

Optimal Income Strategies

Economic Narrowing: Limited Breadth

- Data supports our outlook for slowing growth and cooling inflation
- Anticipate a modest Fed rate cut cycle with limited recession risk
- Increased caution due to upward revisions in growth expectations

What's happening?

Broader indicators for the US economy have softened amidst mixed messages in the labour market. We expect weaker household consumption to weigh on growth. The latest inflation figures point to a gradual deceleration following a services-led spike in the first quarter. We still foresee GDP growth of 2.4% for 2024, slowing to 1.6% in 2025.

In the Eurozone, economic growth is driven by a resilient services sector well-anchored in expansion territory, whereas the manufacturing sector remains depressed with recent surveys indicating renewed weakness. Financial conditions have tightened in line with elections. Although inflation edged higher, we still expect a decisive decline in service inflation in the fall. We maintain our subdued growth outlook for 2024 at 0.6%, expanding to 1.1% in 2025.

In China, there has been a modest lift in retail activity, and industrial output has been supported by government-led investment. However, the longer-term outlook is more challenging, and a difficult external environment underscores the need for domestic rebalancing. We maintain our GDP growth forecast at 5.0% in 2024, slowing to 4.2% in 2025.

Emerging markets are also experiencing central bank caution, reflecting persistent inflation and currency softness against a strong dollar. Expectations for monetary loosening are being delayed, and there is a risk that fiscal discipline is fading in several jurisdictions.

Central banks are adopting a more cautious stance despite a few having initiated policy easing. The US Federal Reserve is likely to cut rates twice this year, starting in September, despite its own cautiousness. The European Central Bank cut rates but did not provide clear guidance for future policy moves, though we continue to forecast another two cuts this year. The Bank of England is set to ease in August following June's "finely balanced" outcome. The Bank of Japan is unlikely to hike rates aggressively.

Positioning & Performance:

	GLOBAL OPTIMAL STRATEGY			OPTIMAL STRATEGY			DEFENSIVE OPTIMAL STRATEGY		
	Dec-23	May-24	Jun-24	Dec-23	May-24	Jun-24	Dec-23	May-24	Jun-24
Net Equity	65,5%	90,6%	71,2%	54,1%	75,4%	56,4%	34,4%	34,4%	34,5%
Equities	63,0%	86,7%	88,5%	60,0%	76,2%	75,2%	33,7%	40,3%	41,2%
Equities derivatives	8,6%	9,0%	-2,1%	-0,8%	2,2%	-14,7%	0,7%	-5,9%	-6,7%
Risk Mitigation Strategies	-6,1%	-5,1%	-15,2%	-5,1%	-3,0%	-4,1%	0,0%	0,0%	0,0%
Fixed Income	21,3%	5,3%	5,3%	33,5%	19,3%	19,5%	28,5%	55,2%	52,8%
Govies	1,0%	0,0%	0,0%	1,0%	0,0%	0,0%	0,0%	0,0%	0,0%
Bond Derivatives	8,1%	44,2%	42,5%	9,4%	31,8%	28,8%	17,5%	42,9%	44,2%
High Yield Credit	1,2%	1,0%	1,0%	3,4%	3,7%	3,9%	10,5%	15,9%	15,4%
Investment Grade	17,3%	4,1%	4,0%	26,5%	15,4%	15,4%	17,9%	39,3%	37,4%
Emerging Debt	1,8%	0,3%	0,3%	2,6%	0,2%	0,2%	0,0%	0,0%	0,0%
Diversification	3,4%	1,5%	2,6%	1,5%	0,8%	0,8%	5,6%	2,6%	2,6%
Cash & Money Market	9,8%	2,6%	21,0%	10,7%	4,4%	23,2%	31,6%	7,8%	10,2%

We trimmed our exposure in developed equities in our portfolios. This adjustment does not indicate a significant change in the fundamental macroeconomic backdrop. But growth forecasts have been revised upwards across the board, leaving little room for upside surprises. The widely accepted "Goldilocks" narrative is now at risk from any negative developments.

Hence why within our equity allocation, we have adopted a more neutral stance, moving away from our previous conviction of a broadening market in Europe. While French politics have not significantly impacted European small and mid-caps, disappointing soft data in economic surveys has tempered our short-term enthusiasm. Market concentration is now extreme, and this lack of breadth is unlikely to support a recovery in weaker, higher-beta segments of the equity market until more positive signs.

We have trimmed exposure to government bonds, reducing interest-rate sensitivity (duration). Our macroeconomic outlook maintains that mild US labour market softness and modest disinflation could prompt the Federal Reserve to initiate interest rate cuts by September. This scenario, broadly anticipated by markets, remains finely balanced. We find the risk asymmetry no longer sufficiently favourable, prompting us to take profits on our overweight position in government bonds.

Outlook

During a financial industry conference in late April, we remarked that the European elections were "very important for Europeans, not at all for financial markets." Recent weeks, however, have humbled us. While there were surprises in some member states (such as the Greens in Germany and the Far-Right in France), the varied nature of these outcomes ultimately aligned with poll projections for the composition of the European Parliament. Yet, as one election can overshadow another, the true surprise stemmed from the local impacts of these continent-wide elections. The resulting market reactions were rational, especially following a robust risk-on start to the year: OAT-Bund spreads widened to levels not seen since 2017, a period marked by uncertainty over the French Presidential run-off candidates, leading related assets (notably French banks) to suffer. Consequently, we opted to reduce our exposure in these areas until clearer policy directions emerge or market pricing incorporates sufficient stress premiums to justify risk exposure.

While French politics do not significantly sway global financial markets, we adjusted our overweight position in developed equities. We do not indicate a notable shift in the fundamental macroeconomic landscape: the Atlanta Federal Reserve's US GDP nowcasting model projects annualized growth above 3%, job creation remains robust, and the latest US inflation figures brought a favourable surprise. Our heightened caution stems from substantial upward revisions in growth expectations, encompassing global GDP, US GDP, and corporate earnings. Earlier this year, economists and strategists debated scenarios ranging from soft to hard landings; today, nearly 90% of economists surveyed in mid-June anticipate a soft landing, marking a significant consensus shift. June also saw record revisions in GDP growth forecasts for major global economies, leaving little room for positive surprises. Similarly, equity analysts have substantially upgraded earnings forecasts, reinforcing a broadly accepted Goldilocks narrative that now faces vulnerability to negative surprises.

Further influencing our tactically prudent allocation are optimistic to slightly stretched investor sentiment and positioning. Additionally, the recent uptick in implied rates for bond volatility (as seen in the MOVE index), previously noted in our May MAI Views as supportive of equity multiple expansion, raises concerns alongside ongoing multiple expansions. This divergence between rates volatility and equity multiples suggests near-term market fragility concerns.

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