asset Solutions Team (MAST), as of 30 June 2024. Projections or other forward-looking statements regarding future events, targets, management discipline or other expectations are only current as of the date indicated. There is no assurance that such events will occur, and if they were to occur, the result may be significantly different than that shown here.

Key Global Themes

3. U.S. dominance continues for now

- The first half of the year has been defined by broad market participation, coupled with continued U.S. leadership. However, should economic trends continue to deteriorate, allowing for an accelerated rate-cutting cycle, certain assets with larger valuations cushions are set up well to outperform.
- European equities, currently undervalued, have seen earnings beat expectations with improving forward-looking projections. Stabilization in China could also present an opportunity going forward.
- US small-cap equity valuations are near all-time lows relative to large caps, while investment-grade bonds have been challenged since late 2021. US rate cuts could benefit both and the prevailing economic environment will determine which of these assets outperforms.

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Asset Class Overview

Broad Asset Class Outlook

Current outlook
• Represents previous view

		Underweight	Neutral	Overweight
Broad Asset Classes	Equities			•
	Fixed Income	•		

- While we continue to **favour equities over fixed income**, this has shifted toward neutral relative to our previous view. Corporate earnings growth has remained resilient amid a higher interest-rate environment; however, some economic data has softened such as unemployment and GDP growth.

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Asset Allocation View

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Active Asset Allocation Views

• Represents previous view

	Underweight	Neutral	Overweight
Asset Class: Equities			
United States			■ •
Canada	■ •		
Non-U.S. developed markets		■ •	
Europe		■ •	
Emerging Markets		■ •	
U.S. small cap			■ •
United Kingdom		■ •	
Japan			■ •
Emerging Latin America		■	•
APAC ex-Japan		■ •	
Mainland China		■ •	
Hong Kong		■ •	
Real estate investment trusts		■ •	
Infrastructure			■ •
Commodities			■ •
Asset Class: Fixed Income			
U.S. investment grade		■ •	
Canadian investment grade		■ •	
Asia investment grade		■ •	
U.S. high yield	■ •		
Asia high yield		■ •	
Leveraged loans		■ •	
Emerging-market debt			■ •

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3 Equity View

Broad Equity:

- The United States remains the most resilient global market, underpinned by strong economic growth and corporate earnings. However, marginal improvements in earnings growth in other parts of the world combined with extended valuations within U.S. large-cap stocks have led us to moderate the magnitude of this overweight.
- US small-cap equities are currently trading near 20-year relative lows versus large-cap stocks with earnings expectations over the next few quarters looking favorable relative to large caps. Fed rate cuts are anticipated to be the crucial catalyst in unlocking small caps relative opportunity potential.
- Our view on European equities currently remains neutral but leaning toward positive based on an improving growth outlook, attractive valuations relative to the United States, and a relative more dovish central bank stance.

Regional/Sector-specific Equity:

- We continue to maintain an overweight position in Japanese equities because of a robust fundamental outlook, reasonable valuations, and positive corporate governance reforms.
- Our perspective on China equities remains neutral but is leaning more positive driven by attractive valuations and a stabilised economy. However, weakness in the Chinese property market persists and large-scale fiscal stimulus appears unlikely.
- We've **shifted our view from overweight to neutral on emerging Latin America**, particularly in Brazil, as the relative monetary policy tailwind is waning, along with growing fiscal challenges, which have put pressure on relative returns.
- Commodities offer valuable portfolio diversification in an environment where interest-rate and inflation volatility pose challenges to the correlation benefits between equities and longer duration fixed income.

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3 Fixed Income View

Fixed Income:

- We favour leveraged loans to high-yield bonds due to more favourable spreads and attractive yield. Additionally, leveraged loan issuers have already adjusted to higher short-term rates while investment-grade and high-yield bond issuers are just now starting to experience the effect of higher interest costs.
- We have a divergent view within the US investment-grade bond universe with government debt remaining neutral, while our view on investment-grade credit is less favorable as spreads are not sufficiently compensating investors for any potential risk-off event. From a duration perspective, we’re biased toward shorter duration assets.
- We remain overweight in emerging-market debt, driven by strong foreign currency reserves, positive sovereign debt trends, and elevated spreads relative to US corporate high-yield debt.

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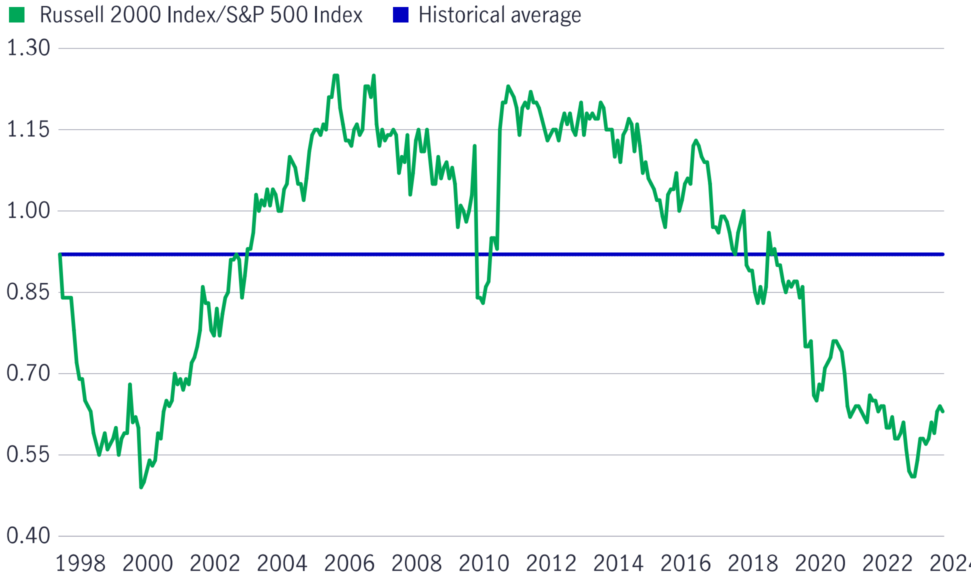
US small-cap equities: tailwinds are building

- When the Fed starts its rate-cutting cycle, US small-cap equities are particularly well poised to rally based on higher sensitivity to short-term rates given their leverage and debt structures and current low valuations relative to US large-cap stocks.
- As high inflation and elevated interest rates have kept relative small-cap performance subdued, potential tailwinds have been building. These include improvements in manufacturing activity globally and earnings expectations that are elevated relative to large caps for the second half of 2024 and into 2025.
- Valuations for US small-cap equities are near all-time lows on a relative basis versus large-cap equities. While valuations are historically not a great indicator of near-term performance, the valuation gap demonstrates upside potential should small caps rally.
- While the opportunity for small-cap outperformance is present, a shift away from large-cap leadership will require a catalyst. This could be investor sentiment or election policy, but the most likely catalyst would be interest-rate cuts. Given the combination of small caps greater sensitivity to short-term rates and low relative valuations, investment return potential is attractive.

US small-cap and large-cap relative P/E ratio (31/1/1998–30/4/2024)



Source: FactSet, May 2024. Small-cap stocks are represented by the Russell 2000 Index, which tracks the performance of 2000 publicly traded small-cap companies in the United States. Large-cap stocks are represented by the S&P 500 Index, which tracks the performance of 500 of the largest companies in the United States. It is not possible to invest directly in an index. Trailing price to earnings (P/E) is a valuation measure comparing the ratio of a stock's price with its earnings per share over the past 12 months. Past performance does not guarantee future results.

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