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Outlook: Something's gotta give

Consensus is clustered around a trilogy of lower inflation, rate cuts and continued growth. Is the market beginning to question this benign path?

Emiel van den Heiligenberg
Head of Asset Allocation

Tim Drayson
Head of Economics

The first quarter saw a strong rally in risk assets amid increasingly widespread optimism. Yet April hints the path to a soft landing has narrowed, and, at this altitude, investors risk being more exposed to a shift in the wind or a decline in visibility. This creates a potentially unforgiving environment for risk assets.

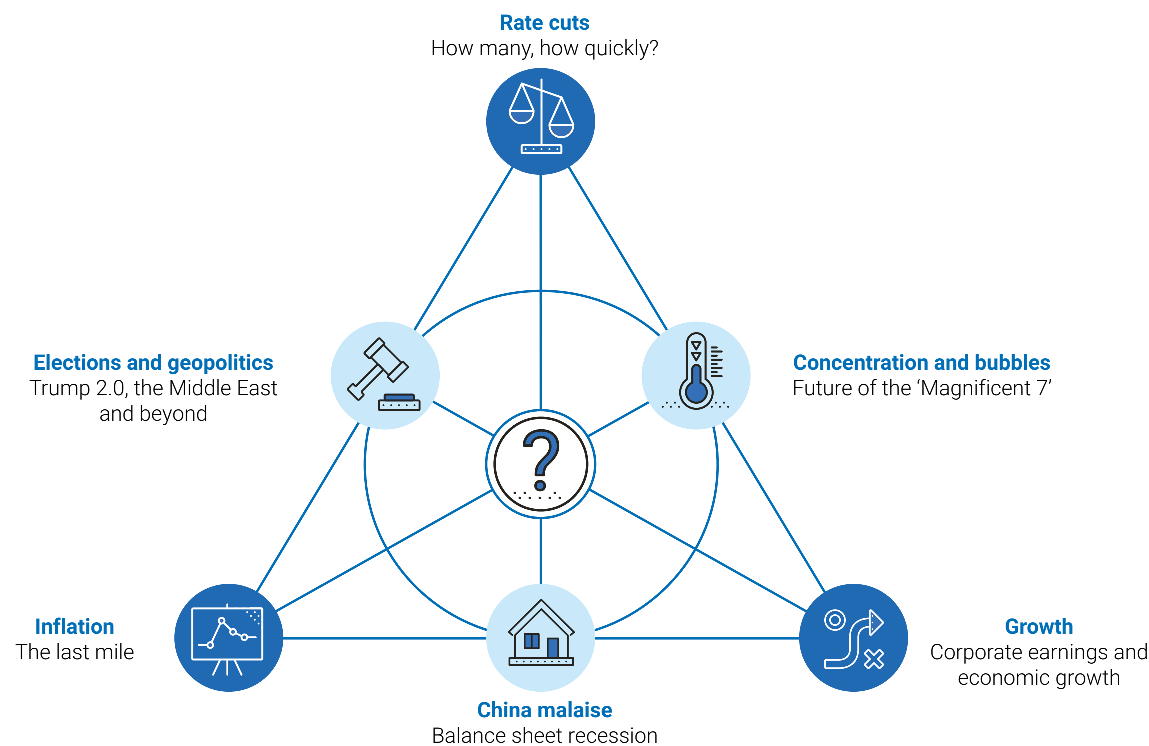
Since our last quarterly update US GDP expectations have gathered pace, with virtually all forecasters now giving up on recession. Despite the positive growth momentum, a gradual cooling is still widely expected, so consensus is now heavily clustered around a narrow soft-landing window. Inflation has surprised to the upside in the first three months of 2024, driven by sticky services prices. This combination has led markets to pare rate cut expectations this year from six to no more than two.

Yet this delay in rate cut expectations has not proved too problematic for equity markets, which despite some increase in volatility in April, partly due to heightened geopolitical risks, have taken the view that this is merely a bump in the road to rate cuts amid a higher neutral rate.

LGIM

Investors hoping for a perfect landing, but face crosswinds

Achieving the trilogy of lower inflation, rate cuts and strong growth appears to be a tricky balancing act



Source: LGIM, as at 13 March 2024.

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Another rabbit in the hat

The continued resilience of the US economy surprised many, ourselves included. As we've highlighted previously, fiscal policy has been highly supportive for growth, with Federal spending and deficits exceeding expectations, alongside robust state and local government spending. Excess household savings and the onshoring boom also played a part.

Developments in labour markets have recently emerged as another potential explanation, with recent Congressional Budget Office data showing US immigration has been much stronger than previously estimated.

This is likely to be a hot-button topic ahead of the election, but from an economic viewpoint, it's had the unintended consequence of allowing the labour market to rebalance alongside still strong employment growth. Job vacancies are being filled, but unemployment remains relatively stable.

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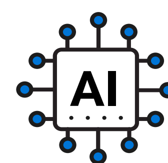


Assessing the potential of AI

The strong performance of equity markets in the quarter has also been supported by continued optimism around artificial intelligence (AI).

Our team continues to assess the possible macro impacts of AI as we move rapidly from proof of concept to real-world solutions. There's no doubt that a sudden spike in productivity would be disruptive, potentially eroding the negotiating power of labour, causing deflation, or even displacing whole groups in society whose skills cease to be valued.

We've also been mulling the evidence on whether a bubble is forming in AI stocks – refer to my article in this quarterly to read why I'm optimistic on this front.

And yet…

Despite the consensus optimism, we remain short risk assets. We believe the combination of what's priced in equity markets, credit valuations, rate cuts, top-down earnings, 'Goldilocks' growth and inflation expectations will prove difficult to achieve, and a deviation from this narrow path is most likely to negatively impact equities.

Strong nominal US GDP growth and a rise in productivity growth have helped companies meet or beat earnings expectations, lifting markets. But if inflation is to fall back to target, this could put pressure on margins – a typical late-cycle development.

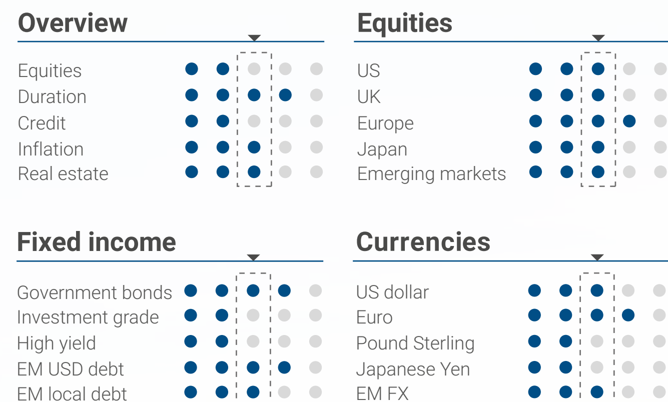
This also means the economy and markets are vulnerable to shocks, for instance the human tragedy and flare up of geopolitical risk we unfortunately see unfolding in the Middle East at the moment.

Outside the US, changes to growth and inflation outlooks have been more subtle as growth has continued to stagnate, though expectations remain for some recovery through the year.

China remains a notable laggard, with the property overhang dragging on activity and prices, though some policy support is allowing the broader economy to muddle through for now. Read our outlook for China, written by our Global Emerging Market Economist Erik Lueth and Strategist Patrick Greene.

Also check out Bruce White's Olympics-inspired analysis of the diversification bonus, as well as the latest update to our Capital Market Expected Return Assumptions (CAMERA), showing our long-term return expectations.

Our key asset class views

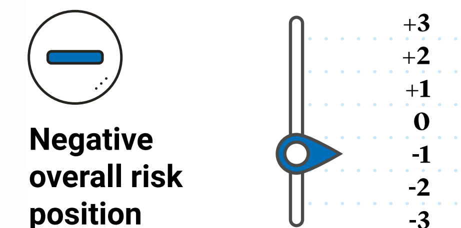


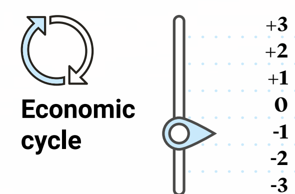
= Strategic allocation

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 13 March 2024. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. Regional equity views should be read in conjunction with the overall equity view. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

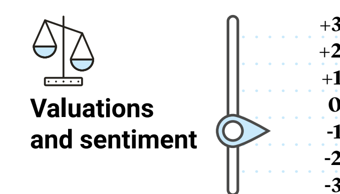
The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Our core asset allocation view

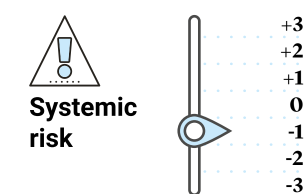




Central view for weak growth, recession risks elevated and upside scenarios capped



Regional split in valuations but overall neutral, while sentiment has a mild bullish tilt



Financial crisis risks have subsided but geopolitical backdrop remains tense

Source: LGIM. Views current as at 13 March 2024. **Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.**

Economic cycle
US is still late cycle and growth expected to slow
Tight macroeconomic backdrop limits upside growth potential
A wide range of potential outcomes, and little conviction in any
Valuations and sentiment
Sentiment indicators have moved bullish, positioning starting to follow
Relative valuations don't offer the natural bullish support for equities
Absolute valuations moving towards expensive in some pockets
Systemic risk
Banking crisis has subsided, some credit and real estate risks remain
Increased risks of escalation of the conflict in the Middle East
Indicators show no signs of private sector debt distress

China's L-shaped recovery

Erik Lueth
Global Emerging Market Economist

Patrick Greene
Strategist

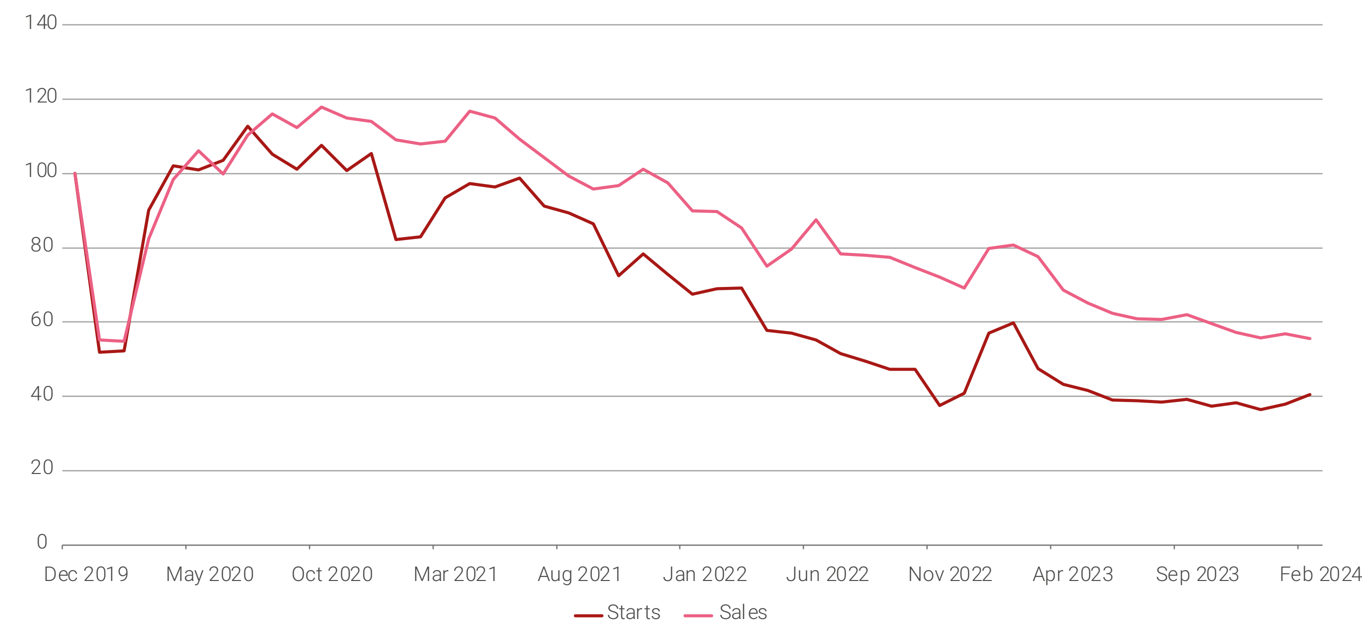
China's leadership set the 2024 growth target at 'around 5%', in line with last year's target and actual outcome. It will be challenging to hit this target, in our opinion. As top investment banks are split on China's growth prospects, we sit in the pessimistic camp. Why?

For starters, China is still in the thralls of a property market correction. Estimates of the housing overhang range from two to three years of sales.[1] Although the government has announced some social housing projects, details are scant, and estimates suggest additional demand amounts to a mere half year of sales.[2]

In addition, housing sales – already down 45% from 2019 levels – continue to contract.[3] With half of developers facing severe financial stress, households are not confident that pre-paid houses will ever be delivered. The government has, so far, failed to solve this crisis of confidence.

1. Sources: IMF, 2023, China, Selected Issues https://www.imf.org/en/Publications/CR/Issues/2024/02/08/Peoples-Republic-of-China-Selected-Issues-544651 and LGIM calculations.
2. Source: Dragonomics, 13 November 2023, The quiet stimulus to construction, and LGIM calculations.
3. Source: Macrobond as at 20 March 2024.

China: property activity



Source: LGIM, Macrobond as at 20 March 2024.

Second, the property downturn has put many local governments in a difficult financial position as they rely on land sales for revenues. As major conduits of fiscal stimulus they may be missed in action when they are most needed.

Indeed, late last year the central government instructed 12 of the 34 local governments to curtail spending and halt some infrastructure projects.[4]

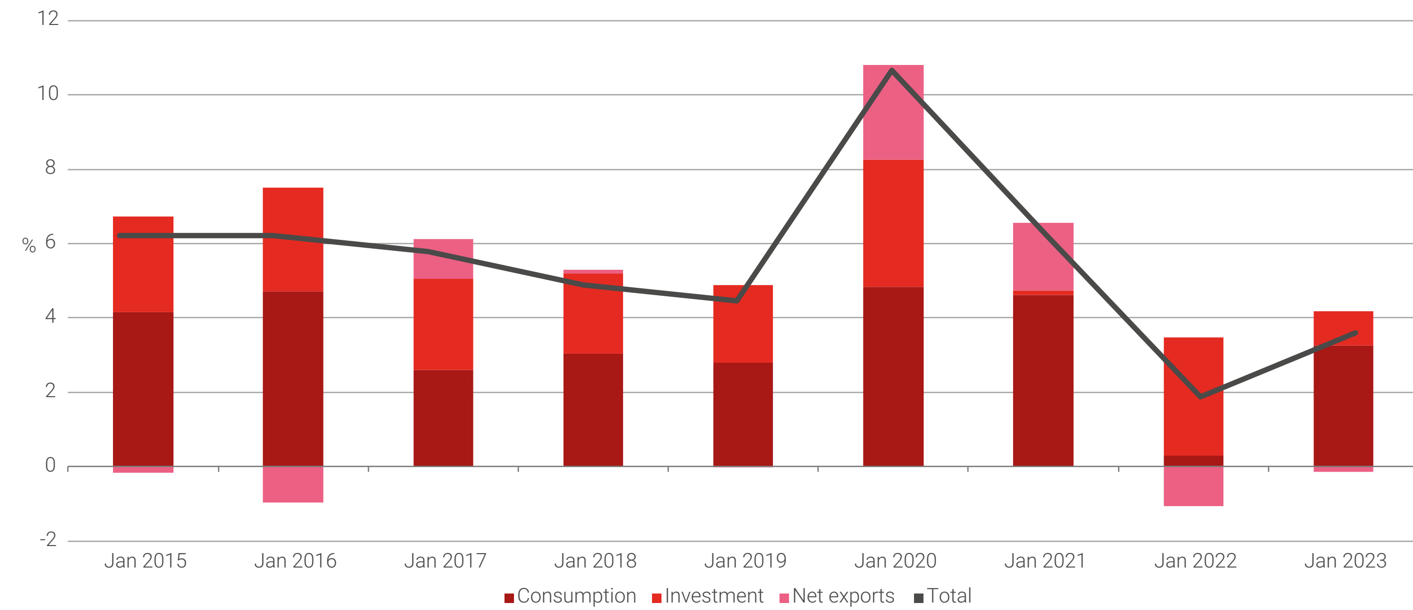
The central government is picking up some of the slack by issuing an ultra-long bond equivalent to 0.8% of GDP, but most estimates see the augmented deficit rise by just 0.5% of GDP.[5] This is 1.5 percentage points more stimulus than last year, but not enough to meet the growth target, in our view.

Finally, China does not have the benefit of rebounding from zero-COVID this year. Some 80% of growth was due to consumption last year. With pent-up demand out of the way, this is unlikely to be repeated. On the contrary, a weak labour market and depressed prices of property – households' main asset – are likely to weigh on consumption.

The statistical carry-over is also weaker. If GDP remained at the end-2023 level this year, average GDP would be 1.6% higher than last year. Last year, the statistical carry-over was 1.9%.

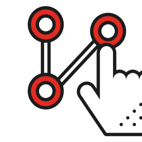
4. Source: Goldman Sachs, 6 Mar 2024, Beijing's Balancing Act between Infrastructure Stimulus and LGFV Deleveraging.
5. Source: Goldman Sachs, 6 Mar 2024, Beijing's Balancing Act between Infrastructure Stimulus and LGFV Deleveraging; JP Morgan, 5 March 2024, 2024 NPC takeaways.

Contributions to GDP growth



Source: LGIM, Macrobond as at 20 March 2024.

The risks to our economic outlook are two-sided. On the downside, financial stress in the property sector or among local governments could lead to a credit crunch. On the upside, policymakers could increase stimulus and finally address the crisis of confidence in the property sector.



What this means for our positioning

The difficult backdrop for growth contrasts with a growing sense of optimism from investors. To be clear, the Chinese stock market has had a dire few years and sentiment is far from exuberant. But we think the flurry of small announcements from policymakers that led Chinese equities to rally over 15% between 22 January and 21 March are being extrapolated too far. It is also worth remembering that Chinese companies' earnings per share have a very loose relationship with macroeconomic growth.

So, we are tactically underweight Chinese equities and prefer other equity markets. But this is a short-term view, and we will look to add Chinese equities back if we see any sign of sustained growth in earnings per share.

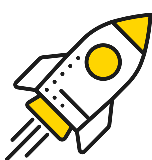
Bubble trouble: is the stock market riding for a fall?

Emiel van den Heiligenberg
Head of Asset Allocation

Austria, March 2000. I'm skiing with one of my friends. After a few runs he signals to stop as he needs to make an urgent call. I can't really follow the conversation, but I later understand he's subscribed to the initial public offering (IPO) of internet service provider World Online.

"I didn't realise you're an investor too," I say. "I wasn't until now," he replies, "this is going to be my first investment. I went all in – the internet IPO seems like a sure thing."

I still regret that I didn't recognise this conversation for what it was: one of the clearest sell signals I've been handed in my career.



To the moon

In my 30-year career as an investor, stock market bubbles have always been a fascination.

The combination of hope, greed and almost unstoppable herd behaviour drives a perfectly reasonable narrative – like the idea that artificial intelligence (AI) will impact large parts of society and increase productivity – into overdrive, with investors extrapolating exponential profit growth into eternity and sending valuations into the stratosphere.

After the bubble bursts, everyone understands asset prices were bonkers, but in the middle of the mania the attraction can be irresistible.

Are we in bubble territory?

Over the years I have constructed a 'bubble indicator', which helps me judge whether markets are in danger of implosion. The bubble index contains 36 sub-indices in subcategories like excessive valuations, the macro environment, speculative trading and leverage, investor sentiment, and signs of herd behaviour.

The latest reading of the LGIM Bubble Index shows some frothiness and a very slow increase, but it's still quite far from bubble-like levels.

Some seeds of exuberance are present. We are late in the economic cycle and there is plenty of liquidity in the system. AI is an archetypical technological breakthrough in that it feeds the idea that "this time is different". Pockets of the market have very rich valuations and market concentration in performance is rising.

However, there remain plenty of signals that we are potentially not yet at nosebleed highs:

Overall leverage is not excessive

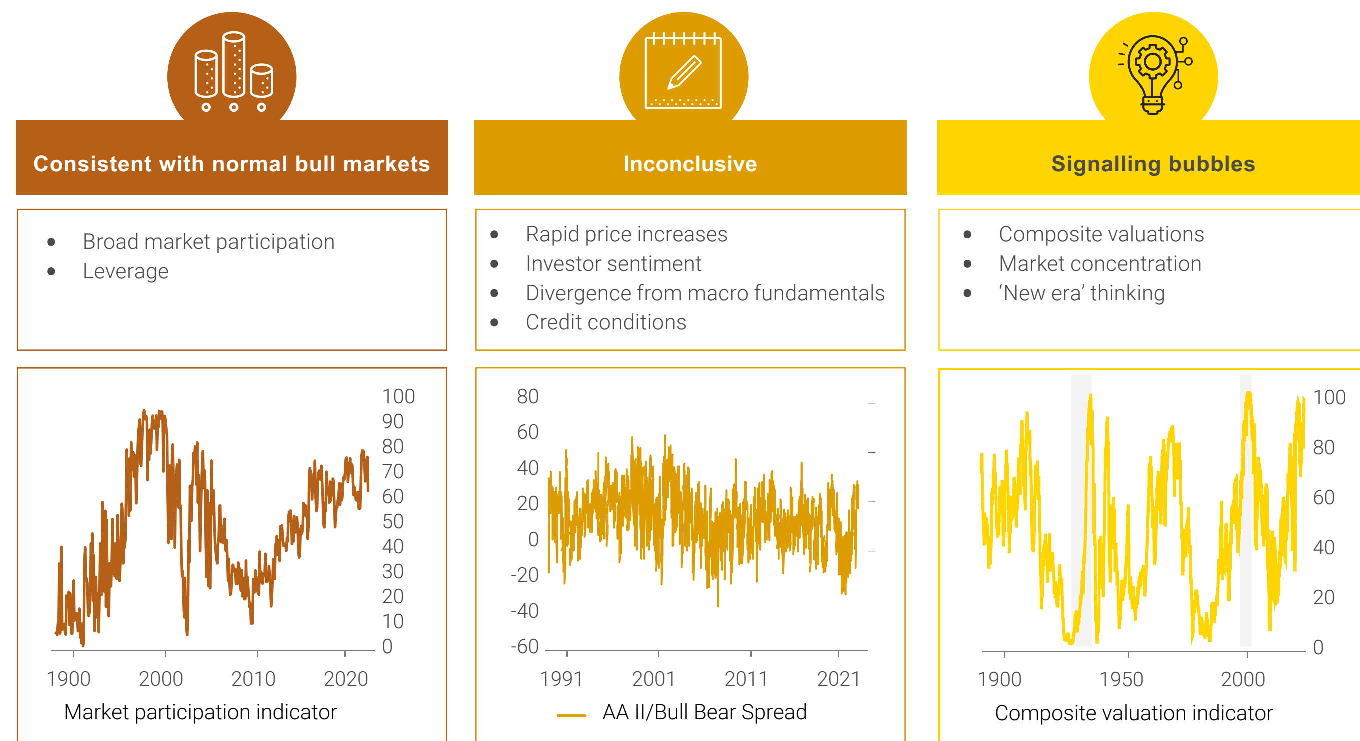
Financial deregulation and financial engineering facilitating easy money and a rapid increase in leverage aren't yet omnipresent

M&A and IPO cycles remain relatively normal

Heiligenberg Index

Source: LGIM as at 21 March 2024.

Equity bubbles are complex, often only identifiable in hindsight
Several indicators are often associated with the formation of a bubble in equity markets



Source: LGIM as at 21 March 2024.

The fact that the bubble has not yet occurred doesn't make further increases in prices a given. Bubbles are difficult to anticipate, and full acknowledgement only happens after the burst.

There's no doubt that US equities are rich relative to their own history, other equity markets and compared with bonds. We derive from this that returns over the medium term are likely to be below average, but this doesn't tell you much about expected returns over the next three years.

But valuations are not, in our view, excessive like they were in the 1990s, and some frothy areas such as the SPAC boom have already deflated.

Are we nearly there yet?

The LGIM Bubble Index is at a level comparable with 1997 in the tech bubble or 2005 in the US housing market bubble, suggesting a bursting isn't imminent.

AI could feed a narrative that grows into an exuberant mania. However, this is just one possible outcome. It's by no means guaranteed, or even the most likely outcome. As such, other macro questions remain very relevant.

We continue to believe in diversifying our portfolios. Though we like equities with AI exposure, we don't believe investors should go all in on the theme in anticipation of a bubble emerging.

Special thanks for Roger, a friend for life and a great predictor of stock markets, for helping to shape my thinking around market bubbles.

Diversification for the win

Bruce White
Head of Dynamic Strategies

We're just a few months away from the Paris Olympics, so what better time to shoehorn in a sporting slant on portfolio analysis?

Our portfolio Olympics pits four natural resource asset classes against one another, vying for gold, silver and bronze medals, as well as a wooden spoon for last place. The contenders are Gold Miners, Silver Miners, Copper Miners (as the key ingredient in bronze), and timber and forestry companies ('Wood Choppers').

For the first head-to-head race, we examine the realised geometric return on each of those asset classes over the longest common period we have for those indices:[7]

The individual results: geometric return asset class ranking

Index returns Jan 2007- Feb 2024	Geometric return % p.a.	Standard deviation	Beta to global equities	Arithmetic return % p.a.
Global Equities	6.88%	16.4%	1.00	8.03%
1. Wood Choppers	**4.05%**	22.8%	1.20	6.63%
2. Copper Miners	**2.71%**	40.9%	1.79	11.25%
3. Gold Miners	**1.24%**	39.8%	0.82	8.91%
4. Silver Miners	**-2.58%**	41.2%	1.11	5.92%

Source: LGIM as at February 2024.

It is clear on this geometric return race that the Wood Choppers win gold, copper silver, gold bronze and silver takes the wooden spoon. Simples. Or is it?

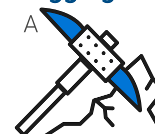
Realistically, we aren't looking to allocate 100% to these asset classes. More likely, they will receive just a small slice of the portfolio, and to keep it straightforward the remainder will be in global equities. Let's say that is 2% for Wood Choppers, scaled down for the miners in proportion to their much higher volatility.

The table below evaluates their usefulness as 'team players', that is a portfolio's return including a monthly rebalanced slice to each index and global equities.

The differences are small, as you would expect from just a small allocation. But in the photo finish for the impact on portfolio return, gold now wins gold, copper silver, silver bronze and wood wood.

Why? How do gold miners manage to juice up portfolio performance when they weren't the best performing?

Digging deeper



A look at the other characteristics of the asset classes reveals why. All have high volatility compared with equities. That high volatility causes higher arithmetic returns (the simple average of returns in each time period). Compare an asset that falls 10% then rises 11.11% with an asset that falls 50% then rises 100%. They have the same geometric return, but the latter much higher arithmetic return.[8]

When we look at a rebalanced allocation to those assets we are interested in arithmetic returns, as we take a weighted slice of each arithmetic return to add to the overall portfolio's arithmetic return.

So, adding in an asset with high arithmetic return will boost the arithmetic return of the overall portfolio. That will boost the geometric return of the overall portfolio if the addition compensates for any volatility increase in the portfolio from adding in that asset. This is the 'diversification bonus' for an asset.

Looking at the first table, gold miners have a lower arithmetic return than copper miners, but the latter has a high beta, so adds to portfolio risk. An asset class with high, idiosyncratic volatility is better all else equal for adding to a portfolio's geometric returns. Though portfolio return-to-risk ratios will only improve for relatively incremental allocations.

The conclusion from this isn't anything in particular about those specific asset classes; instead it's that geometric returns are an incomplete lens when evaluating potential asset classes in a portfolio context.

The volatility and beta to the portfolio matter from both a return perspective, especially for high-volatility assets, as well as the risk impact.

The team results: asset classes in a multi-asset portfolio

Returns of Portfolio (weight to index) Jan 2007- Feb 2024	Portfolio geometric return % p.a.	Portfolio standard deviation
Global Equities	6.88%	16.39%
1. Global Equities + Gold Miners (1.15%)	6.90%	**16.36%**
2. Global Equities + Copper Miners (1.12%)	6.89%	**16.54%**
3. Global Equities + Silver Miners (1.11%)	6.85%	**16.42%**
4. Global Equities + Wood Choppers (2.00%)	6.84%	**16.46%**

Source: LGIM as at February 2024.

It should be noted that diversification is no guarantee against a loss in a declining market.

7. Indices used are MSCI World Developed USD, Solactive Pure Gold Miners USD TR, Solactive Silver Miners USD TR, Solactive Copper Miners USD TR, S&P Forestry & Timber Index USD TR. Data source: Bloomberg L.P. as at February 2024.
8. The approximate relationship is that geometric average return is equal to the arithmetic average of returns less half of the square of volatility (standard deviation).

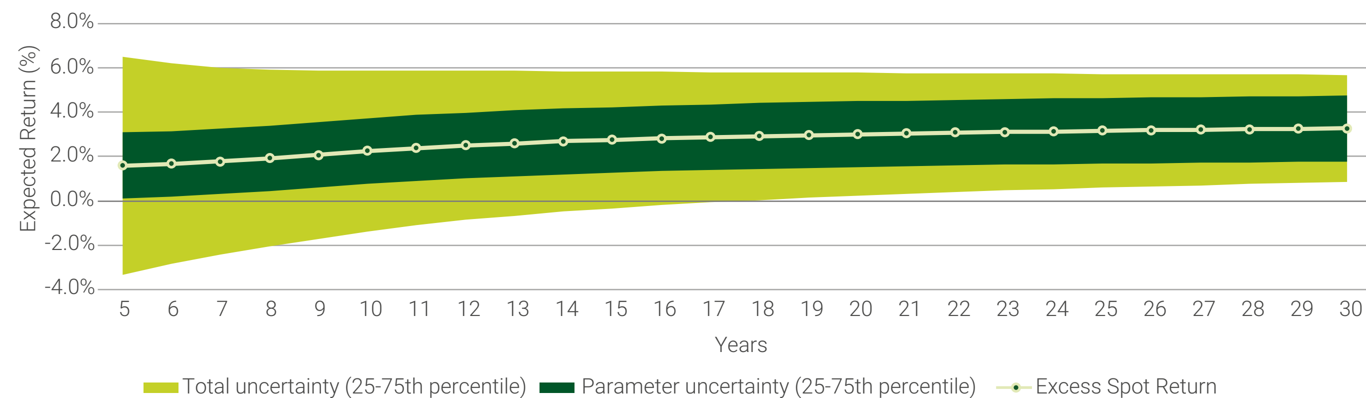
CAMERA: our capital market assumptions update

Tim Armitage
Multi Asset Fund Manager

Last quarter we introduced CAMERA, our capital market assumptions framework. CAMERA combines two sources of return expectations – those from an equilibrium model that is primarily risk-based, and those from a model that is primarily valuation-based – to form a sensible blend of expected returns over a range of time horizons. The framework is based on the premise that in the long run, expected returns should converge to some equilibrium level, while over shorter horizons we may expect some deviation from equilibrium assumptions as a function of market valuations.

Over the past quarter, valuation-based return estimates for most broad equity markets as well as alternatives such as UK property and infrastructure have fallen modestly, leading to a slight steepening in the upward-sloping term structure of returns. Conversely, most bond markets have seen small increases in valuation-based return estimates, while equilibrium returns across all markets have remained relatively unchanged.

Expected excess return term structure: US equity



Source: LGIM as at 21 March 2024.

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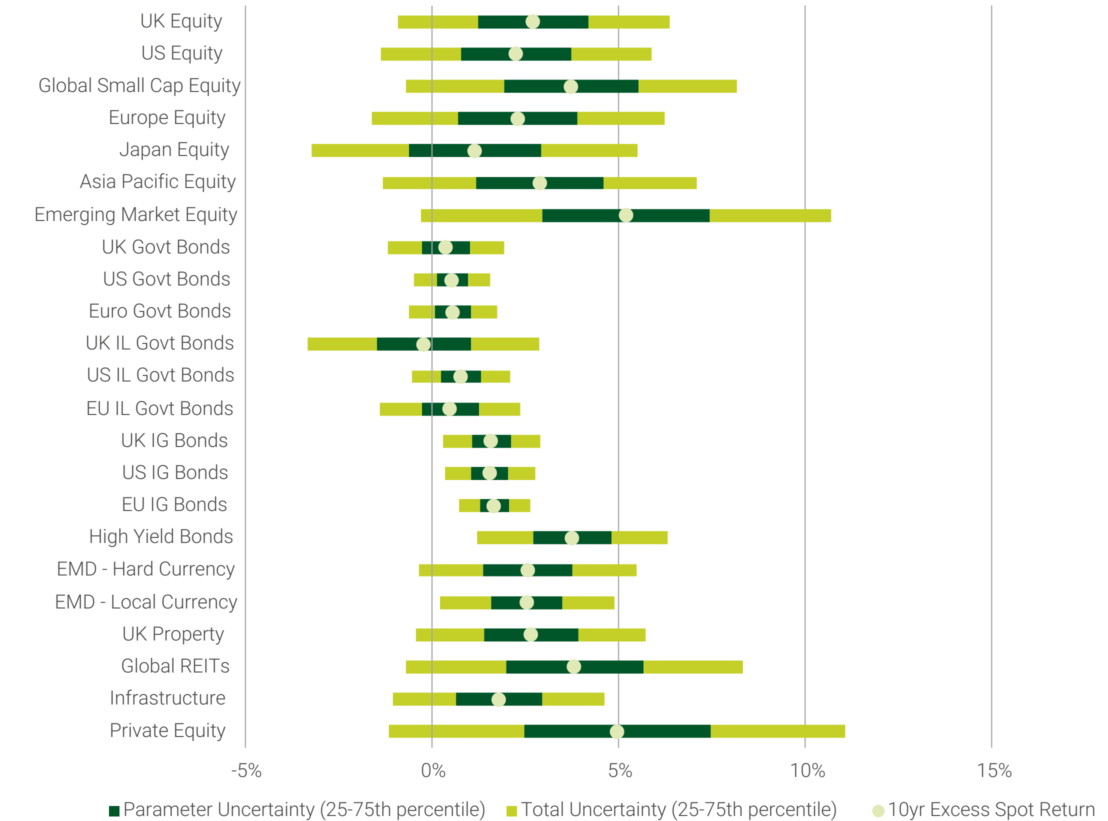
Ten-year excess return distributions



Source: LGIM as at 26 March 2024.

Long-term excess return expectations

	Expected excess returns				One-year asset class volatility
	5 Years	10 Years	20 Years	30 Years	
UK Equity	2.6%	2.7%	2.9%	3.0%	15.6%
US Equity	1.6%	2.3%	3.0%	3.3%	15.5%
Global Small Cap Equity	3.2%	3.7%	4.3%	4.5%	19.0%
Europe Equity	1.7%	2.3%	3.0%	3.2%	16.8%
Japan Equity	0.6%	1.2%	1.8%	2.1%	18.7%
Asia Pacific Equity	2.7%	2.9%	3.1%	3.2%	17.9%
Emerging Market Equity	5.0%	5.2%	5.5%	5.6%	23.5%
UK Govt Bonds	0.5%	0.4%	0.2%	0.1%	6.7%
US Govt Bonds	0.7%	0.5%	0.4%	0.3%	4.3%
Euro Govt Bonds	0.7%	0.6%	0.4%	0.4%	5.0%
UK IL Govt Bonds	-0.3%	-0.2%	-0.1%	-0.1%	13.3%
US IL Govt Bonds	1.0%	0.8%	0.5%	0.4%	5.6%
EU IL Govt Bonds	0.6%	0.5%	0.4%	0.3%	8.1%
UK IG Bonds	1.8%	1.6%	1.4%	1.3%	5.6%
US IG Bonds	1.7%	1.6%	1.4%	1.4%	5.2%
EU IG Bonds	1.9%	1.7%	1.5%	1.4%	4.0%
High Yield Bonds	3.8%	3.8%	3.7%	3.6%	10.9%
EMD - Hard Currency	2.7%	2.6%	2.5%	2.4%	12.5%
EMD - Local Currency	2.2%	2.5%	2.9%	3.0%	10.0%
UK Property	2.4%	2.7%	2.9%	3.0%	13.2%
Global REITs	3.5%	3.8%	4.2%	4.3%	19.3%
Infrastructure	1.4%	1.8%	2.3%	2.5%	12.1%
Private Equity	4.8%	5.0%	5.2%	5.3%	26.1%

Source: LGIM as at 26 March 2024.

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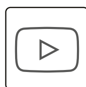

Key risks

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