BROOKS MACDONALD

Chief Investment Office

Asset Allocation Overview Q3 2024

For professional advisers only

Markets test belief in goldilocks

- A generally constructive global economic growth outlook is still pushing back on fears of a meaningful recession, but we recognise some early signs of fatigue in consumer and labour market momentum.
- After a mid-Q3 hiatus, markets recover their poise with remarkable speed. However, recent market volatility shows that sentiment is vulnerable should economic and corporate data deteriorate.
- Our asset allocation goal continues to be one of 'balance', keeping exposure to more than one economic scenario outcome, but taking a conviction position around opportunities for rotation.

Markets still believe in goldilocks. That is the verdict that has been delivered during Q3 – the belief that past years of sky-high inflation has been curbed by the fastest interest rate hiking cycle in decades, but crucially without sinking hopes of still-resilient broader economic growth. Not only that but with inflation rates having now fallen close enough to target, central banks are now coalescing around a message of rate cuts looking forward. During Q3, both the Bank of England and the US Federal Reserve (Fed) cut interest rates for the first time in over four years since March 2020. Out has gone the interest rate message of 'higher for longer'. In its place, is the declaration, in the words of Fed Chair Powell, arguably the world's most important central bank official, that "the time has come for policy to adjust".

Not that this belief in goldilocks was not tested. Indeed, the middle month of Q3, August, was a remarkable month. For a brief time, fear trumped everything, with a triple-punch for investors: mixed US megacap technology results, a Bank of Japan interest rate hike, and weaker than expected US jobs data. Individually, investor sentiment might have been able to weather the news, but together these proved enough to send markets into a tailspin. At one point in early August, an expected volatility 'market fear gauge' measure based on US equity index options registered its biggest intraday jump in history. Almost immediately, markets clamoured for central banks to provide emergency rate cuts, such was the scale of panic gripping sentiment. Yet, by August-end, equity markets were back up to close to all-time highs, while US equities on an equal-weighted basis through to mid-September were notching up fresh record highs.

What happened to bring investor confidence back so swiftly? Bluntly, the bears were defeated by a continuation of good news. First, central bankers took turns to pour cold water on fears of recession. Then, we had more good news around inflation, as price pressures in advanced economies continued to moderate. Finally, we saw another calendar quarter of good corporate results – indeed, for the top five hundred companies in the US, the growth in their aggregate annual earnings per share for Q2 was shaping up to be the strongest since Q4 2021.

Yet, if we dig beneath the surface of headline equity indices, despite the renewed apparent calm, we recognise there are important questions that continue to challenge investors: from determining the path for inflation and interest rates, to market volatility and recession fears, megacap technology valuations, to changing market leadership, the issue of debt sustainability, as well as the ongoing suitability of our

asset allocation principles themselves. While our asset allocation adheres to a central constructive scenario, we nonetheless acknowledge the potential for these and other tail-risks to emerge. Ultimately, we continue to seek to navigate the investment climate by staying invested but keeping balance through a well-thought-out diversified asset allocation.

Our top three investment risks

Inflation

Should inflation pressures see a resurgence, 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 recalibrate fiscal and monetary policy settings following past years' pandemic support and subsequent inflationary pressures.

Geopolitical risk

Should there be an escalation in either current or future theatres of conflict, 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	The UK equity market index derives around three-quarters of its revenues from outside the UK, making it sensitive to global trends. These trends still point to constructive economic growth and an easing inflation picture. UK equities are a key part of our investment mix. We focus on value stocks in sectors like resources and financials, which balance our growth investments in other regions.
US	POSITIVE	No change	US corporate results show a robust economy in which resilient consumers still benefit from a relatively strong job market. Company earnings growth expectations for 2024 and 2025 are encouraging compared to 2023. The Fed's recent interest rate cut could boost smaller and mid-sized companies, which we increased exposure to earlier this year, and where we see a relative valuation opportunity versus larger capitalised companies.
Developed Europe (excluding UK)	NEUTRAL	No change	With European natural gas prices much lower than during the pandemic, cheaper energy is helping improve the inflation outlook. This could lead to interest rate cuts and provide relief for businesses and households. Although long-term issues exist between the euro area's monetary and fiscal policies, the medium-term outlook is more positive, thanks to relatively attractive valuations.
Japan	NEUTRAL	No change	Japan's main stock exchange has been working to make companies more efficient. Along with the welcome return of inflation after years of slow economic growth, this has boosted the outlook for Japanese equities, especially in the financial sector. However, Japan still faces challenges like high public debt and an ageing population, which pose risks as the Bank of Japan raises interest rates from very low levels.

Asset class	Outlook	Change since previous quarter	Rationale
Asia Pacific (excluding Japan)	NEUTRAL	No change	We downgraded the region to neutral earlier this year, mainly due to reducing our overweight position in China to neutral. Given its economic challenges, we see China more as a potential risk than an opportunity. Indeed, the longer-term investment outlook could worsen before it improves.
Emerging Markets	NEGATIVE	No change	China, previously a major buyer of global commodities from emerging markets, has been cautious about using aggressive infrastructure spending to boost its economy this year. This shift impacts resource-export-led emerging markets. Moreover, China's move to effectively export its excess manufacturing capacity, hoping to sell goods abroad that cannot be sold domestically given weak demand, could challenge the profitability of companies in these markets.
Equity themes			
Technology	POSITIVE	No change	With a focus on profitable, cash generative technology exposures, we see long-term growth from technology's ability to identify, enter and disrupt new markets, creating new revenue streams and barriers to entry. More recently, generative Artificial Intelligence (AI) has catalysed revenue and earnings forecasts for the sector as companies seek to lift their productivity. As for all our asset allocation choices, we encourage regular rebalancing of portfolio exposures in line with our central investment guidance; given the hitherto strong performance of megacap technology stocks, that message is especially important here.
Healthcare	POSITIVE	No change	Western health-care systems are geared toward long-term elective care and demographic tailwinds, where growth in appetite-suppressant drugs is the latest example. Highlighting the overlap between our Healthcare and Technology themes, generative AI has the potential value across 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. Completing the investment picture, recent interest rate cuts should buoy longer-term growth valuations.
Fixed income			
UK sovereign	POSITIVE	No change	Higher yields on gilts, reflecting the current interest rate environment, can play a more constructive role in asset allocation. Recognising inflation and interest rate uncertainty, including timing of further rate cuts and the eventual 'landing zone' for interest rates longer-term, we prefer shorter-dated bonds to manage interest rate sensitivity.
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. We prefer investment grade over high yield debt, where the latter is more vulnerable to any weakening in the economic outlook as well as greater sensitivity to adverse liquidity and market stress events.

Asset class	Outlook	Change since previous quarter	Rationale
International sovereign	NEUTRAL	No change	As markets continue to coalesce around an economic 'soft-landing', 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 earlier this year. Our preference for shorter-dated bonds also reflects the potential risk we see for higher yields given longer-term concerns around expected continued US fiscal deficit spending and debt issuance in particular.
International credit	NEUTRAL	No change	Credit spreads versus sovereigns are some way below past episodes of significant market stress. Corporate balance sheets are relatively well-capitalised, but we prefer investment grade over high yield debt, where the latter can prove more sensitive to 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 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, lifting sentiment, though 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 historically provided superior yields to bonds, returns can become more correlated with equities if markets suffer a significant correction. In addition, pricing of structured return products can vary at times, in part given issuer appetite as well as expected market volatility levels going forward.

Important information

Important information. All data provided as of 20 September 2024 unless otherwise stated. Past performance is not a reliable indicator of future results. Investors should be aware that the price of investments and the income from them can go down as well as up and that neither is guaranteed. Investors may not get back the amount invested. Changes in rates of exchange may have an adverse effect on the value, price, or income of an investment. Investors should be aware of the additional risks associated with funds investing in emerging or developing markets. The information in this document does not constitute advice or a recommendation and you should not make any investment decisions on the basis of it. This document is for the information of the recipient only and should not be reproduced, copied, or made available to others.

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