Parmenion

Macro Outlook & Asset Allocation Update

Summary

Disinflation will persist, but at a slower pace

Globally, headline and core inflation have fallen as post-Covid supply constraints eased. Meanwhile, cyclical demand has moderated as higher interest rates slow economic activity. Further falls are expected through 2024, especially in the US as wage pressures ease and shelter (rent) comes in.

Consensus expects a soft landing - and a policy pivot

Fixed income yields rallied in Q4 in expectation of a pivot in interest rates. But if central banks are successful in slowing growth without triggering a recession, meaningful interest rate cuts would be unwarranted.

Central banks' insistence on 'higher for longer' raises the risk of recession

After the fastest increase in interest rates since the 1980s, the probability of recession is not insignificant. Leading indicators, such as the inverted yield curve, soft PMI new orders, negative money supply growth, falling job vacancies and weakening commodity prices all continue to flag the recession risk.

For risk adjusted returns, fixed income looks attractive

Higher starting yields in fixed income plus scope of capital appreciation from duration points to the prospect of positive real returns for investors. The outlook of falling interest rates is expected to lead to a reversal of some of the $5.8 trillion invested in money market funds.

Opportunities are available in equities, selectively

Quality, small and mid caps and emerging market equities are deeply unloved, underheld and cheap. For long term investors these represent compelling opportunities.

Contents

What's been going on in the world?

Markets delivered considerably better returns than expected in 2023, albeit with heightened volatility. Equities led as inflation underpinned nominal corporate earnings and strength in labour markets buoyed consumption. Meanwhile, fixed income rallied meaningfully in the final quarter in anticipation of falling interest rates in 2024 as inflation heads back to target.

Defeating inflation was the primary focus of markets through 2023 as central banks sought to regain control. This meant hiking interest rates into restrictive territory to create some economic slack. The speed and magnitude of the increases were on a level not seen since the 1980s, yet the consensus expectation of widespread recession did not materialise. Primary reasons for this included reduced sensitivity to interest rates as corporates and households had locked in cheap financing/fixed rate mortgages, fiscal stimulus (especially in the US), and resilience in the labour market as companies chose not to cut headcount having experienced recruitment challenges through 2022. However, monetary policy takes time to take effect, so it remains to be seen whether central banks have got it right (i.e. soft landing), or taken things too far. We will find out as 2024 unfolds.

Global manufacturing faced multiple headwinds through the year as rising interest rates weakened demand, cost of inventories climbed and deglobalisation weighed on international trade. As a trade-oriented region, European GDP growth slowed accordingly, with Germany formally entering a recession. This was compounded by weaker than expected economic activity in China, where business and consumer confidence were negatively impacted by government policy uncertainty and on-going concerns over stability in the property sector.

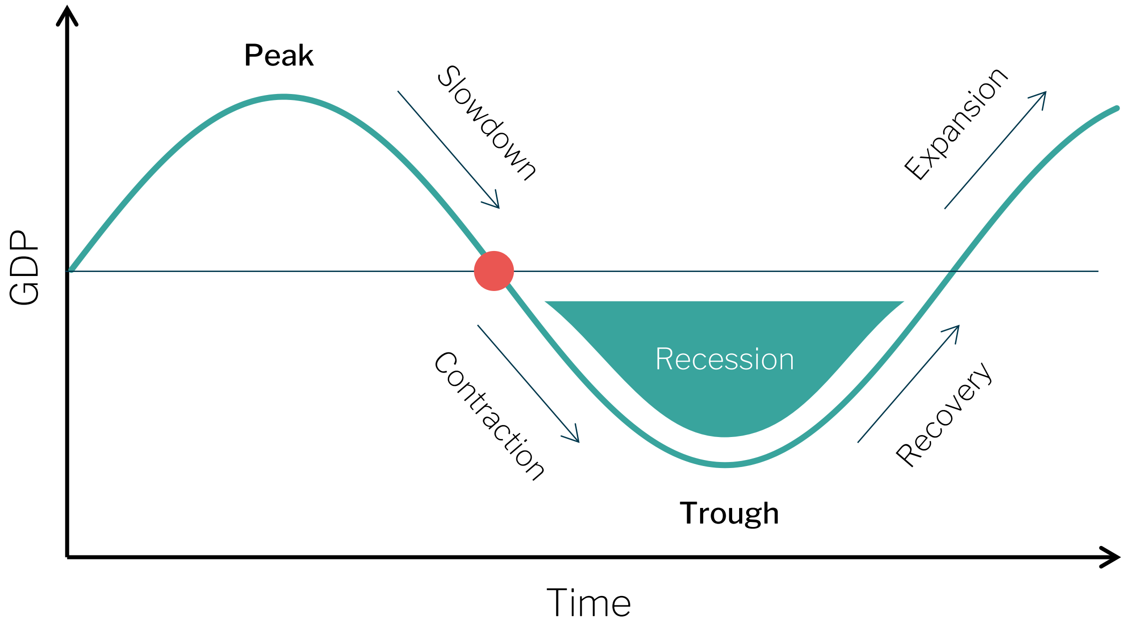
Japan experienced a revival in investor interest as corporates were required by the Tokyo Stock Exchange to publish the actions their companies would take to close the discount to book value and raise returns for shareholders. Combined with the Bank of Japan's continued loose monetary policy and weakness in the Yen, this meant that export competitiveness was maintained, supporting upside surprise in GDP growth.

The UK flirted with recession but managed, just, to keep its head above water. With our major trading partner (EU) struggling economically, inflation squeezing real incomes and political uncertainty and incompetence prevalent, investment and consumption activity was subdued.

Geopolitical risk intensified following the horrendous attack by Hamas on Israel in October. So far, markets have assumed that hostilities are unlikely to widen further, so risk premia and oil prices have remained broadly stable.

Labour market resilience is beginning to show signs of cracking, as job vacancies shrink and unemployment climbs. In an election year, this will attract greater attention.

Where are we in the economic cycle?



Charting where we are in the economic cycle is particularly challenging following the unusual policies adopted during and post Covid. Nonethless we believe we're late cycle.

Conventional leading indicators including new orders, money supply, credit conditions, temporary employment, quit rates etc collectively point towards a slowdown and the possibility of a recession. Its size and duration is unclear.

Monetary policy works with a lag, so we believe the full impact of cumulative interest rate rises is yet to be felt. Slowing corporate revenues points to a growing risk of rising unemployment, which will weigh on consumption and GDP growth.

Economic Cycle	Recovery			Expansion			Slowdown			Contraction		
TAA Committee Member	Early	Mid	Late	Early	Mid	Late	Early	Mid	Late	Early	Mid	Late
Steve Williams									●			
Jasper Thornton-Boelman									●			
Peter Dalgliesh										●		
Simon Molica										●		
Harry Garrett								●				
Tim Willis										●		

What are the opportunities?

Following the increase in yields, fixed income offers investors an attractive income, diversification via duration exposure, and scope for capital appreciation. Quality, small and mid caps and emerging market equities are also attractively valued.

Government bonds rallied hard into year end. However, the yields available still represent attractive insurance for investors if the consensus of a soft landing turns out to be optimistic.

Small and mid caps have had a torrid time over the last 12-18 months and we believe they're now priced for a recession. History points to them outperforming following a peak in interest rates, and this presents compelling opportunities.

Encouragingly, emerging markets have seen positive inflows through 2023 due to greater confidence in the robustness and resilience of their monetary and fiscal policies. With US dollar strength abating, this bodes well for emerging markets, particularly if China adds countercyclical policies to stimulate economic growth, which is what we expect through 2024.

What do we need to be cautious of?

A revival in inflation will force central banks to consider additional rate rises. However, unless it's structural, we believe markets will look through it.

Tightening liquidity through higher interest rates and central bank quantitive tightening raises the risk of growing defaults and delinquencies. This will heighten risk premia, slowing investment activity to the detriment of long term growth and productivity. With tight credit spreads in investment grade corporate bonds, this reduces their downside protection. By contrast, emerging markets debt looks more resilient as their central banks are further ahead in the disinflation cycle having raised interest rates earlier in 2021, well ahead of their developed market peers.

Consensus analyst earnings forecasts assume a soft landing. Anything weaker will lead to downward revisions. With disinflation coming through, companies won't feel the benefit of expanding nominal revenues, yet with costs remaining elevated (e.g., wages), margins look vulnerable to the downside. Care and selectivity are key, especially in the highly concentrated US market. The 'magnificent seven' (Facebook, Apple, Amazon, Alphabet, Netflix, Nvidia, Microsoft) have delivered handsome returns for investors, but expectations are now high and any disappointment likely to be punished heavily.

What's our tactical position as a result?

Asset Class	(--) Double underweight	(-) Underweight	(=) Neutral	(+) Overweight	(++) Double overweight
Managed Liquidity	○	○	○	●	○
Global Government Bonds	○	○	○	●	○
Global Index Linked Government Bonds	○	●	○	○	○
UK Corporate Bonds	○	○	●	○	○
Global Strategic Bonds	○	○	●	○	○
Diversified Alternatives	○	○	○	●	○
UK Equity	○	●	○	○	○
US Equity	○	●	○	○	○
Europe ex UK Equity	○	●	○	○	○
Japan Equity	○	○	○	●	○
Asia Pacific ex Japan Equity	○	○	●	○	○
Emerging Markets	○	○	○	●	○
Global Smaller Companies	○	○	●	○	○

What worked and what didn't?

With the prospect of a peak in interest rates, equity like returns in fixed income since the end of October have validated the appropriateness of our approach through a risk adjusted lens.

In hindsight, we may have turned cautious too soon. Worried that equity valuations did not adequately reflect the risks to growth, we moved underweight EU, UK and US equities mid-year.

Moving overweight Japan captured the re-rating that has begun to come through following the announcement by the Tokyo Stock Exchange for corporate management to focus more explicitly on growing shareholder value.

The underweight position in Index Linked bonds helped to mitigate volatility and protect investors from the rise in real yields as central banks raised rates.

We took profits in UK Value & Income in anticipation of a cooling in commodity prices.

Removing the US Small Cap exposure early in the year added to returns with proceeds invested into more large cap oriented funds.

Narrowing the underweight to the US helped to lessen the negative geographical attribution.

We took profits by moving to neutral in Corporate Bonds, before spreads then tightened even further.

The underweight to Europe has worked against us, although the economy has been weaker than expected. Monetary tightening appears to have gone too far and valuations are unexciting.

The overweight to emerging markets has yet to deliver. However, with valuations at historical lows versus developed markets, government and corporate balance sheets looking robust, and the US dollar appearing to be rolling over we are confident returns will be rewarding for investors in due course.

2024 Strategic Asset Allocation Changes

As we conclude our macro-economic outlook, let's pivot to the updates to our Strategic Asset Allocation.

In a nutshell

This year we're making two small but important changes to the portfolios:

1. **We're adding Global Small Cap Equity to Risk Grade 5 onwards** - to provide more diversified exposure to higher risk, higher returning asset classes and take advantage of Global Small Cap Equity's attractive value. This should also improve the consistency of the portfolios' performance without compromising the long-term return profile.
2. **We're combining UK Growth and UK Value and Income into a single UK Equity asset class –** to help us focus on the asset class construction, and make sure we have the desired diversification amongst our active UK Equity managers (this won't affect our Ethical Active solutions which already have a consolidated UK Equity asset class).

This section explains how our latest economic outlook and market analyses have informed adjustments in our Strategic Asset Allocation this year.

As well as making sure that our portfolios remain robust to the ever-evolving economic landscape, our Strategic Asset Allocation provides the baseline or neutral position for all our tactical asset allocation adjustments.

Our changes

Adding Global Small Cap Equity

From Risk Grade 5 onwards, we allocate to a set of higher-risk assets, which increases in size as we move up the Risk Grades. The objective is to deliver additional return by allocating to riskier assets. These assets focus on equity regions where long-term returns have been meaningfully higher and currently include:

- Asia Pacific ex Japan
- Emerging Markets
- China A-shares (active portfolios only)

By adding the Global Small Cap Equity asset class to this bucket, we're including an asset that has a long history of excess return. Importantly, the return profile is different to that of Asia and Emerging Markets. This means better diversification within these higher risk assets.

This is also a great opportunity because the asset class' price to earnings ratio has shrunk meaningfully over the last 18 months. Analysis of this trend through our capital market assumptions (CMAs) shows it's now very attractively valued.

Consolidation of UK equity asset classes

For most solutions other than Ethical, we split our UK equity exposure between UK Growth and UK Income. The unique UK equity market has historically provided clear differences in the investible universe between these two styles. For example, the concentrated nature of the index for income producing companies (FTSE UK Equity Income) offers a very different return profile. The benefit of this diversification was clearly felt during 2022 where its high concentration to energy and materials offered strong inflation protection to portfolios.

Over several years however, the number of funds in the IA UK Equity Income peer group has dropped dramatically, and the yield enhancement on the FTSE All Share has disappeared.

This makes it difficult to implement solely to this asset class. To address this, and our continued belief in the diversification benefits that UK Income can offer, the consolidated UK Equity asset class includes both UK Income and UK Growth funds.

For passive investors, there'll be no change to the funds used, but the split will move to 70% FTSE All Share tracker and 30% UK Equity Income from the current 50/50 split.

For active investors, we'll be making some small adjustments to the funds used and how they're blended, to create the best balance between income and growth characteristics.

Our approach to Asset Allocation

The objective of our Strategic Asset Allocation is to deliver the best possible client outcomes for the investment mandate and risk level that's been chosen for them.

Three key principles guide our choice of the mix of asset classes that make up the asset allocation:

1. **We prioritise consistency of returns -** we don't take large bets on certain asset classes, we truly believe in the benefits of diversification and how this impacts portfolios at different points in the economic cycle.

2. **We investigate, evolve and validate -** revalidating our Strategic Asset Allocation is a process that's 11 months in the making. Continuously seeking improvement, we research new asset or sub-asset classes and reassess existing ones to ensure value, and explore potential weaknesses. Our approach, always evidence based, analyses at least 20 years of asset class interactions. This might involve adding or retiring asset classes for incremental enhancements that provide long term value, rather than major changes.

3. **We look back to look forward -** we also produce our own in-house capital market assumptions (CMAs). These represent forward-looking estimates of expected returns on a long-term average basis, i.e. through a typical market cycle of around 10 years. They're not forecasts and won't drive changes on their own but support our decisions on asset allocation tilts in pursuit of attractive potential long-term returns.

We also have three longstanding beliefs that inform our decision making when it comes to portfolio construction, and when deciding on strategic asset allocation changes.

– **We believe in the power of Government Bond duration** – it offers an element of defence to serious equity weakness. While 2022 was an unusual event that saw equities and bonds fall together, their typically negative correlation to equities is a critical part of any balanced portfolio over the long term.

– **We believe in unique advantages of UK equities** - we continue to have a home bias to UK equities. They offer a unique style of investment outcome which complements the more tech heavy biases in other large indices. They also offer an inherent level of inflation protection.

– **We believe diversified alternatives are critical to our defensive approach –** this unique asset class is designed to provide a real return over the long term, but with defensive characteristics negatively correlated to fixed interest. This was particularly important in 2022 as it offered an element of downside protection when bonds couldn't.

Summary of changes

Our changes are driven by two themes - diversification and opportunity:

1) We're reducing exposure to Asia and Emerging Markets and introducing Global Small Cap.

2) We're combining UK Growth and UK Value and Income into a single UK Equity asset class.

For passive portfolios, the new Global Small Cap asset class will be delivered through a dedicated Global Small Cap fund.

For Active, we'll split the allocation between US Smaller Companies and UK Small Companies, with a bias towards the US.

All changes will keep each Risk Grade within their acceptable range of risk tolerance. A full Risk Grade by Risk Grade summary of changes can be found overleaf.

Changes by risk grade

Risk Grade	Changes
1	No change
2 - 10	An allocation to Global Small Cap, taken pro-rata from Asia and Emerging Markets. UK Growth and UK Value and Income have been combined into a single UK Equity asset class

Core asset allocation 2024

(% change in brackets)

This table shows the asset allocation changes for our Strategic Active, Multi-Option, Passive and Conviction solutions, the purest representation of our strategic asset allocation.

This also acts as the neutral position for our Tactical Active and Passive solutions. These changes apply to all our other accumulation solutions (Strategic MOXP, Ethical A-D, Passive ESG and Tactical Income), but will be implemented in slightly different ways, depending on the solution's mandate and risk framework.

Asset Class	1	2	3	4	5	6	7	8	9	10
Managed Liquidity	60%	27.5%	17.5%	10%	5%	2.5%	0%	0%	0%	0%
Global Government Bonds	13.5%	19%	16.5%	13.25%	10.5%	7%	5.25%	3%	1%	0%
Global Index Linked Government Bonds	7.5%	10.5%	9%	7.25%	5.5%	4%	2.75%	1.5%	0.5%	0%
UK Corporate Bonds	4.5%	7.75%	8.5%	8.5%	8.25%	7%	6%	4%	1.75%	0%
Global Strategic Bonds	4.5%	7.75%	8.5%	8.5%	8.25%	7%	6%	4%	1.75%	0%
Diversified Alternatives	10%	10%	10%	10%	10%	10%	10%	7.5%	5%	0%
UK Equity	0%	8%	13.5%	19%	20%	20%	21%	22%	20%	18%
US Equity	0%	5.5%	10.25%	14.75%	16%	19.75%	21%	22.5%	26%	30%
Europe ex UK Equity	0%	2%	3.25%	5%	5.25%	6.5%	7%	7.5%	8.75%	10%
Japan Equity	0%	2%	3%	3.75%	3.75%	3.75%	3.5%	3%	2.5%	2%
Asia Pacific ex Japan Equity	0%	0%	0%	0%	1.5% (-0.5%)	2.5% (-0.5%)	3.5% (-0.75%)	5% (-1.25%)	6.5% (-1.75%)	8% (-2%)
Emerging Markets Equity	0%	0%	0%	0%	4.5% (-1%)	7.5% (-2%)	10.5% (-2.75%)	15% (-3.75%)	19.75% (-4.75%)	24% (-6%)
Global Smaller Companies	0%	0%	0%	0%	1.5% (+1.5%)	2.5% (+2.5%)	3.5% (+3.5%)	5% (+5%)	6.5% (+6.5%)	8% (+8%)

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- All data sourced from FE fundinfo.

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