POSITIONING FOR AN UNCERTAIN WORLD

Our Global Asset Allocation report features updated portfolio weights for DM and EM stocks and bonds, optimal country weights and probability forecasts for major equity markets, and a rigorous assessment of the factors driving global portfolio returns.

January 22, 2025

Will US exceptionalism continue in 2025?

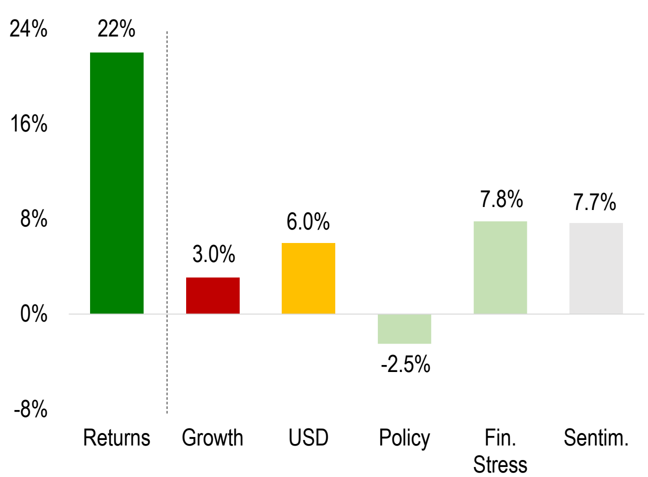
America's world – As has often been the case since the GFC, US stocks beat most other major markets in 2024. The extent of the differential, however, was almost unprecedented, with the S&P beating DM offshore stocks by 22%. Should investors continue to OW the US in 2025, or do large valuation differences call for greater diversification?

In assessing regional positioning, it helps to understand the factors behind the large US returns premium. We can see this in F1, which isolates the influence of various drivers to relative returns versus international stocks. The US fared better in a number of aspects, benefiting from resilient activity (including strong tech demand), a strong dollar and better financial conditions.

This year, however, our research reveals that US equities have less of an edge. One source of risk is that markets are pricing in very strong profitability. While we also expect earnings to grow, there is a high likelihood that they disappoint as spending decelerates. Negative earnings surprises would hurt investor sentiment, weighing on valuations.

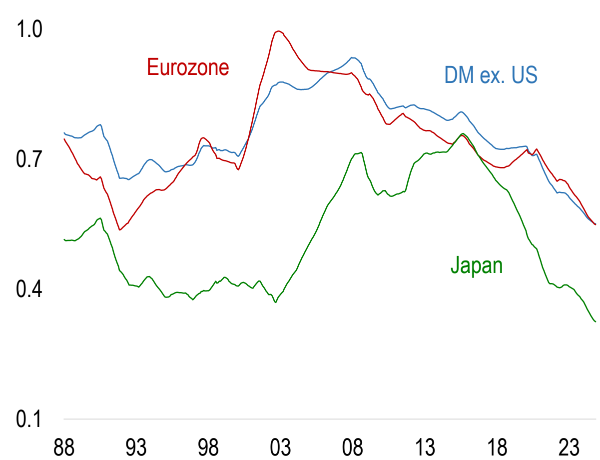
If US stocks lose momentum, regional rotation may prove effective, especially since the dominance of US big tech has lowered the correlation with offshore assets in recent years (F2). Naturally, the degree of rotation also depends on external conditions. One key determinant, in this respect, is the USD outlook, a topic we explored in this month's *Global Macro Strategist*.

F1: US stocks are shining as bright as ever
Drivers decomp - US / offshore stocks (2024)



Note: Contribution of selected drivers to real returns on the MSCI World between Dec. 2023 and June 2024. Policy captures actual and expected changes in policy rates, money supply and corporate policy (for Japan). Source: Numera Analytics.

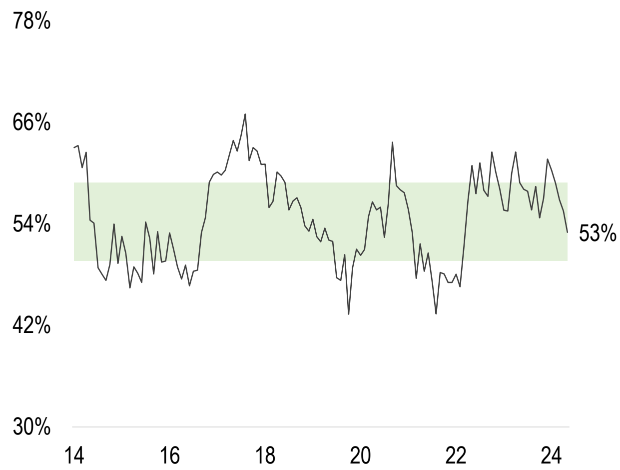
F2: US-offshore link continues to weaken
Time-varying correlations - S&P vs. offshore



Note: Chart tracks the time-varying correlations between local currency returns on US and international equities. Source: Numera Analytics.

F3: Dollar upside is lower than last year

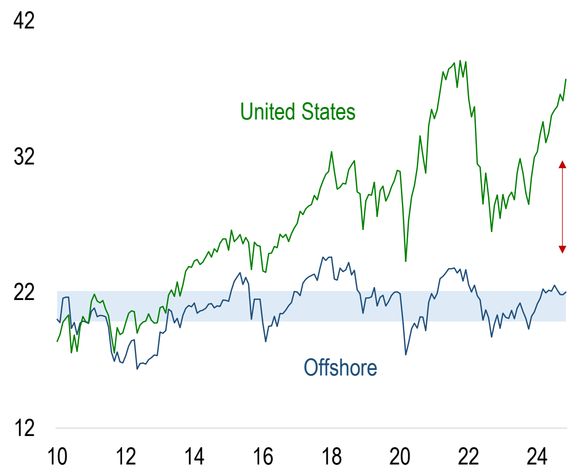
12M probability of USD appreciation vs. EUR



Note: Chart tracks the likelihood that the USD will appreciate against the EUR over the next 12M. Source: Numera Analytics.

F4: Valuation gap is back to its 2021 peak

US and offshore cyclically-adjusted P/Es



Note: Chart compares cyclically-adjusted price-to-earnings (CAPE) ratios for the US and offshore equity markets. Source: Barclays; Numera calculations.

During the post-GFC period, the dollar has appreciated about 2% per year. In periods of USD strength, US equities have outperformed 90% of the time, with an average returns premium of 10% per year. Strong tech earnings allowed the S&P to remain competitive in periods of USD weakness, but the differential is much more modest at 3.5%.

So will the dollar keep rallying this year? In the near-term, expectations of ‘higher-for-longer’ Fed policy should continue to exert upward pressure on the dollar, favouring US assets. As the year progresses, however, we expect US growth to slow and layoffs to rise, resulting in more cuts than priced by markets. This helps contain USD risks at a 12M horizon, even if elevated trade policy uncertainty still makes USD appreciation the most likely outcome (F3).

A strong dollar reduces the immediate appeal of offshore rotation. For longer holdings, however, we find that a neutral US / DM offshore split maximizes portfolio returns (T2). Besides less US macro upside, this reflects a remarkably high valuation gap (F4). The only other time this was as wide as today (in 2021), offshore outperformed by 8% over the next 12M. Although the current macro context differs significantly from 2021, the gap calls for further diversification.

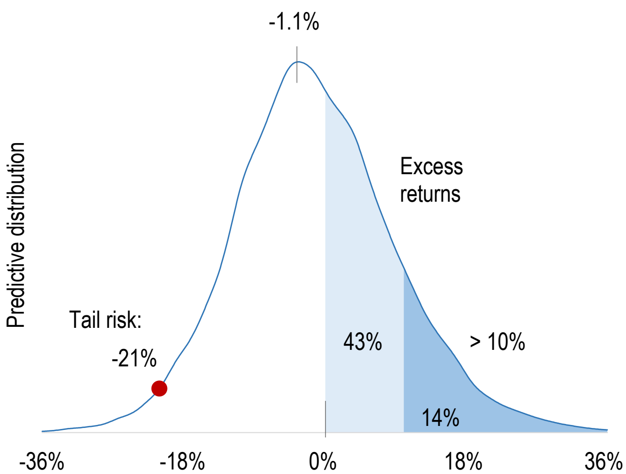
T1: Offshore equity upside 12M positive returns probabilities	Offshore	Canada	Eurozone	Japan	UK
March 2024	62%	66%	53%	66%	60%
September 2024	67%	67%	55%	67%	68%
January 2025	71%	75%	65%	72%	67%

Note: Likelihood of positive real returns over next 12M. Results derived from our proprietary GAA model. Source: Numera Analytics.

Historically, investors looking to rotate internationally first turn to Europe. Macro conditions in the EZ (ETF: EZU) have been much less favourable to risky assets since 2023, as ECB tightening had a pronounced impact on demand, and higher wage and energy costs hurt earnings. As we discussed in this month's *Global Macro Perspectives*, improved consumer confidence points to stronger domestic demand this year, improving the upside of EZ stocks (T1).

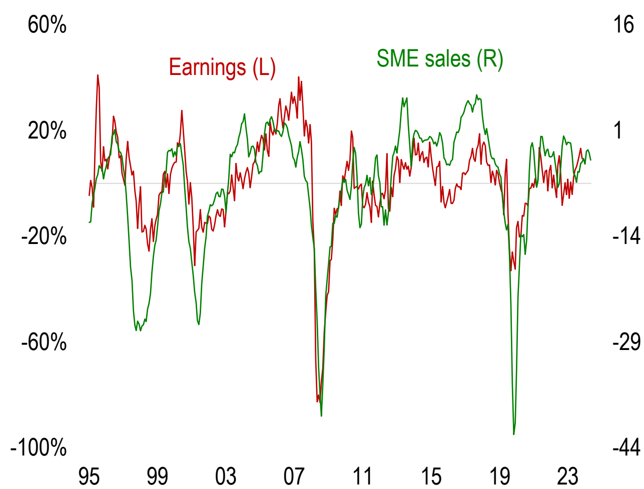
But while EZ stocks are more attractive in absolute terms, the likelihood of outperformance is still low (F5), suggesting investors should look for 'alpha' elsewhere. One important headwind is the fact that Germany is trading well above the level implied by macro fundamentals, increasing downside risks should global risk appetite deteriorate.

F5: Europe is still not a great diversifier
EZ / DM equity returns - 12M outlook (%)



Note: There is a 43% probability that EZ stocks outperform DM equities this year, and a 14% chance they deliver double-digit gains. Should the EZ underperform, the worst potential outcome would be a 21% shortfall. Source: Numera Analytics.

F6: Pick-up in JP growth crucial for Nikkei
JP real earnings per share vs. SME sales



Note: Chart compares cyclical fluctuations in real earnings per share for Nikkei firms against SME sales in Japan. Source: MSCI, Japan Finance Corporation.

Japan, in our view, is a better diversifier. Consumption should pick up as wage growth strengthens, a key tailwind since Nikkei earnings depend strongly on domestic activity (F6). Valuations also make for a better entry point than last year. Foreign equity inflows slowed since the Nikkei sell-off in August, realigning multiples to their long-term average. Japan, in addition, has a lower correlation to US stocks than Europe, helping reduce portfolio volatility (F2).

In positioning in Japan, FX risk makes the choice of instrument particularly important. USD returns (ETF: EWJ) have consistently trailed the local market since 2022, owing to large JPY losses. The yen should regain lost ground this year, favouring unhedged positions. Conditional on JPY appreciation, the likelihood of positive returns exceeds 80%.

Smaller countries also offer opportunity. We especially like Canada (ETF: EWC), a market that delivered reasonable returns last year despite dismal domestic macro conditions. In the near-term, Canada's resource tilt makes it a useful hedge against inflation risk, while valuations stand to gain from BOC cuts. We also find that the loonie is now trading at a significant discount in response to aggressive short selling, and should benefit from the recent oil rally.

Strategic Asset Allocation:

- **Stocks vs. bonds** – *OW bonds*. Global risk appetite soured as the Fed signaled limited easing in 2025. This hurts stocks and bonds, but equities are more attractive for now given resilient global activity (F7). A higher bond weight maximizes risk-adjusted returns 12M out, owing to a high probability that the US economy slows. This would drive down sovereign yields (trading well above 'fair' value), and weigh on earnings and investor sentiment.

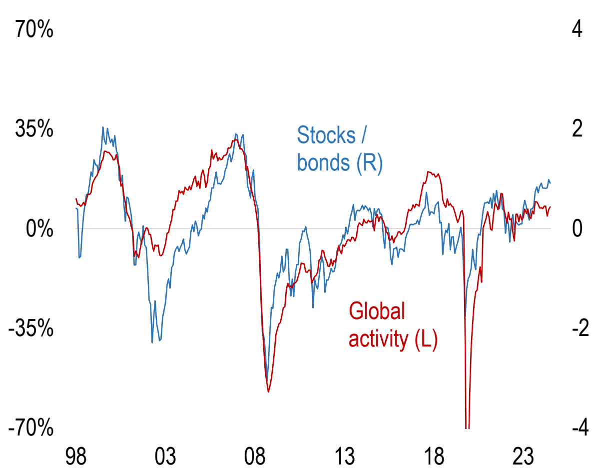
- **US vs. offshore stocks** – *Neutral*. US stocks retain a tactical edge, benefiting from a strong dollar and resilient activity. The upside is lower at longer holding periods, as negative US growth surprises should weigh on valuations and contain USD risks. Across offshore markets, we favour Japan and resource exporters like Canada. Besides their 'alpha' potential, both are useful to portfolio construction given their relatively low correlation to US stocks.

- **DM vs. EM stocks** – *OW EM*. Unlike DMs, most EMs are trading below 'fair' value, which improves their relative appeal. EMs should also benefit from greater-than-expected Fed cuts, partly owing to their high USD sensitivity (F9). We also expect EM growth to remain resilient this year, and to benefit from greater policy support in China.

- **US vs. offshore bonds** – *OW US*. Offshore bonds fell 8% last year, as a strong USD and BOJ policy normalization offset the impact of rate cuts in other DMs. A strong USD calls for continued OW positions on US bonds for now. Sticky ECB inflation and low unemployment, and higher JP inflation curb the appeal of offshore debt 12M out.

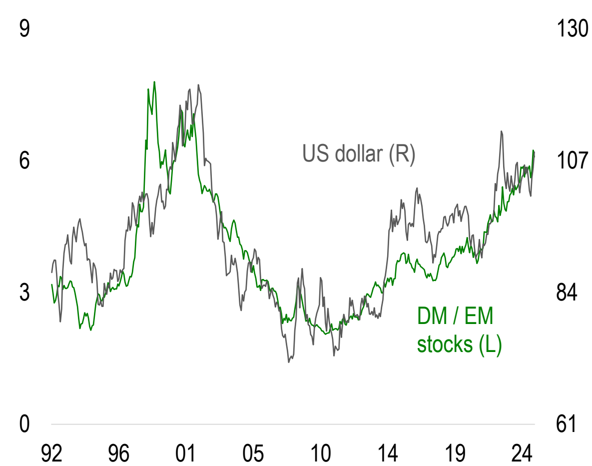
- **DM vs. EM bonds** – *OW EM*. EM debt is far outpacing DM bonds, benefiting from high coupon rates and narrow spreads amid global macro optimism. This should continue in 2025 even if risk appetite weakens, since resilient EM growth should prevent spreads from widening enough to offset their significant coupon edge.

F7: Stocks / bonds vs. global activity index
Deviations from trend and diffusion index



Note: Chart plots the relative performance of stocks to bonds against Numera's global activity index, a high frequency proxy of the global business cycle. Both series shown as deviations from trend. Source: Numera Analytics.

F8: DM / EM equities vs. US dollar index
Relative performance and price index



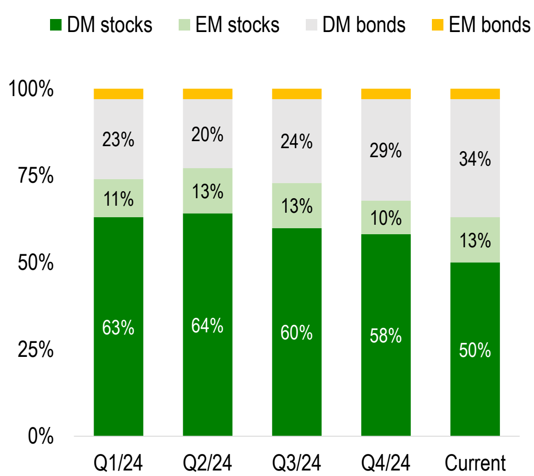
Note: Chart plots the relative performance of DM to EM equities against the tradeable US dollar index (USDX). Source: MSCI, ICE; Numera calculations.

T2: Asset allocation Optimal weights (%)	Benchmark[a]	Positioning[b] Current	Strategic	Longer-term
DM stocks	54%	50%	31%	48%
United States	36%	45%	21%	41%
DM ex. US	18%	5%	10%	7%
EM stocks	6%	13%	13%	10%
DM bonds	38%	34%	53%	42%
United States	33%	34%	49%	41%
DM ex. US	5%	0%	4%	1%
EM bonds	1%	3%	3%	1%
Stocks	60%	63%	44%	58%
Bonds	40%	37%	56%	42%
United States	69%	79%	70%	81%
DM ex. US	23%	5%	14%	8%
EMs	7%	16%	16%	11%

a. Benchmark weights match the iShares core growth asset allocation ETF (AOR), a balanced global stock-bond portfolio.

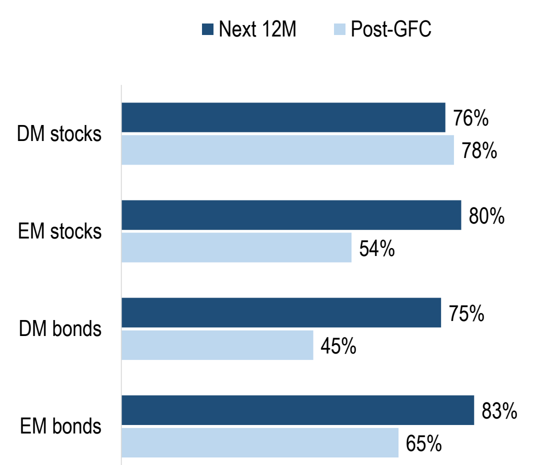
b. Weights maximize risk-adjusted returns for current macro context, over the next 12M, and over the next 5 years.

F9: Numera suggested positioning
Optimal portfolio weights over time



Note: Weights chosen to maximize risk-adjusted portfolio returns for the current global macro environment (see T3 for details). Source: Numera Analytics.

F10: Positive returns probability by asset
12M comparison versus post-GFC average



Note: Bars compare likelihood that major global asset classes deliver positive real USD returns over the next 12M. Source: Numera Analytics.

Strategic Asset Allocation

Overweight	Neutral	Underweight
●	●	●

T3: Strategic allocation Positioning by asset	Asset allocation[1]	Country rotation[2]	Key macro factors
DM stocks	Underweight	-	Currently neutral, but reduce exposure as US growth slows
United States	Underweight	Neutral	Tech trading at a premium; risk of pullback as growth slows
DM ex. US	Underweight	Neutral	Likely pick-up in growth, lower USD risks, low financial stress
Australia	-	Overweight	Terms of trade + AUD upside, responsive to CN stimulus
Canada	-	Overweight	BOC cuts support valuations, oil jump boosts terms of trade
Europe	-	Neutral	Neutral to moderately UW; better diversification elsewhere
Eurozone	-	Underweight	Upside is improving, but other markets are better diversifiers
Switzerland	-	Underweight	CHF trading at a premium, which curbs overall risk-reward
United Kingdom	-	Overweight	Attractive valuations, improving activity, share buybacks
Japan	-	Overweight	Likely pick-up in domestic activity + strengthening of JPY
EM equities	Overweight	-	Fed cuts, less USD risks, low US growth beta, CN stimulus
EM Asia	-	Neutral	We are neutral, but cross-country diversification encouraged
China	-	Underweight	CN no longer trades at a discount; growth challenges remain
India	-	Overweight	Growth premium + business dynamism, but expensive
South Korea	-	Overweight	Bearish sentiment has pushed stocks well below 'fair' value
Taiwan	-	Underweight	Similar risk profile to Korea, but overstretched valuations
EM EMEA	-	Overweight	Effective hedge against inflation risks, reduced USD risks
Latin America	-	Overweight	Low valuations, resilient regional activity, commodity upside
Brazil	-	Overweight	Low valuations, resilient BR economy, less BRL downside
Mexico	-	Overweight	Reduced MXN risk, valuation upside from Banxico cuts
DM bonds	Overweight	-	Gradually increase exposure as G10 easing cycle continues
United States	Overweight	-	Treasury yields should fall in 2025 as growth decelerates
DM ex. US	Neutral	-	Neutral as market overestimating ECB easing cycle
EM bonds	Overweight	-	Wider EM-DM growth premium, low global financial stress

1. Positioning relative to 60/40 global benchmark. See T2 for the recommended portfolio weights.

Top Conviction Calls & Scorecard:

Global Investment Ideas Top Conviction Calls	Action	Open date	Recently closed	Trailing stop-loss[1]	P&L	Report
BRL / USD (w. carry)	Long BRL	15-Oct-24	27-Dec-24	-8.0%	-8.0%	PDF
Chile stocks	Long	24-Oct-24	3-Jan-25	-7.0%	-7.0%	PDF
AUD / GBP	Long AUD	4-Nov-24	-	-4.5%	0.1%	PDF
Mexico stocks	Short	4-Nov-24	-	2%	5.4%	PDF
MXN / USD	Put option	6-Nov-24	29-Nov-24	2%	2.0%	PDF
US / EM stocks	OW	6-Nov-24	-	4.3%	7.5%	PDF
Germany stocks	UW	13-Nov-24	-	-6.0%	-5.2%	PDF
UK bonds	Long	18-Nov-24	-	-9.0%	-0.9%	PDF
CA bonds	Long	20-Nov-24	-	-8.0%	1.1%	PDF
CORRA futures	Call option	26-Nov-24	20-Dec-24	20.0%	21%	PDF
ECB futures	Put option	2-Dec-24	10-Dec-24	15.0%	15%	PDF
Henry Hub futures	Put option	5-Dec-24	20-Dec-24	-60.0%	-60%	PDF
EM stocks	Long	8-Jan-25	-	-9.0%	-0.4%	PDF
JPY / USD	Long JPY	8-Jan-25	-	-5.8%	2.0%	PDF

1. Stop-loss threshold matches the expected loss over the remaining holding period, relative to the current P&L.

Benchmarks:

- **Stocks**: United States: S&P 500 TR; Offshore: MSCI World excl. USA index and country breakdown; EM: MSCI emerging markets USD index and country breakdown.
- **Bonds**: United States: ICE BofAML US Treasury TR (all maturities); DM ex. US: ICE BofAML Global Government excl. US TR USD (all maturities); EM bonds: ICE BofAML EM external sovereign index TR USD.