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Do Fundamentals Support a Risk-on Tilt?

Surprisingly strong economic growth, declining inflation, and easy financial conditions have buoyed an optimistic outlook.

Key Points

- **Economic growth and corporate earnings continue to surprise on the upside**, especially in the US. While valuations are on the rich side, we think fundamentals and policy may support a risk-on tilt and that positive sentiment can be sustained. We have a moderately overweight view on global equities and credit spreads.[1]
- **In equities, we favor the US and Japan over Europe and emerging markets** (EM). The US is our top developed market (DM) due to the macro backdrop and our confidence in artificial intelligence's (AI) potential to continue underpinning earnings growth. We have a moderately overweight view on Japan and remain skeptical we'll see any material improvement in China considering problems in real estate and consumer confidence.
- **We have less conviction on duration[2] and maintain a neutral view on government bonds.** The jury is still out on the timing of Federal Reserve (Fed) rate cuts, but we think the European Central Bank (ECB) could cut rates earlier and by more given a clearer disinflation picture and weaker growth than in the US. We've moved to a slight overweight view on spreads, thanks to positive fundamentals and technicals. Within spreads, we prefer European over US high yield.
- **We've moved to a neutral view on commodities. We remain biased toward higher inflation in the long term, but richer valuations in oil and gold suggest waiting for better entry points.**
- **Downside risks to our views include a hard landing precipitated by a spike in inflation and a Fed pivot back to tightening**, or a stagflationary scenario with sticky inflation and waning growth. Upside risks include an even more benign environment than our base case, with sustained growth that's well above trend but not inflationary.

Insight from sub-adviser Wellington Management

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From a market perspective, we might be close to nirvana. Growth has surprised to the upside, inflation is coming down, earnings have supported rich valuations, and financial conditions are easy. No wonder why investors' risk appetite has roared back.

Importantly, central banks are viewed as credible, having worked to tone down the market's rate-cut expectations. The repercussions of a policy error are well understood by markets in all regions: Ease too soon and risk having to reverse course and tighten more aggressively, reviving the possibility of a recession. Ease too late and risk the cumulative effects of restrictive policy tipping the economy into recession.

While this environment may seem too good to be true (and only the 1995-1996 period resembles it), we're hard-pressed to identify risks that could sustainably derail it over the next six months, though the US election is top of mind. But even if US political turmoil threatens the positive risk environment, central banks seem to have a "free option" to cut rates in response, given that they consider current policy to be restrictive.

Now more confident in the fundamental and technical picture, we've raised our views on global equities and credit spreads to moderately overweight. Were it not for rich valuations, we might have moved to an even stronger overweight view. Within equities, we favor the US and Japan over Europe and EMs. In the US, we're loath to discount AI as a transformative technology given the earnings power demonstrated by the Magnificent Seven.[3] While we've reduced our view on Japan to moderately overweight, we think there could still be another leg to the country's economic recovery, with recent wage hikes inspiring more consumer spending.

Now that markets are in line with central-bank projections of rate cuts this year, we have a neutral view on duration. We see relative value in being long duration in European vs. US government bonds; US growth is much stronger than in Europe, and the disinflation trend is clearer in Europe. In credit, we've moved to a moderately overweight view from underweight. Valuations are rich, but we think they could stay that way for a while given the positive economic backdrop and strong demand for income. We also see better value in European high yield relative to US high yield.

Equities: More to Like in DMs, While Worries Linger in EMs

We've increased our view on global equities from neutral to moderately overweight. Economic growth is firming up with the US leading the way, but global laggards are also improving. New orders suggest global manufacturing activity is picking up to join already healthy services activity. With global equity valuations relatively high, we would expect earnings expansion and upward revisions of earnings-per-share (EPS)[4] growth to be the main drivers of performance. We'd turn more bullish on further evidence that the economic expansion and the equity rally are broadening out.

We've reduced our long-standing overweight view on Japan to a moderately overweight view. We're still positive on the path of structural reforms, which give further runway for a re-rating. Moreover, strong wage hikes driven by union agreements could boost inflation further, especially on the services side. This is a positive for domestic consumption, which has lagged the recovery. It's noteworthy that company profits have been resilient in the face of rising wages so far. However, our outlook on both inflation and short-term rates is above consensus following the recent policy move away from negative interest rates and a cap on Japanese government-bond yields. As a result, a stronger Japanese yen is a risk, as EPS is very sensitive to moves in the currency given the export orientation of the market.

We've turned more positive on the US where both earnings and the economy show resilience, and the AI theme seems likely to continue boosting the market's relative prospects. While valuations of the Magnificent Seven stocks remain higher than the broad market, the companies have delivered on earnings, so their valuations have actually come down in recent months despite strong price gains (**FIGURE 1**). Recent dispersion within the Magnificent Seven (with Tesla and Apple underperforming for idiosyncratic reasons) has also left more opportunities for active managers, though we would still like to see increased breadth across the US market. Meanwhile, in an environment of resilient growth, equities have delinked from rate expectations: The market is now expecting only three rate cuts in 2024, down from nearly seven, but equities have shrugged it off. We think this dynamic could continue.

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately OW	↑
Defensive fixed income	Neutral	—
Growth fixed income	Moderately OW	↑
Commodities	Neutral	↓
Within Asset Classes		
Global Equities		
US	Moderately OW	↑
Europe	Neutral	↑
Japan	Moderately OW	↓
China	Moderately UW	↓
EM ex China	Moderately UW	↓
DM Government Bonds		
US government	Underweight	↓
Europe government	Overweight	↑
Japan government	Neutral	↑
Credit Spreads		
US high yield	Moderately UW	↓
Europe high yield	Moderately OW	↑
Global investment grade credit	Moderately OW	↑
EM debt	Neutral	—
Bank loans	Neutral	↑
Securitized assets	Neutral	—

OW = overweight, UW = underweight

Views have a 6-12 month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 3/31/24, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

FIGURE 1: Magnificent Seven's Earnings Have Cheapened Valuations
Weighted 12-month forward P/E

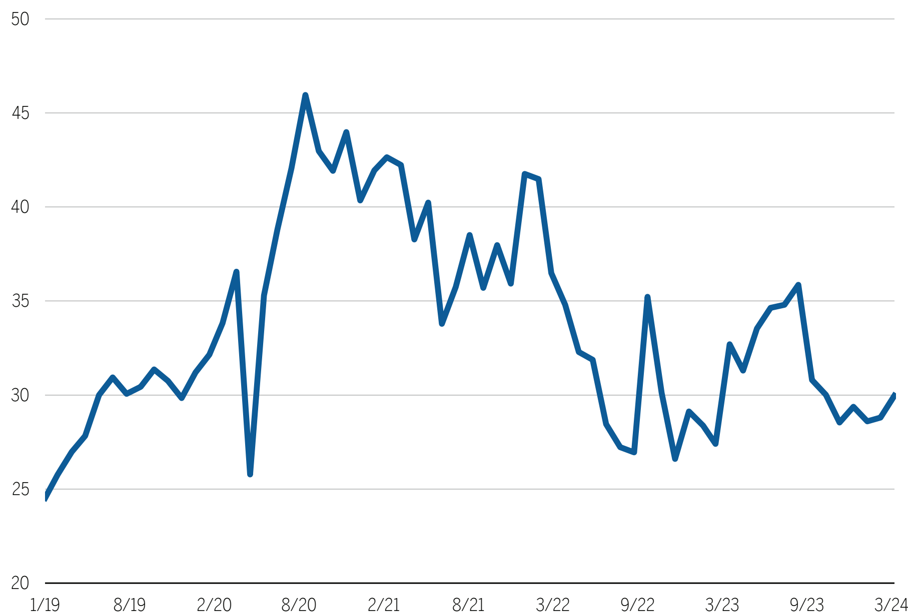

Chart data as of 1/1/2019-3/31/24. **Past performance does not guarantee future results**. Weighted average 12-month forward P/E ratios of the Magnificent Seven. The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock. For illustrative purposes only. Data Source: Refinitiv.

Recent dispersion within the Magnificent Seven has left more opportunities for active managers.

We changed our view on European equities from underweight to neutral. We see signs that economic momentum has bottomed out and the disinflation trend is more reliable than in the US, giving the ECB a clearer path to cut rates. Earnings have been more lackluster, with earnings revisions the worst among the major regions we monitor. A turn in earnings momentum and/or breadth would give us more confidence to turn positive on this inexpensive market.

We have moderately underweight views on China and EM ex-China. China's headwinds are more structural, with factors such as internal deleveraging and geopolitical uncertainty limiting the potential for the market to outperform over a 12-month horizon. The policy response remains tepid or reactive as the government is unwilling to deploy its full policy toolbox to stem deflation, all of which has left private-sector confidence suppressed.

EM ex-China is a more positive story, with robust macro momentum in India and other parts of Asia and structural reform in South Korea. The impact of the AI ramp-up on semiconductor demand should be positive for the region. We need stronger conviction on the global cyclical expansion and a meaningful decline in the US dollar before we can move away from our underweight view here, which is more tactical than our underweight on China.

At the sector level, we have an overweight view on energy, financials, and consumer discretionary, and an underweight view on healthcare, industrials, and materials. Consumer discretionary is our largest overweight view, with interest rates and macro fundamentals now supportive (e.g., real disposable incomes are rising) and valuations providing a tailwind. The materials sector is our largest underweight view, with sentiment, trend, and valuations all serving as headwinds.

Government Bonds: For Now, Rates Have Adjusted Appropriately

The two main policy events of the first quarter were Fed and ECB campaigns to adjust rate-cut expectations from six to three and the Bank of Japan's (BOJ) decision to end its negative interest-rate policy. Ten-year yields in the US and Europe rose around 30 basis points (bps),[5] much more than in Japan, where expectations exceeded the BOJ's measured announcement.

Now that these events have unfolded and volatility has dropped, we're happy to sit with a neutral overall duration view until some mispricing appears. One exception is our view that European rates could rally earlier and more than US rates. The premise here is that while European growth may be improving, it's from a near-recessionary base. This is because European growth is bifurcated between the north and south, with the latter being more service-oriented than Germany, the largest European economy. Long the powerhouse of Europe, Germany is now the laggard as it deals with structural challenges from weak manufacturing, high wages, and competition from China. In addition, now that energy prices have come down, inflation is on a clearer downward trajectory. We think the bar for the ECB to cut rates is lower than it is for the Fed, with US inflation being stickier.

European rates could rally earlier and more than US rates.

We changed our view on Japanese government bonds from underweight to neutral. The BOJ not only ended negative interest rates, but also its yield-curve[6] control as well as its ETF and real-estate investment trust purchase programs. While these changes were dramatic in direction, the ultimate impact seems mild at this juncture given the leeway the BOJ gave itself to manage the shift and to prevent rates from spiking higher. As a result, yields actually fell after the news.

Credit: Confident Enough to Take a Cautious Step Forward

In a world of easing credit conditions, expected policy rate cuts, lower inflation pressure, and solid growth, we've raised our view on credit spreads to moderately overweight. With yields lower across credit markets, companies have been coming to market to issue new debt and refinance existing debt. This supply has been met by a supportive demand backdrop, as investors seek to lock in yields ahead of rate cuts.

There are signs we're at or near a peak in default rates in high-yield markets, which has historically been associated with flat or tightening spread levels. We're keeping a close eye on distress ratios,[7] which typically lead default rates and have been coming down in recent months (**FIGURE 2**). Given spreads are already tight vs. history, we don't think there's much room for further tightening and instead anticipate spreads will remain range-bound this year. In this environment, we expect income to be the primary return driver for credit investors, which motivated our move to a moderate overweight view on credit.

FIGURE 2: Lower Distress Ratios Indicate We May Be Near a Peak in High-Yield Defaults

High-Yield Distress Ratio (%)

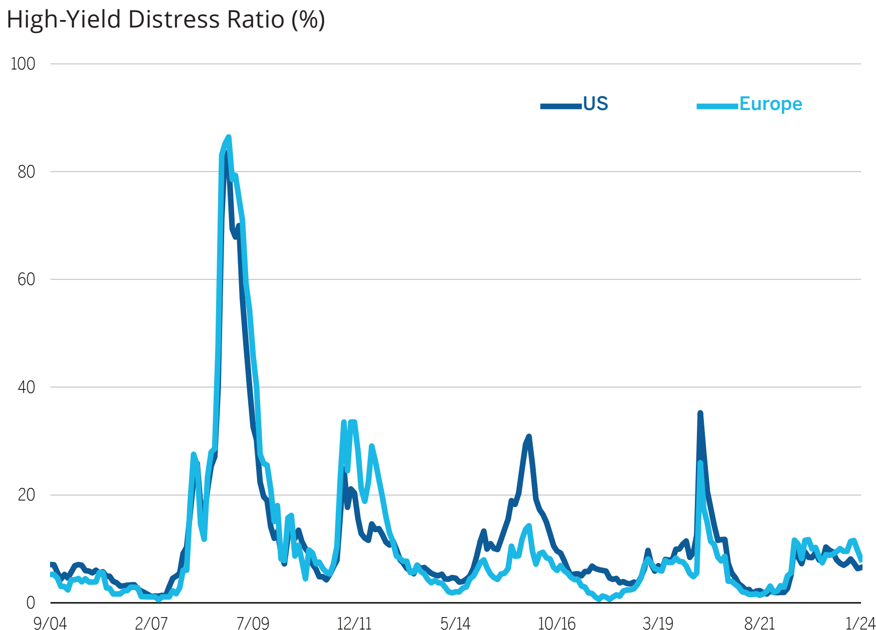

Chart data: 9/04-1/24. Data Sources: Wellington Management and FactSet, 2/24.

That said, we continue to believe there are risks for credit in 2024, with the market priced for a benign environment. The recent decrease in yields is beneficial for companies looking to refinance, but current yields are higher than the weighted coupons, so some businesses may still struggle with refinancing.

We have a slight preference for European high yield over US high yield. On valuation, Europe is where there's still a bit of premium left and the potential for some tightening in spreads. We're also turning more constructive on the European macro outlook, which may give central banks the latitude to cut interest rates sooner than the Fed.

Commodities: Questions Arise for Gold and Oil

Based on our outlook for gold and oil, we've moved from an overweight view on commodities to a neutral view. Gold has been a strong performer in recent months, but we see limited potential for further price appreciation. Central banks and other investors have been building gold allocations this year after weak sentiment in 2023, and more recent gains have been driven by an expectation of lower real yields later in 2024. With heightened geopolitical risks priced in, we think much of the positive case has already played out.

One of the main drivers of our positive view on oil in recent quarters has been an expectation of constrained supply from OPEC. While this expectation hasn't changed, growth in non-OPEC supply from the US and Latin America is weighing on our outlook. We believe geopolitical risk in the Middle East limits the downside risk to oil prices somewhat, but overall, we're less constructive than we have been.

Risks

Downside risks include a scenario in which core inflation reaccelerates or spikes, leading central banks to push back against aggressive rate-cut expectations or even to resume hiking. Other possibilities resulting from the lagged impact of tighter monetary policy include financial accidents in commercial real estate or other vulnerable areas, or the possibility of a recession. We could also see the Middle East conflict broaden, pushing up oil prices and increasing macro uncertainty. Finally, there's the potential for US political turmoil precipitated by the lead up to a fraught election period.

Upside risks include an even more benign environment (vs. our base case) in which loosening financial conditions lift growth above trend and disinflation resumes. Other upside possibilities include a scenario in which equity-market gains become more broad-based and, therefore, more durable, as well as a resolution to the conflicts in the Middle East and/or Ukraine.

Investment Implications

- **Consider increasing equity allocations** — The improving global economic environment could support valuations and continued earnings expansion, despite more measured rate-cut expectations.
- **Anticipate broadening in the equity rally** — We see signs of the rally broadening beyond the Magnificent Seven, which could benefit some market segments that have lagged, such as value and small caps. Regionally, we favor the US and Japan, but we've also lifted our view on Europe. From a sector perspective, we favor energy, financials, and consumer discretionary.
- **Consider maintaining a neutral duration stance and overweighting credit** — DM rates are fairly priced in our view. However, we see potential opportunity in some divergence between the ECB and the Fed, with the ECB likely to cut rates sooner. Credit spreads could stay tight for a while given the positive fundamental backdrop, lower anticipated defaults, and strong institutional demand.
- **Benign expectations could be disrupted** — While we favor a risk-on tilt, we're concerned about volatility later in the year stemming from the stark policy differences between the US presidential candidates and the market implications. Heightened geopolitical tensions could also induce higher volatility.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[3] The Magnificent Seven stocks are a group of high-performing and influential companies in the US stock market: Alphabet, Amazon, Apple, Meta, Microsoft, NVIDIA, and Tesla.

[4] Earnings-per-share is the projected growth rate in earnings per share for the next five years.

[5] A basis point (bps) is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[6] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[7] Distress ratios measure the percent of holdings in the ICE BofA High Yield Euro and US Indices with an option-adjusted spread of > 1,000 bps. An Option-adjusted spread is a measurement tool for evaluating yield differences between similar-maturity fixed-income products with different embedded options.

Important Risks: Investing involves risk, including the possible loss of principal. Security prices fluctuate in value depending on general market and economic conditions and the prospects of individual companies. • Foreign investments may be more volatile and less liquid than U.S. investments and are subject to the risk of currency fluctuations and adverse political, economic, and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets such as China. • Investments in the commodities market may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments linked to prices of commodities may be considered speculative. Significant exposure to commodities may subject the investors to greater volatility than traditional investments. The value of such instruments may be volatile and fluctuate widely based on a variety of factors. • The value of the underlying real estate of real estate related securities may go down due to various factors, including but not limited to, strength of the economy, amount of new construction, laws and regulations, costs of real estate, availability of mortgages and changes in interest rates. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • Loans can be difficult to value and less liquid than other types of debt instruments; they are also subject to nonpayment, collateral, bankruptcy, default, extension, prepayment and insolvency risks. • Diversification does not ensure a profit or protect against a loss in a declining market.

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