Asymmetry in motion

Ambiguous near-term economic conditions and heightened geopolitical risk make adaptability more important than ever.

Emiel van den Heiligenberg
Head of Asset Allocation

> **When the facts change, I change my mind. What do you do, sir?**
>
> *— John Maynard Keynes*

2023 was a difficult year for economists, ourselves included, as a much-heralded recession failed to materialise. Following this no-show, we must now contemplate three options:

1. **Embrace randomness:** Accept the unpredictability inherent in economic forecasting, which in turn supports a diversified approach..

2. **Join the consensus:** Conform to the majority view, risking the loss of individual insight.

3. **Persist with the recession forecast:** Stick to the view even when the facts change. If none of these makes sense, there is a fourth way: adapting our outlook.

If you know our Head of Economics Tim Drayson, you will know that the first two options don't appeal to him, although he acknowledges there are times when joining the consensus makes sense.

But as the facts have changed – most notably the Federal Reserve (Fed)'s pivot and greater than expected fiscal spending – the outlook should adapt. Tim has revised our forecast; while we still believe the lagged effects of this year's rate hikes could precipitate a US recession in 2024, this is no longer our base case economic forecast. Instead, we expect a period of weak US economic growth, and should recession occur, it will be milder than we previously anticipated.

Our resolution for 2024 is to approach economic forecasting with a lighter touch, focusing on balancing risks rather than precise predictions.

Better, but still not good

With our pessimism toned down, does that mean we have become optimists? No. We believe that our change in outlook is symptomatic of a broader change in the consensus that is playing out. We expect to remain below consensus forecasts, albeit with a smaller gap than before.

Those with bearish 2024 views (formed in October/November for year-ahead outlooks) have been pushed by events into upgrading. Estimates of the earnings profile priced into markets are consistent with earnings expectations in the US that are even more optimistic than the 10-12% bottom-up consensus. If we correct for standard overoptimism, we get to a 7% level of earnings growth.

The overwhelming base case is for those expectations to be disappointed, not exceeded. Moreover, if we put either our roadmap or consensus in our profit modelling, we would end up at single-digit negative earnings growth. This is because the delta, or change, in nominal growth is the most important driver.

Balancing probabilities

We think the rally in markets in November and December shows that US recession risk is still underappreciated by investors. We now feel the global economy faces an asymmetric outlook in 2024.

Our recession indicators continue to flash red. This is not an environment for strong growth, even if recession is avoided. We may have upgraded our central case, but none of that has changed the previously identified late-cycle pressures stemming from low unemployment, tight labour markets, slowing nominal GDP growth, a weak housing market and tight bank lending conditions.

In summary, we are less worried about recession as a central case, but it is different from resetting the clock to early/mid cycle. The range of the scenarios we consider indicate a negative return on risk assets. This is due to a higher recession probability than normal and a lower expected return should the cycle continue like it did in 2023.

So, even if recession is avoided, we do not expect a strong economic environment or market performance. High valuations in equities, and a significant amount of rate cuts already priced, also limit potential for a major rally, and we note that the market has become marginally more expensive over the past quarter.

We believe that our change in outlook is symptomatic of a broader change in the consensus that is playing out.

Beneath the surface, there is a regional split between the US (expensive) and the rest of the world (neutral to cheap). This disparity between the US and the rest of the world is true even after adjusting for sectoral differences and mega-cap stocks, though the gap is smaller once these effects are removed.

To learn more about our long-term asset class expectations, turn to the article written by Tim Armitage and Martin Dietz on our new CAMERA capital markets assumptions framework.

Elephants in the room

Multiple geopolitical risks and a busy election calendar, meanwhile, create volatility and uncertainty.

The most important political event of 2024 is the US elections. Polls suggest a Trump win in the upcoming election is a distinct possibility, albeit not inevitable – our Assistant Economist Matthew Rodger covers the current landscape in his article below.

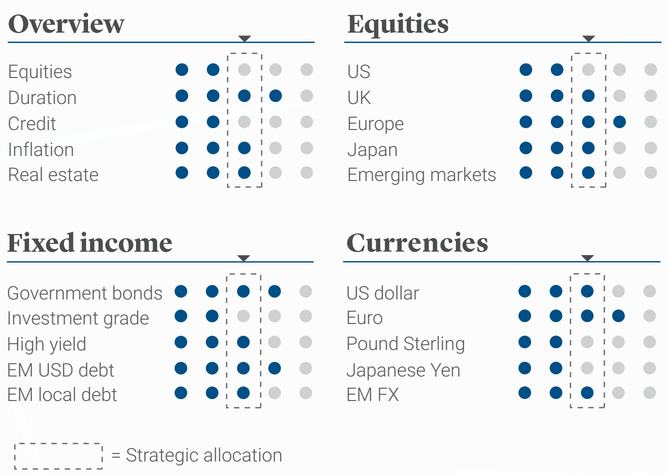
A Trump win could result in trade disputes, tariffs, more tax cuts and further US isolationism. All of these are, in principle, inflationary and could drive yields up. In his section of this outlook, Christopher Jeffery, Head of Rates & Inflation Strategy, offers a perspective on the rates outlook for both the US and the UK.

Tax cuts could be good for stock markets, but that depends where we are in the cycle by the end of 2024 when a potential new president takes his or her seat. If inflation is low and growth is below trend, tax cuts should cause equities to rally; if inflation is above target, we could see rates up significantly, the Fed turning much more hawkish to rein in inflation and equities potentially anticipating a hard landing.

Outside the US, geopolitical risk scenarios on our radar include an escalation of the Ukraine war with NATO mobilising, intensified hostilities in the Middle East, a Chinese naval blockade of Taiwan, and increased tensions on the Korean peninsula.

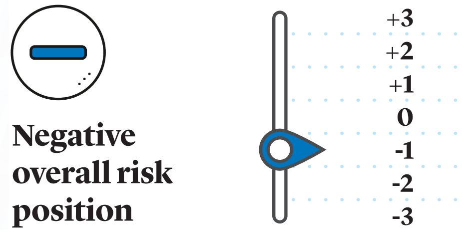
We believe that embracing uncertainty is key to success against this complex backdrop. We need to prepare for different scenarios, not just our cautious central outlook.

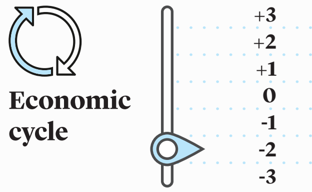
Our key asset class views



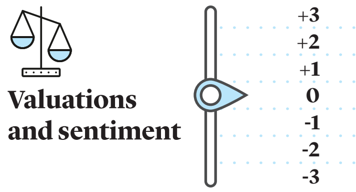
This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 8 January 2024. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in 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

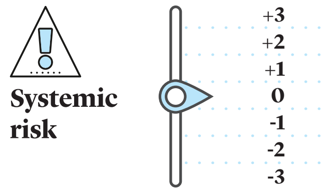




Central view for a mild recession but soft landing chances have improved



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 16 January 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
Unfavourable mix of lower growth and higher inflation, relative to consensus
Tight macroeconomic backdrop limits upside growth potential
A wide range of potential outcomes, and little conviction in any
Valuations and sentiment
Sentiment indicators improving and no longer bearish
Relative valuations don't offer the natural bullish support for equities
Absolute valuations neutral, edging towards expensive in some pockets
Systemic risk
Banking crisis has subsided, some credit and real estate risks remain
Multiple potential flashpoints for potential geopolitical escalation
Indicators show no signs of private sector debt distress

Introducing our capital market assumptions framework

Tim Armitage
Multi Asset Fund Manager

Martin Dietz
Head of Diversified Strategies

Underpinning every decision we make on behalf of our clients is a series of expectations – based in part on our experience of the past – of how the future is likely to unfold.

Photographs are a wonderful way of preserving the past, allowing us to delve into our memories to relive special moments. However, our CAMERA (Capital Market Expected Return Assumptions) allows us to take a different type of snapshot – one of the future.

Underpinning every decision we make on behalf of our clients is a series of expectations – based in part on our experience of the past – of how the future is likely to unfold. Making decisions about the medium- to long-term future can be especially challenging, which is why it is important to have a robust framework in place.

Here we introduce CAMERA, our capital market assumptions framework, bringing together our valuations-based medium-term asset-class return expectations and our long-term risk-based equilibrium model.

Designed in partnership with our Solutions team, the framework is based on the premise that in the long run, expected returns should converge to some equilibrium level, while in the medium term we anticipate returns to deviate from equilibrium assumptions as a function of market valuations.

The framework also acknowledges the uncertainty inherent in making forecasts by including two measures – parameter uncertainty and realised return uncertainty – around its median return estimates.

Long-term equilibrium returns

Our starting point for estimating expected future returns is broadly based on the Capital Asset Pricing Model (CAPM).

We derive initial return estimates for different asset classes by estimating the marginal contribution of each asset class to the risk of a global diversified multi-asset portfolio. This assesses the sensitivity of each asset class to changes in the value of the global market portfolio but (in a deviation from CAPM) gives a higher weight to downside scenarios. This gives an estimate of the relative riskiness – and from this the relative return expectations – of each asset class. Into this we incorporate our estimate of the long-term forward-looking equity risk premium, currently in the region of 3.5-4.0% per annum.

Quantitative and qualitative adjustments are then made to address some of the shortcomings of CAPM. These adjustments are estimated from a range of analyses, including quantitative multi-factor decompositions of risk drivers, academic studies and economic rationale, such as rewards for illiquidity.

We are also careful in applying the model to bonds, and override it in some cases. For example, for investment grade credit, expected long-term excess returns are based on long-term average spread levels less an allowance for losses from downgrades and defaults.

Valuation-based deviations

Over shorter horizons we can expect some deviation from equilibrium, and therefore adjust our long-term expectations using measures of 'bottom-up' asset market returns. The metrics used vary by asset class, but all reflect an element of current market pricing, whether that be nominal bond yields, credit spreads or dividend yields.

It is worth noting, however, that while current market conditions influence our valuation-based expected returns, in practice our broader dynamic processes take into account other factors to determine the likelihood and time horizon of mean reversion to any 'fair value'.

Parameter uncertainty

Understanding uncertainty is critical to making good investment decisions. Any forward-looking return assumption is really a point estimate, a central point within a distribution of possible outcomes. But even that distribution can paint a misleading picture of the risk of long-term outcomes, and ignore the risk that the assumptions made are incorrect.

By also incorporating parameter uncertainty in our framework, we can take a more honest and realistic snapshot of the future.

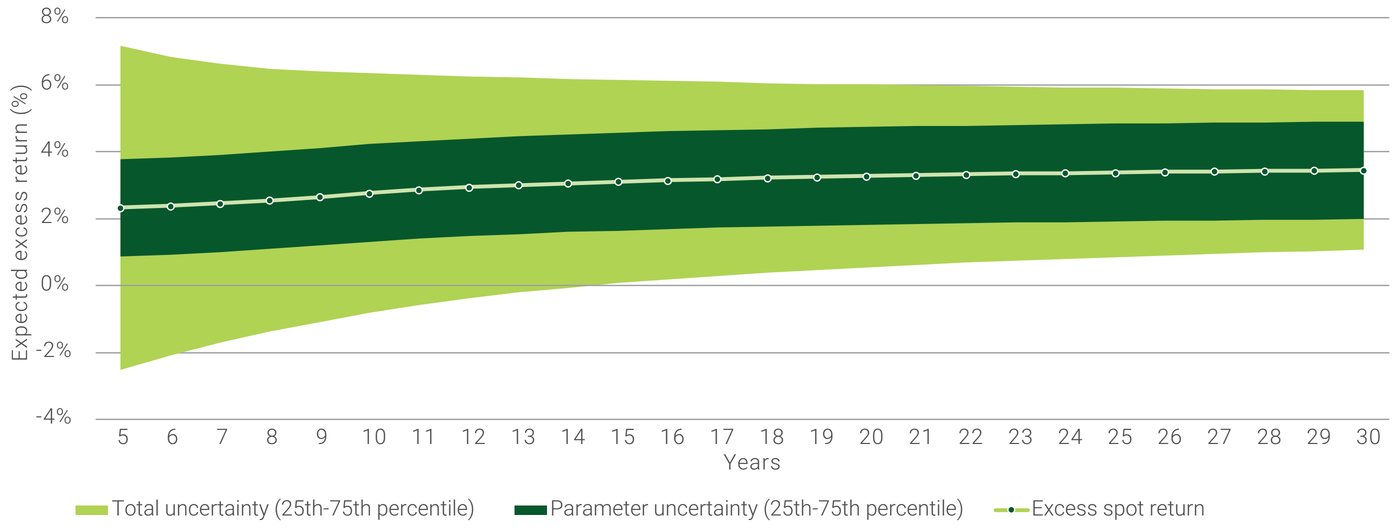
How we use CAMERA

Equilibrium returns are an essential ingredient in our strategic asset allocation process, and – alongside other characteristics – help to determine how much of each asset class is held in a fund.

The valuation measures that guide the medium-term deviations shown in CAMERA are used in a number of ways in our investment process. They can be thought of as one lens of many through which we form our tactical and medium-term views.

Going forward, we will be including a quarterly update of the framework in this publication, and highlighting any notable changes in either medium- or long-term assumptions. For more detail on the overall framework, please speak to your LGIM representative.

Expected excess return term structure: US equity



Ten-year excess return distributions

Q1 2024 | Outlook: Asymmetry in motion

	Expected excess returns				One-year asset class volatility
	5 Years	**10 Years**	**20 Years**	**30 Years**	
UK Equity	3.1%	3.1%	3.1%	3.1%	15.7%
US Equity	2.3%	2.8%	3.3%	3.4%	15.3%
Global Small Cap Equity	3.6%	4.0%	4.4%	4.6%	18.8%
Europe Equity	2.5%	2.8%	3.2%	3.3%	17.0%
Japan Equity	1.6%	1.8%	2.2%	2.3%	18.9%
Asia Pacific Equity	3.2%	3.3%	3.3%	3.4%	17.9%
Emerging Market Equity	5.6%	5.7%	5.7%	5.7%	23.9%
UK Govt Bonds	0.4%	0.3%	0.1%	0.1%	6.2%
US Govt Bonds	0.6%	0.5%	0.4%	0.3%	4.2%
Euro Govt Bonds	0.6%	0.5%	0.4%	0.3%	4.8%
UK IL Govt Bonds	-0.4%	-0.3%	-0.1%	-0.1%	12.6%
US IL Govt Bonds	0.9%	0.7%	0.5%	0.4%	5.8%
EU IL Govt Bonds	0.6%	0.5%	0.4%	0.3%	8.3%
UK IG Bonds	1.4%	1.4%	1.3%	1.3%	5.2%
US IG Bonds	1.4%	1.4%	1.3%	1.3%	4.7%
EU IG Bonds	1.6%	1.5%	1.4%	1.3%	3.9%
High Yield Bonds	3.3%	3.4%	3.4%	3.5%	11.1%
EMD - Hard Currency	2.5%	2.4%	2.4%	2.4%	12.5%
EMD - Local Currency	2.5%	2.8%	3.1%	3.2%	10.2%
Global REITs	4.0%	4.2%	4.4%	4.4%	19.2%
Infrastructure	2.0%	2.2%	2.5%	2.6%	12.0%
UK Property	2.8%	2.9%	3.1%	3.1%	12.9%
Private Equity	5.0%	5.1%	5.3%	5.3%	26.3%

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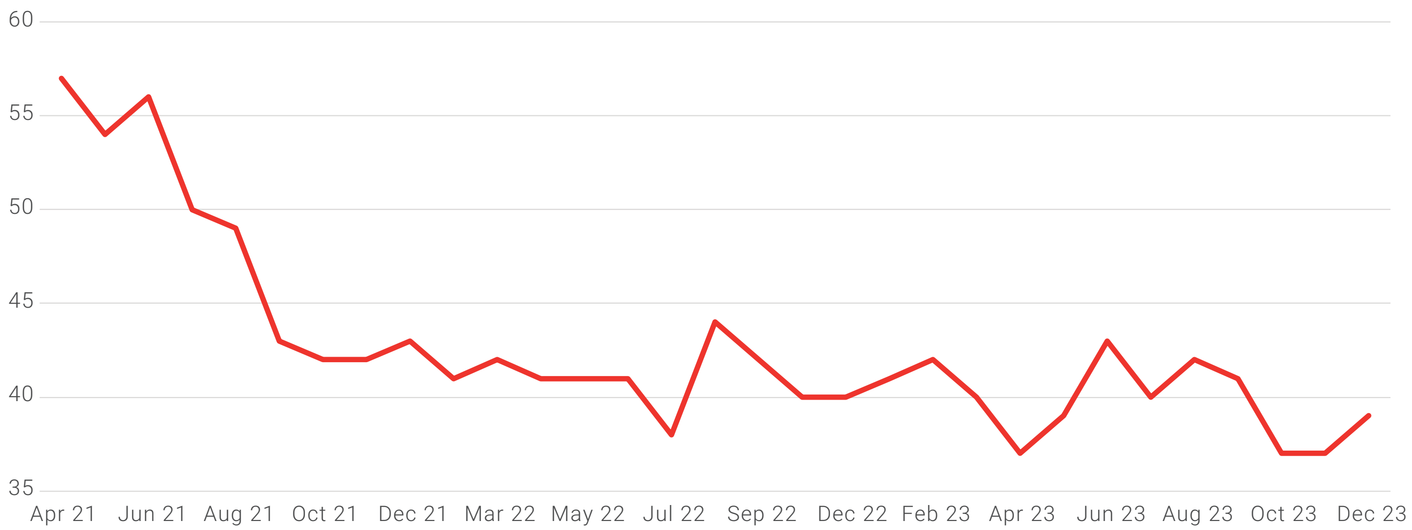
The year of the vote

Matthew Rodger
Assistant Economist

The year ahead brings elections for roughly two-fifths of the world's population and an equal share of its GDP. Two elections catch our eye. Primarily the November election in the US, which looks set to be a re-match of the 2020 contest between Joe Biden and Donald Trump.

Polling indicates Trump could become the first president since Grover Cleveland to regain the presidency after having lost re-election. With real wage growth still sluggish, Biden remaining unpopular, and an electoral college system that benefits Trump-leaning rural voters,[1] Trump could certainly start 2025 in a new term as US president.

Biden's approval rating



Source: Gallup

1. Source: https://blogs.lse.ac.uk/usappblog/2020/10/29/why-donald-trumps-electoral-college-advantage-could-be-even-bigger-in-2020/

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What would this mean?

Firstly, the stimulus taps could be back on. Trump has made no secret of his desire to make the tax cuts he passed in 2017 permanent,[2] costing about an estimated $3.5 trillion until 2033, according to the Congressional Budget Office. While equities might gain in the short term from these measures, with the Fed in inflation-fighting mode any new stimulus would keep rates higher for longer, reducing expected returns from Treasuries.

Secondly, the trade wars could return. Trump would likely extend tariffs[3] to both allies and rivals, looking to cut deals in the areas of trade, migration and security. Foreign equities, particularly in countries which export to the US, such as China, Mexico or Japan, could suffer in the short term, and tariffs could also push inflation higher, damaging fixed income returns. Nevertheless, some US equities might see some upside from reduced price competition.[4]

Lastly, strains on US institutions would probably increase. Trump signalled[5] he would re-impose an executive order 'Schedule F' making Federal employees easier to fire and use the Department of Justice to pursue political opponents. Such actions would heighten concern about the independence of America's judicial and civil arms and would presage battles with the courts. This could also raise risk premia associated American assets, dampening global returns.

The UK goes to the polls

In the UK, a general election is expected later this year. The Conservatives trail Labour in the polls and barring a surprise turnaround, Labour leader Sir Kier Starmer looks set to take office by the start of 2025.

Although Labour's policy platform is not yet finalised, there are a few hints of what they would change. Firstly, they plan to ease planning restrictions on construction[6] to encourage the building of new homes and other forms of physical investment. Secondly, a Labour government would likely ratchet up green investment.[7] Although the exact funding allocation remains undecided, Labour would seek to accelerate the development of green energy through subsidies, possibly similar to the Inflation Reduction Act in the US.

Lastly, taxes may increase.[8] Although differences in borrowing plans from Labour and the Conservatives are minimal, Labour would seek to finance higher spending by raising taxes on income and capital gains, which could weigh on equity and consumption performance.

In the coming elections, investors will brace for potentially seismic shifts in policy and geopolitics. The prospect of a new US president and a UK general election remind us that decisions at the ballot box can loom large in market psychology.

2. Source: https://www.bloomberg.com/news/articles/2024-01-06/trump-considers-making-2017-personal-tax-cuts-permanent?leadSource=uverify%20wall
3. Source: https://www.reuters.com/world/us/payback-time-trump-plans-mass-firings-deportations-second-term-2023-11-14/
4. Source: https://www.cbsnews.com/news/steel-companies-benefiting-from-trumps-tariffs/
5. Source: https://www.axios.com/2022/07/22/trump-2025-radical-plan-second-term
6. Source: https://labour.org.uk/updates/press-releases/angela-rayner-speech-at-labour-party-conference/
7. Source: https://labour.org.uk/updates/press-releases/ed-milibands-speech-at-labour-conference/
8. Source: https://ifs.org.uk/sites/default/files/output_url_files/BN209.pdf

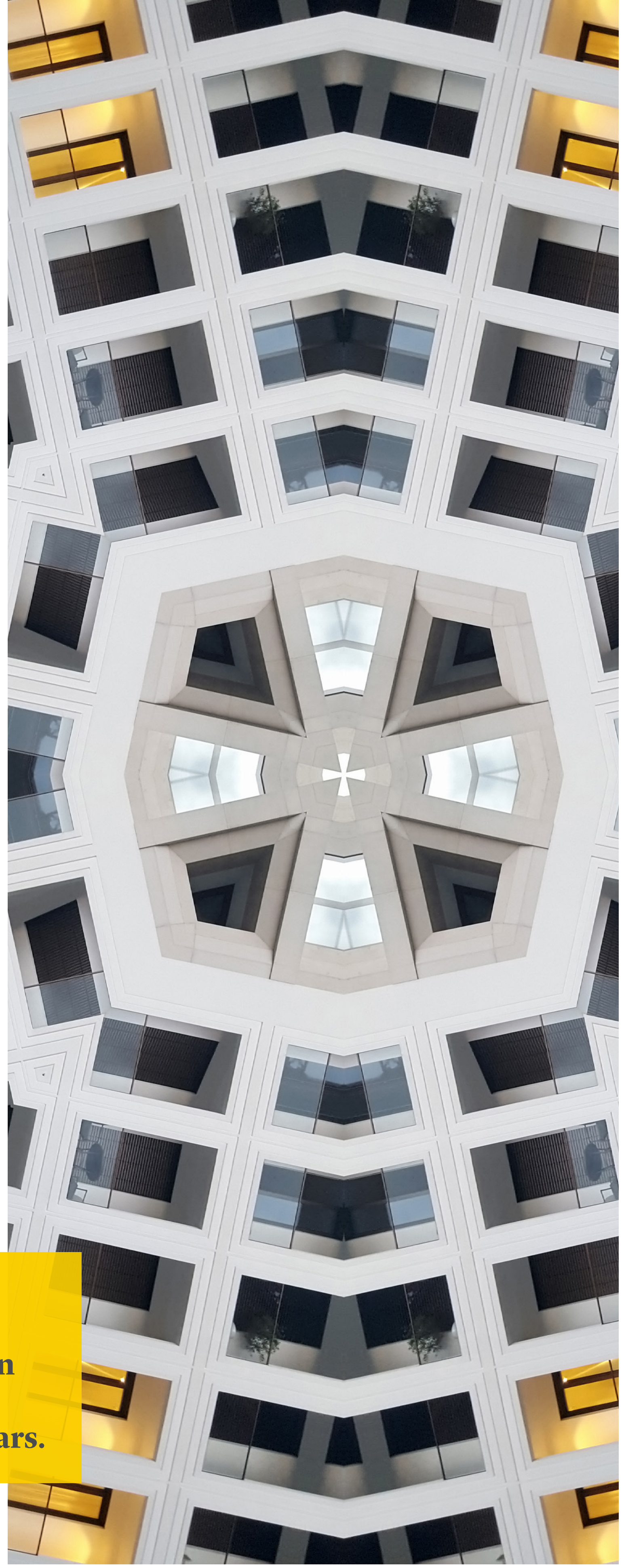
Will the rates rally continue?

Christopher Jeffery
Strategist

Global government bonds delivered mid-single-digit returns in 2023[9] after two consecutive down years. That's scant comfort to investors who have seen underperformance in real terms of 25-40%, depending on the index, since mid-2020.[10]

Looking ahead, we think there are three good reasons to expect performance to finally turn around:

i. First and foremost, real yields on government bonds are now back above zero. We can see that looking at inflation-linked debt: despite the Q4 rally, the yield on 10-year TIPS[11] in the US is still close to 2%, from a trough of below -1%. We can see the same looking at nominal yields relative to central bank objectives. In the UK, for example, 10-year nominal gilt yields are currently over 150 basis points (bps) above the Bank of England's inflation target, having been nearly 200bps below that target three years ago.[12]



Global government bonds delivered mid-single-digit returns in 2023 after two consecutive down years.

9. Source: The Bloomberg Global Treasury Index, GBP hedged, returned 5.8% in 2023. As at 31 December 2023.
10. Source: Bloomberg Global Treasury Index, FTSE Actuaries UK Conventional Gilts All Stocks Index, Bloomberg LP, as at 31 December 2023.
11. Treasury Inflation-Protected Securities
12. Source: UK gilt yields were 3.53% at year-end (source: Bloomberg LP), relative to the Bank of England's inflation target of 2% (source: BoE), as at 31 December 2023.

ii. Second, the soft growth backdrop is starting to loosen labour market conditions: across the Western world, the number of people who are unemployed is rising relative to the number of job vacancies. That is a precondition for wage growth moderation and could precipitate a broader economic downturn.

iii. Finally, inflation itself looks to be on a firmly downward trajectory, implying an end to the rate-hiking cycle that has dominated pricing in recent years. According to the New York Federal Reserve, global supply chain pressures have swung from the tightest conditions in a generation in mid-2021 to the loosest.[13]

There are three major risks to this outlook:

Geopolitical concerns: Escalating tensions in the Middle East could pose a threat to the smooth transit of freight through the region. More seriously, a Chinese naval blockade of Taiwan would reignite worries about shortages, especially in the electronics industry.

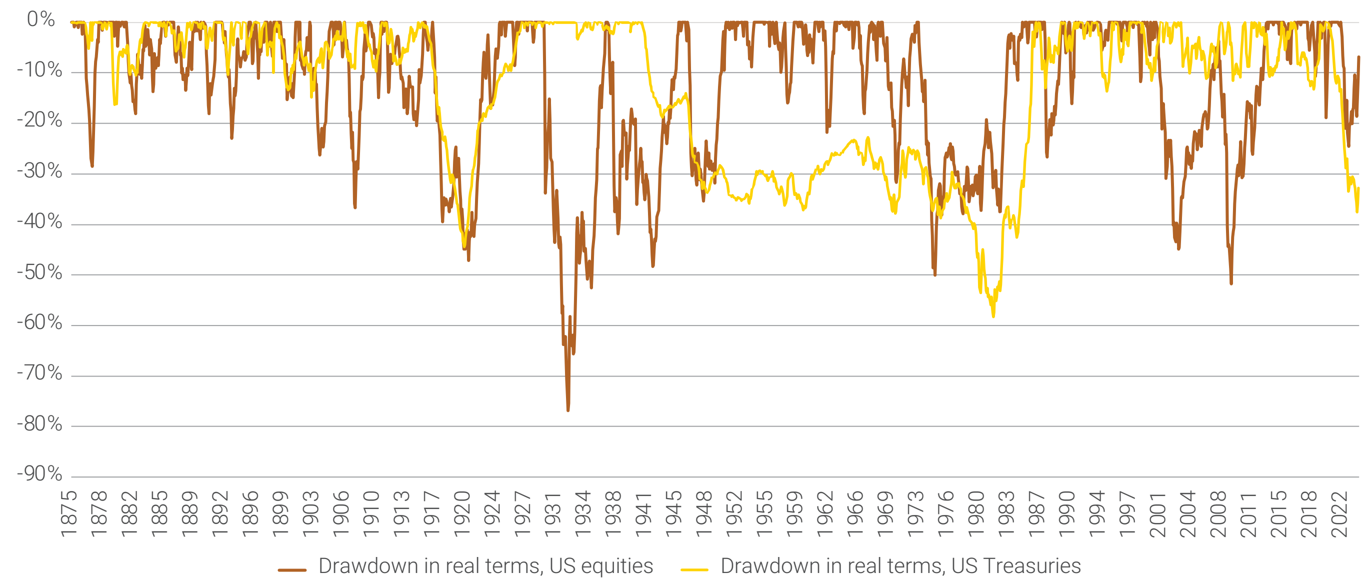
Economic resilience: We see sluggish growth, with elevated risks of a recession in the year ahead. If a recession doesn't materialise until 2025 or later, we would expect the rate cuts currently priced into the front end of the US/UK/European curves to partially disappear.

Government bond supply: When we take account of the unwind in central bank portfolios, G7 governments are set to issue in excess of $3 trillion of net new debt for a second consecutive year. Unlike in 2023, there is unlikely to be an outright fiscal impulse supporting growth. However, the weight of issuance could put upward pressure on yields.

Positive real returns in 2024 would be a fillip for bond investors and continue the recovery from the real drawdown of nearly 40% seen in 2022/23.[14] But it is a low bar to meet when cash also yields 5%.

We believe that yields are set to fall enough to deliver a capital gain to investors as well, but that becomes a harder argument to make if US and UK 10-year yields drop back below 3.5%.

Real returns: equities and bonds



Source: Robert Shiller (prior to 2023 Q3), Bloomberg LP (2023 Q3-Q4), as at 31 December 2023.

Key risks
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.

13. Source: https://www.newyorkfed.org/medialibrary/media/markets/survey/2023/sep-2023-smp-results.pdf
14. Source: Bloomberg Global Treasury Index, FTSE Actuaries UK Conventional Gilts All Stocks Index, Bloomberg LP, as at 31 December 2023.

Contact us

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LGIM talks

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