BROOKS MACDONALD

Chief Investment Office

Asset Allocation Overview Q2 2024

For professional advisers only

Diversification in an uncertain world

- Despite political volatility, global economic growth, consumer spending, and corporate earnings still prove constructive.
- Inflation rates continue to moderate globally, buoying hopes for more interest rate cuts to come over the rest of this year and beyond.
- In an uncertain world, diversification and avoiding concentration risk through a broad investment style mix remains key.

During Q2, markets had to contend with a slew of unexpected political events globally. In the UK, a general election was called for 4 July, triggering an examination of competing parties' tax and spend priorities. In Europe, the European parliamentary elections catalysed an unexpected snap French parliamentary election, where the risks of more extreme political party policy drove sharp falls in French banking stocks. Meanwhile, in the US, June saw a criminal conviction of a past president, Donald Trump, for the first time in US history. In emerging markets, investors were also at times wrong-footed by unexpected market volatility around election results in India, South Africa, and Mexico.

Weighing against the negative of such political uncertainty, at a fundamental level, the tailwinds that have supported markets so far this year continued in Q2. Company earnings painted a constructive picture, with US companies reporting earnings ahead of consensus expectations at a rate above longer-term averages. Supporting our thematic, longer-term, through-the-cycle investments in technology and healthcare in particular, these two sectors delivered the highest percentages of companies reporting earnings above estimates. Encouragingly, while markets have been led narrowly by technology stocks through 2023 and early 2024, during Q2 we saw some tentative signs of a broadening-out of sector performance. April and May saw more confidence in the outlook for a wider set of stocks, though June saw technology back on the front foot. That is not to detract from the continued meteoric rise of Nvidia, the US listed generative Artificial Intelligence semiconductor designer, which briefly became the world's biggest company in June. Valued at more than US$ 3 trillion in mid-June, Nvidia's market capitalisation was bigger than all of the companies in the UK FTSE 100 equity index combined.

From an economic perspective, belief in a 'goldilocks' soft-landing scenario, where higher interest rates bring down inflation without derailing economic growth more broadly, continued in Q2. During the period, a global central bank interest rate cutting theme tentatively started. Following Switzerland's rate cuts in March and again in June, central banks across Sweden, Canada, and the eurozone cut interest rates for the first time in their respective monetary policy cycles. However, while underlying inflation readings have generally continued to moderate, the disconnect between falling and low goods inflation versus stickier services inflation has persisted. If not monetary policy, it is fiscal policy that is arguably currently boosting economies and markets. Advanced economies are enjoying unemployment rates still reasonably close to historically low levels, wage growth rates are running above pre-pandemic averages,

and economic growth estimates are still generally constructive. Despite this, governments are spending pro-cyclically, with government spending exceeding tax revenues. On both sides of the Atlantic, the US and the UK have been running budget deficits – while these cannot last indefinitely, this scale of government support arguably explains in large part the resilience of the consumer and corporate outlooks in turn.

In recent years, investors have had to navigate a marked pick-up in the frequency and size of rotation between growth and value investment styles, such as between technology companies and banks, respectively. We have also seen increased market concentration in technology stocks in particular. Helping to drive these changing narratives has been the changing outlook for inflation, interest rates and economic growth. However, as we look forward, it is important to recognise that our investment style selection is more than just a binary choice between the 'value versus growth' debate. Between value and growth sits a space occupied by a 'blend' or what we consider 'core' strategies. These are an important building block in our asset allocation approach. Alongside regular rebalancing of portfolios, in line with our stated target of balancing global equity investment styles, this helps to provide an important level of diversification not always readily available in passive equity indices.

Across our asset allocation, we think carefully about our asset choices, but also what our goals are for each of these assets. Fundamentally, we see a contrast between equities and bonds. While equities provide exposure to an encouraging economic and market outlook, our fixed-income positioning is more than just a hunt for yield. Yes, income is back in fixed income again, but a key aim for our government bond allocations is to provide an important counterbalance to the risks we take elsewhere. Between these two central pillars sit alternative assets, including property, uncorrelated multi-asset investments, and structured return products. This diversification helps us keep exposure to more than one economic and/ or market scenario materialising. What if the excitement around technology and generative AI should ebb? What if inflation should reemerge, prompting renewed rate hikes from central banks? What if geopolitical risks should escalate, challenging global supply chains once more, or worse? Ultimately, our asset allocation adheres to a central constructive scenario, but we acknowledge the potential for tail-risks to emerge.

Our top three investment risks

Inflation

Should inflation pressures see a resurgence and become engrained in the economy more broadly, including wages, this could curtail central banks' room for manoeuvre. This could risk a still-further tightening of monetary policy, with interest rates higher and for longer than expected.

Policy error

Governments and central banks face the risk of unintended policy errors as they seek to transition their economies away from unprecedented pandemic levels of fiscal and monetary support, as evidenced by the concerns over financial systemic stress contagion in early 2023.

Geopolitical risk

Should there be an escalation in either the current theatres of conflict (namely Israel-Gaza and Russia-Ukraine), or indeed future risks of potential conflict (China-Taiwan), such so-called 'tail-risks' would likely have a significant impact on the global economic outlook.

Asset class	Outlook	Change since previous quarter	Rationale
			Equities
UK	POSITIVE	No change	Our positive outlook for UK equities might appear to run counter to the present challenge of still relatively muted UK economic growth, though the inflation picture has indeed improved. However, the domestic picture is not the only driver for the UK equity market investment case. The UK economy and equity market are not the same. The UK equity market has a large international skew, with around three quarters of revenues at an equity index level derived from outside the UK. As such, the UK stock market is particularly sensitive to global trends, which on balance continue to point to a constructive picture of broad economic growth alongside generally still-easing inflation rates. The continued relative attractiveness of UK equities on a valuation basis is an important component of the mix of investment styles we hold. The UK 'value' style exposures we seek, such as resources and financials sectors, provide an important foil to our growth exposures in other asset classes and regions globally.
US	POSITIVE	No change	We have a positive outlook for US equities. Corporate results, in general, continue to reflect a still-resilient US consumer. Analysts' earnings growth expectations for the calendar years 2024 and 2025 are encouraging compared to the outturn in 2023, and banks' credit lending outlooks have seen a relative improvement according to Fed Senior Loan Officer Opinion Surveys so far this year. This could herald a more helpful operating environment for Smaller and MID-sized companies (SMID), which we increased exposure to earlier this year - here we are seeking to take advantage of a relative valuation derating versus larger capitalised companies post-pandemic and capture domestic sensitivity to a generally still-resilient US economic picture. The US has an important role in providing growth investment style exposures within the context of our balanced approach to asset allocation. Our US equity weights also support our longer-term investment themes of technology, healthcare, and decarbonisation, which the US has exposure to at an aggregate equity index level.
Developed Europe (excluding UK)	NEUTRAL	No change	We have a neutral outlook for Developed Europe (excluding UK) equities. We see an improving inflation backdrop, providing some relative relief for both businesses and households. Additionally, the hope is that a still-constructive global economic picture can help feed a European export-led economic growth narrative. Supporting value investment-style exposures, the region's banks are expected to see an improved profit outlook over the medium term, given a backdrop of positive nominal interest rates versus the decade of weak earnings under the European Central Bank's prior negative interest rate regime. Against this, we are mindful that structural tensions remain between the euro area monetary union and fiscal and political sovereignty. Indeed, France's recent and unexpected burst of political uncertainty could potentially link back to these tensions. However, we believe that such concerns are now better balanced by the relatively more constructive medium-term outlook as well as the still relatively attractive valuations we see.
Japan	NEUTRAL	No change	We have a neutral outlook for Japan equities. Market performance over the past year has been supported by hopes that, after years of false dawns around stock market reforms, we might have finally reached a tipping-point. As well as past initiatives by the Tokyo Stock Exchange to promote balance sheet efficiency, a welcome re-emergence of inflation after years of stagnation has buoyed the outlook for the country's financial sector. Looking forward, Japanese banks are expected to see a margin benefit from the re-pricing higher of longer-dated bond yields following the first hike in Japanese interest rates in seventeen years earlier this year. Balancing these hopes, Japan nonetheless still has well-documented structural headwinds, including high public debt levels and a declining and aging population. These provide an unwelcome risk backdrop for the BoJ (Bank of Japan) as it starts the long path of unwinding decades of unconventional monetary policy.

Asset class	Outlook	Change since previous quarter	Rationale
Asia Pacific (excluding Japan)	NEUTRAL	No change	We have a neutral outlook for Asia Pacific (excluding Japan) equities. We see China more as a potential 'value-trap' rather than a 'value opportunity'. As we look forward, increasingly it appears that China's policy makers are focused on only slowly and pragmatically defusing economic structural challenges, primarily the property market which is still navigating years of overbuilding and indebtedness. However, this will take time and China's investment outlook could well turn worse before it looks better. Adding to the uncertainty, US political elections later this year are likely to mean geopolitical tensions will not be far from investors' minds. We remain vigilant towards the investment climate in the region and will be quick to adjust allocations if judged appropriate to do so
Emerging Markets	NEGATIVE	No change	We have a negative outlook for emerging market equities. US dollar resilience continued to be a theme during Q2, serving as a reminder of the challenges for dollar-denominated debt and investment flows into the Emerging Markets region more broadly. Any headwinds for commodity prices might also weigh against those emerging markets which are more resource-export-led. Notably, China, a consumer of a significant share of global commodity exports, has so far appeared reticent to lean heavily on the past model of aggressive infrastructure spending to boost its economy, especially as policymakers seek to manage the structural problems in its property market. This might challenge the traditional emerging market 'playbook' where emerging market export growth feeds off a Chinese-led global commodity reflation narrative. Coupled with the 'near-shoring' of global supply chains post-pandemic, this has undoubtedly complicated what might otherwise be a more normal economic growth profile that emerging economies might hope for.
Equity themes			
Technology	POSITIVE	No change	With a focus on profitable, cash generative technology exposures, we continue to see long-term growth from technology's ability to identify, enter and disrupt new markets, creating new revenue streams and barriers to entry. The emergence of Generative Artificial Intelligence (AI) into the economic mainstream has catalysed revenue and earnings forecasts for the sector as companies seek to lift their productivity.
Healthcare	POSITIVE	No change	Western health-care systems are geared toward long-term elective care and demographic tailwinds, of which the recent growth in appetite-suppressant drugs for weight management is the latest example. Highlighting the complementary overlap between our Healthcare and Technology themes, generative AI technology has the potential to unlock high-value opportunities across the healthcare value chain, in such areas as drug discovery, clinical trial design, and customer engagement.
Decarbonisation	POSITIVE	No change	An expected rise in international climate finance over the coming years should support a long-term investment pipeline opportunity. In addition, the importance of energy security and independence is expected to boost sustainable energy investment.
Fixed income			
UK sovereign	POSITIVE	No change	Higher yields on gilts (where yields move inversely to prices) reflect the current interest rate environment in the UK, as the Bank of England has hitherto delivered on a series of rate hikes. With 'income' back in fixed income, such yields can arguably play a more constructive role in asset allocation. Recognising inflation and interest rate uncertainty, in particular the timing of rate cuts and the eventual 'landing zone' for interest rates longer-term, we continue to prefer shorter-dated bonds to manage interest rate sensitivity.

Asset class	Outlook	Change since previous quarter	Rationale
UK credit	POSITIVE	No change	We have a positive outlook on UK corporate debt, in part given the expected yield pick-up available and versus yields elsewhere globally. Within corporate debt we would continue to distinguish between investment grade and high yield debt, where the latter is more vulnerable to a weakening in the economic outlook as well as a greater sensitivity to adverse liquidity and market stress events.
International sovereign	NEUTRAL	No change	Yields on government bonds have risen significantly over the past couple of years, reflecting the market's outlook for higher-for-longer interest rates, especially so in the case of US Treasuries. However, given the inflation outlook is expected to continue to soften, this might provide some room for manoeuvre for policy makers. Should this encourage confidence in the medium-to-longer-term economic outlook, this could support a steepening in bond yield curves, and give relative support to shorter-dated bond prices which we favour. Balancing the risk of a re-emergence in inflationary pressures, we added to our inflation-linked US Treasuries exposure during Q2.
International credit	NEUTRAL	No change	Credit spreads versus sovereigns have continued to narrow this year and are some way below past episodes of significant market stress. Corporate balance sheets are relatively well-capitalised, but we would distinguish between investment grade and high yield debt, where the latter can at times prove especially sensitive to shifts in the economic outlook as well as relatively weaker liquidity characteristics.
		Alternatives	
Alternatives	NEUTRAL	No change	Last year we reduced our equity sensitivity, moving out of Alternative Income allocations and into short-dated UK government bonds. Within the asset class, our focus on uncorrelated returns, especially in times of broader-market uncertainty, is designed to provide an expected counterbalance to more directional risk exposures elsewhere in our asset allocation.
Property	NEUTRAL	No change	The inflation / interest rate outlook has continued to moderate. While this has lifted sentiment in the sector over the past year, it is important to recognise that central bank policy is still in restrictive territory. Longer-term, the sector offers both generalist and specialist investment opportunities, while valuation discounts to net asset value provide some cushion against any downward estimate revisions.
Structured investments	NEUTRAL	No change	While structured investments have at times historically provided superior yields to bonds, returns can at times become more correlated with equities if markets suffer a significant correction. In addition, it is important to recognise that the prevailing relative pricing attraction of structured return products can vary at times, in part given issuer appetite as well as expected market volatility levels going forward.

Important information

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