Temptation Is One Thing Investors Can't Resist

- The macro climate remains supportive of risk assets and a moderate pro-growth portfolio tilt on a 6-12 month horizon, but bonds will need to calm before risk-on gains fresh traction.
- However, market expectation of Fed rate cuts will unwind further in the year ahead given the strength of the U.S. economy and sticky core inflation, which will eventually push up bond yields.
- We continue to recommend an overweight stance on cash in a multi-asset portfolio, with underweight exposure to bonds and a neutral weight on global equities.
- Maintain a mildly underweight stance on U.S. stocks within a global equity portfolio given rich valuations and outsized earnings expectations. An expected pick-up in economic growth outside the U.S. underpins our overweight recommendations on EM (ex-China), Japanese and euro area stocks, which also offer much cheaper valuations.
- Commodity prices should rise in response to the economic expansion, but only warrant a benchmark weight in a multi-asset portfolio. A narrowing of the U.S.' economic growth advantage versus the rest of the world points to a modest weakening of the U.S. dollar.

This Week's Research

U.K. Policy: What You Need To Know About The Budget And Fiscal Outlook p.17
Why Is U.S. Consumer Sentiment Downbeat? p.18
Why We Are Still Overweight Indian Equities p.19
Absolute Return Strategy: The Return Of The Term Premium p.20
Bank Of Japan: A Hawk In Dove's Clothing p.21

MRB's *Investment Recommendations* click here

Ongoing global economic expansion, central bank policy easing, and abundant financial liquidity continue to tempt investors. Despite a slight bump this week, global equities are near record highs, credit spreads are historically tight, gold and cryptocurrencies are rallying from elevated levels, and private assets are also in vogue. With apologies to Oscar Wilde, investors have found it difficult to resist the temptation to buy risk assets on any weakness.

Indeed, our constructive economic view justifies a pro-growth investment tilt. The caveat, however, is that global equities, and especially U.S. technology stocks, are expensive, as is corporate credit. Moreover, investors have overestimated how much the Fed and some other central banks are likely to cut interest

Table 1 MRB Asset Allocation Recommendations[1] (6-12 month horizon)

Overall Asset Allocation	–	N	+
Equities		■	
Fixed Income	■		
Cash			■
Commodities		■	

Regional Equities[2]

	–	N	+
Australia	■		
Canada	■		
EM Markets			■
Euro Area			■
Japan			■
Sweden		■	
Switzerland		■	
U.K.		■	
U.S.	■		

U.S. Equity Sectors[3]

	–	N	+
Consumer Discretionary	■		
Communication Services		■	
Consumer Staples		■	
Energy			■
Financials			■
Health Care			■
Industrials		■	
Information Technology	■		
Materials		■	
Real Estate		■	
Utilities		■	

Emerging Market Equities[4]

	–	N	+
Brazil			■
China		■	
India			■
Indonesia		■	
Korea			■
Mexico	■		
Saudi Arabia	■		
South Africa		■	
Taiwan			■

1 6-12 month horizon
2 Relative to common currency global equity benchmark
3 Relative to common currency U.S. equity benchmark
4 Relative to common currency emerging markets equity benchmark
5 + = Steepener and - = Flattener
6 Relative to hedged global fixed income benchmark

Note: Apart from the Asset Allocation section, recommendations are within asset classes; + = overweight, N = neutral and – = underweight

Fixed Income

		–	N	+
Duration		■		
Government Bonds		■		
Yield Curve[5]				■
Inflation Protection				■
Corporate Bonds[6]:	Investment-Grade		■	
	High-Yield			■
EM Sovereign:	USD Debt		■	
	Local Currency Debt			■

DM Government Bonds[6] (Currency Hedged)

	–	N	+
Australia			■
Canada			■
Euro Area		■	
Japan	■		
New Zealand			■
Norway			■
Sweden			■
Switzerland		■	
U.K.			■
U.S.	■		

Currencies (vs US$)

	–	N	+
Australia	■		
Canada	■		
Euro Area			■
Japan			■
New Zealand	■		
Norway	■		
Singapore			■
Sweden		■	
Switzerland		■	
U.K.	■		
Emerging Markets			■
U.S. (DXY)	■		

Emerging Market Currencies (vs EM Basket)

	–	N	+
Brazil			■
China	■		
India			■
Indonesia			■
Korea			■
Mexico		■	
South Africa			■
Taiwan			■
Turkey			■

rates in the year ahead, implying that bond yields have an upward bias on a 6-12 month horizon, even after their sizeable rise since mid-September. The geopolitical landscape also remains fraught and while former president Trump may have momentum on his side, the U.S. election is still a wildcard.

Table 2 Recent Change To Our Asset Allocation

DM Government Bonds* (Currency Hedged)

Euro Area	18-Oct-2024	→
Japan	18-Oct-2024	←

* Relative to hedged global fixed income benchmark
Note: Apart from the Asset Allocation section, recommendations are within asset classes; + = overweight, N = neutral and – = underweight

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Taken together, we advocate a moderate tilt in favor of global equities versus bonds on a 6-12 month horizon. We continue to advocate an underweight stance on bonds within a multi-asset portfolio given our expectation that yields will move higher in the coming year as investors at least partially unwind central bank rate-cut expectations, especially for the Fed.

Our generally upbeat equity bias is tempered by the global benchmark being overly concentrated in a handful of U.S. tech stocks, whose ability to meet, let alone beat, expectations is increasingly difficult. If economic growth perks up outside the U.S., as we expect will be the case, then select non-U.S. equity markets would be well placed to outperform on a 6-12 month horizon, albeit contingent on a possible Trump administration delaying and moderating the former president's stance on tariffs and Ukraine. For now, we are sticking with our overweight stance on emerging market (favoring ex-China), Japanese and euro area stocks, and continue to recommend a slight underweight on the U.S. market.

We advocate a moderate tilt in favor of equities versus bonds

Based on our expectation that bond yields will climb further in the year ahead and our discomfort with U.S. tech stocks, we continue to advocate an overweight stance on cash, especially for U.S. dollar-denominated portfolios. See **table 1** for our complete asset allocation recommendations, and **table 2** for changes in the past month.

We expect global equities and risk assets more generally to produce decent absolute returns in the coming year, but recommend resisting the temptation to extrapolate recent price trends and embracing a full-throttle pro-growth bias. A lot can go right, but a lot is also already discounted and conditions could sour if growth-impeding political actions undermine economic sentiment.

Stock/Bond Allocation And Investment Strategy

An ongoing global economic expansion points to the upside for the global stock/bond total (S/B) return ratio on a 6-12 month horizon, and a 60/40 equity bond portfolio expected to generate mid-to-high single digit returns.

U.S. Election 2024: Is A Trump Win Fully Discounted?

Investors have increasingly discounted a Trump win in next week's U.S. election, with a unified Republican Congress. The playbook in 2016 when Trump first won the presidency was initially higher U.S. bond yields, inflation expectations, a firmer dollar and rising stock prices in anticipation of reflationary policies combined with de-regulation.

While Trump may have a slight lead, the outcome remains uncertain given that most swing-state polls are within the margin of error. It is impossible to quantify how much asset prices have shifted in anticipation of a Trump win, but to whatever extent they have, they come on top of already rich U.S. asset prices. This does not preclude equity and other risk asset prices from rising initially if he wins, but the threat of his tariff policies could cap upside or even trigger some reversal as 2025 evolves. The wildcard is the extent to which Trump's policies would be inflationary, which would be negative for both stocks and bonds. The tail risks on the implications of Trump victory are large.

By implication, a Harris win would imply an unwinding of the recent Trump trades. A Harris win would alleviate potential inflationary risks from broad-based tariffs, but current optimism about de-regulation and tax cuts would also dissipate. We assume markets would view a Harris administration as a continuation of the current trend, especially in a split Congress. Our bias is that the tail risks around a Harris win would be narrower than those for Trump.

Given the uncertainties, we do not advocate altering 6-12 month investment strategy in anticipation of the election outcome next week. Stay tuned.

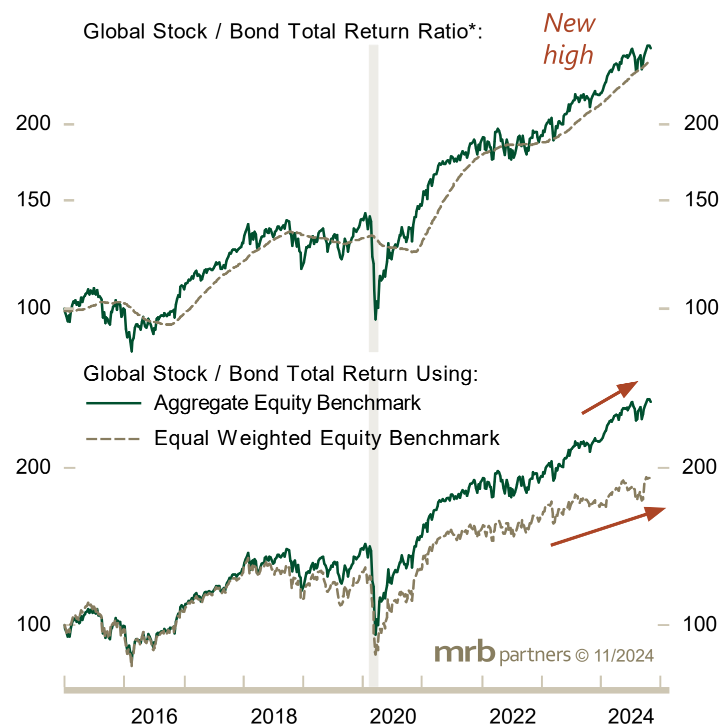
The global S/B ratio continues its uptrend, with a surge since mid-September (**chart 1**). All the gains have derived from global equities, which have generated a 18% return YTD in local-currency terms, while the return on a basket of G7 10-year government bonds has been negligible.

Equity returns have been flattered by the composition of the global benchmark

Equity returns have been flattered by the composition of the global benchmark. The global S/B return ratio based on the global ***equal-weighted*** equity index is only up about 11% YTD, reflecting the lower, albeit still solid, returns from equities using this component.

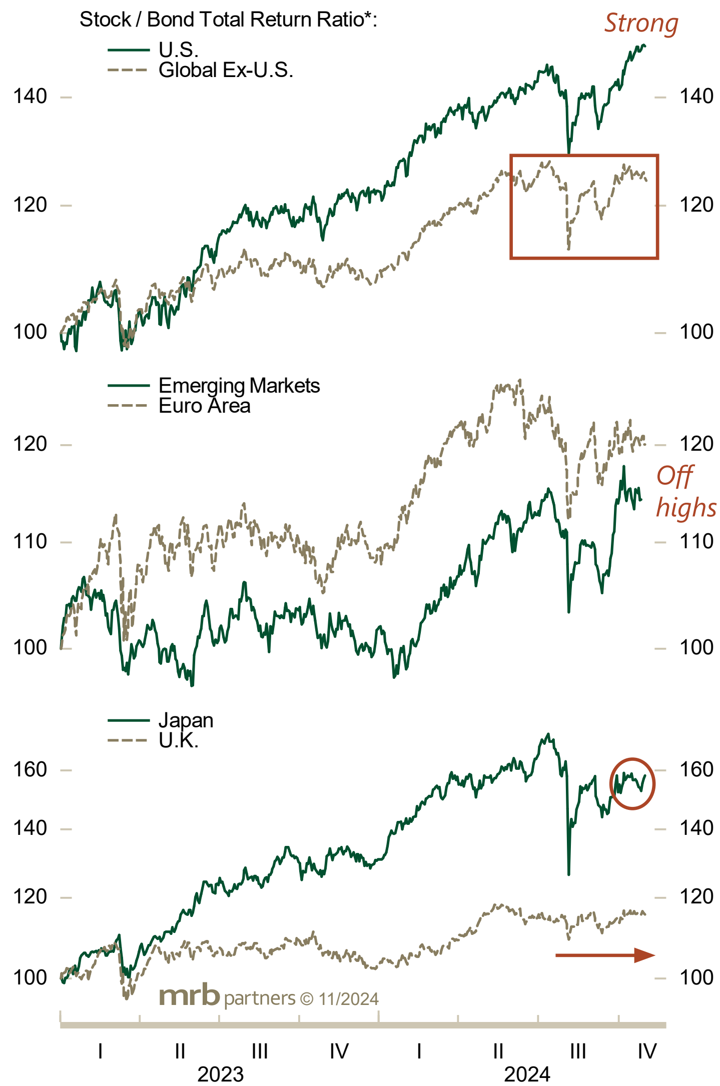
There have also been significant divergences in the S/B ratio across individual markets (**chart 2**). The U.S. ratio of the total return on U.S. stocks versus a U.S. 10-year Treasury is at a fresh high, while that for the global ex-U.S. has stalled in recent weeks, and those of the euro area, Japan and the U.K. are well off this year's highs. The S/B ratio for emerging markets recently soared on the back of a huge bounce in Chinese stock prices following monetary policy stimulus.

Chart 1 Global Stock Returns Outpacing Bonds



* Global MSCI stock market total return index divided by G7 10-year government Bond total return index; local currency; rebased
Note: All panels in log scale; - - - 40-week moving average in panel 1; shaded for NBER-designated U.S. recessions

Chart 2 Stock/Bond Ratios Diverge Across Markets



* Equity benchmark divided by a 10-year government bond; local currency
Source: MSCI and Bloomberg

The strength of the global and U.S. S/B ratios is particularly impressive given the sharp increase in U.S. Treasury market volatility, which in turn reflects renewed uncertainty about the outlook for Fed policy (**chart 3**). U.S. equity volatility has also risen, albeit so far only modestly. However, equities are vulnerable until the bond market calms.

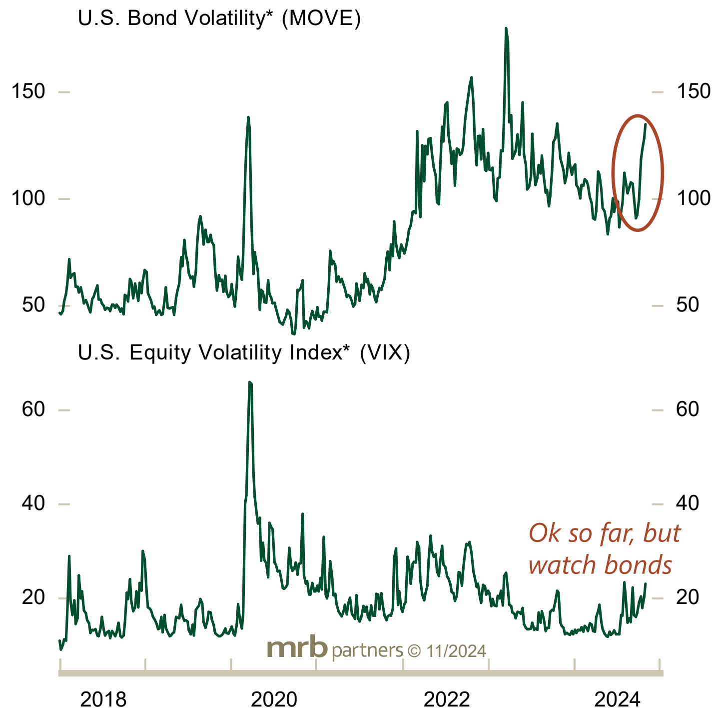
The U.S. remains the lynchpin of the global economy and is still humming along. U.S. Q3 economic growth was a still warm 2.8% and even stronger consumer spending growth, consistent with the underlying trend over the past two years and well above the underlying potential rate[1]. Elsewhere survey data is mixed, with the PMI composite indicator for the euro area hovering just below the 50 expansion line but trending lower[2], while that for EM signals modest, but moderating growth (**chart 4**).

The U.S. is still humming along

[1] **MRB** "*U.S. Economy: On Firmer Ground Than You Thought*", October 2, 2024 and "*Corporate Profits Provide Ballast For The U.S. Economy*", October 15, 2024

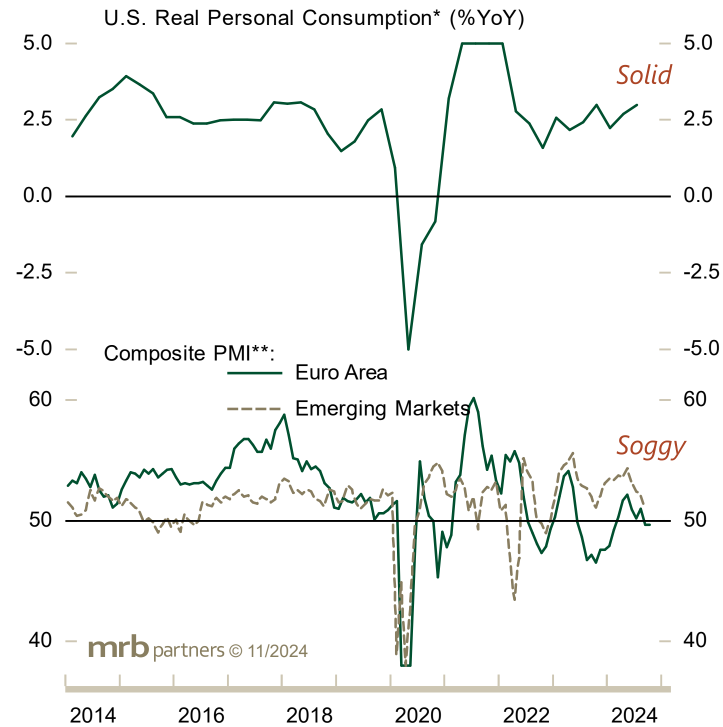
[2] **MRB** "*Euro Area: Member Divergences Provide Opportunities*", October 23, 2024

Chart 3 Big Jump In Bond Volatility



* Source: Bloomberg

Chart 4 Strong U.S., Lackluster Elsewhere



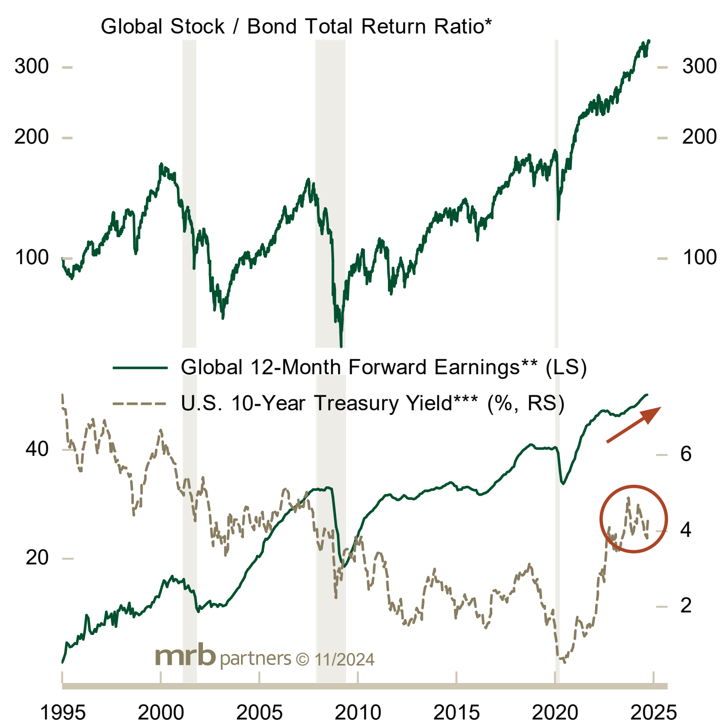
* Truncated above 5% and below -5%; source: U.S. Bureau of Economic Analysis
** Source: S&P Global

More positively, global trade growth continues to expand, albeit also at an historically modest pace.

Our base-case economic scenario remains that economic growth outside the U.S. should gradually firm as past headwinds to growth fade and fresh support arrives from monetary easing, which would reinforce the uptrend in the global S/B ratio. Solid income growth and improving confidence point to a pickup in euro area growth as the drag from the Ukraine war diminishes. A further rebound in the depressed German manufacturing PMI would be a confirming signal that regional economic conditions are poised to sustainably improve. Meanwhile, policy support should help put a floor under residential property prices in China, which in turn should provide a boost to consumer confidence and spending.

While an ongoing economic expansion is usually accompanied by a rising global S/B ratio, rich

Chart 5 Earnings Point To A Higher Global S/B Ratio

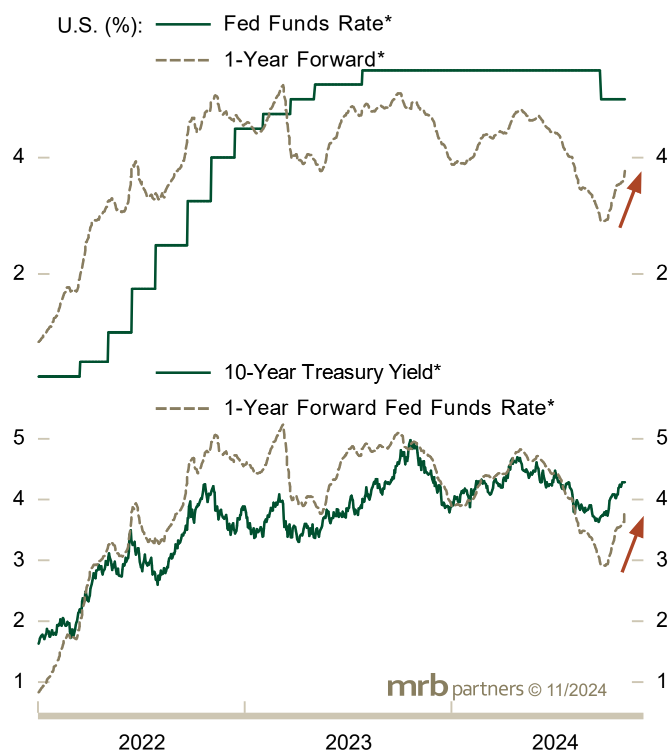


* Global MSCI stock market total return index divided by G7 10-year government Bond total return index; local currency; rebased
** Local currency; rebased
*** Source: Bloomberg
Note: Shaded for NBER-designated U.S. recessions

equity valuations imply potential equity market sensitivity to the higher bond yields we expect in the year ahead. Already, the gap between the 12-month forward equity earnings yield and 10-year government bond yield for global and the U.S. is at its lowest since the early 2000s. Equities can normally withstand rising bond yields if the latter corresponds with rising earnings expectations, which we expect to be the case (**chart 5**, previous page). The caveat is that global and particularly U.S. equity valuations are historically rich and thus may be more vulnerable to the downside if bond yields re-test their 2023 highs down the road, as we expect.

Final Word: *The macro backdrop of ongoing economic expansion and central bank policy easing should enable equities to outperform bonds over the next 6-12 months. Total returns on a 60/40 global equities and G7 10-year government bonds will be moderate, reflecting solid returns for stocks and negligible or negative returns for bonds. Rising bond yields will at some point pose a risk to equities, given the latter's elevated valuations.*

Chart 6 Fed Rate-Cut Expectations Still Too Aggressive



* Source: Bloomberg

Fixed Income

We expect choppy fixed-income markets over the next 6-12 months, with bond yields pushing higher as markets unwind Fed rate cut expectations and rising G7 government bond issuance adding to risks.

Bond yields will push higher as markets unwind Fed rate cut expectations

U.S. Treasury yields continue to move in lock-step with Fed interest rate expectations. The Fed's 50 bp rate cut in September has been followed by a steady rise in the 1-year forward fed funds rate (**chart 6**). The latter is up approximately 80 bps since mid-September, which has coincided with a nearly 70 bps rise in the 10-year Treasury yield.

Fed rate expectations 1-3 years out have risen by a similar amount, with the market now estimating a trough in the fed funds rate of 3.5-3.75%. While that is above the Fed's 2.9% long-run equilibrium, it is too low to cool the economy sufficiently to quell upside inflation risks, since financial conditions are still easy, and the economy is currently operating well above potential[3] (**chart 7**).

[3] MRB "*Monetary Policy: What Do U.S. Financial Conditions Imply?*", October 18, 2024

Moreover, the Fed's forecast of 2% real GDP growth in 2025-2026 implies that the current positive output gap will persist for the next two years. It is hard to square a persistent and large output gap with a forecast that inflation will hit and stay at the 2% target. We expect the Fed to be compelled to raise its long-run equilibrium policy rate in the near year.

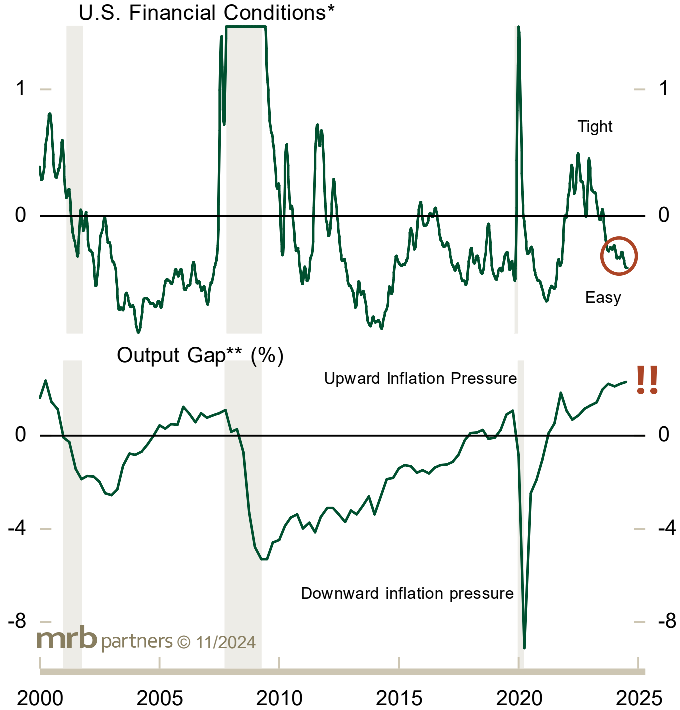
The presidential election is a potential wildcard for bonds given that both candidates advocate a continuation of easy fiscal policy and rising public sector debt. Lax fiscal policy has the potential to add to bond market volatility and upward pressure on yields over the next year, consistent with a rise in the Treasury term premium[4].

Other DM short-term interest rate and bond markets have been moving directionally together, albeit increasingly lagging/diverging with the U.S. (**chart 8**). The ECB, BoE and BoC have greater scope to cut rates compared with the Fed given weaker domestic economic growth and greater economic slack. Still, anticipated upward pressure on U.S. Treasury yields will inevitably push up other DM yields, but to a lesser extent. This week's expansionary U.K. budget underscores the potential upside risk to gilt yields from rising public deficits and debts[5].

Key elements of our fixed income strategy for a 6-12 month horizon include:

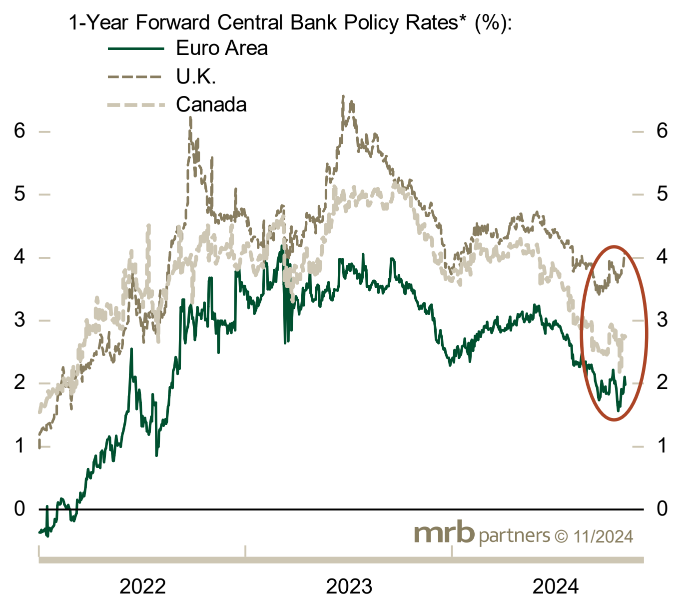
❍ **Duration (Short):** We continue to recommend a modest short-duration bias, consistent with an expected rise in longer-term bond yields (**chart 9**)[6]. A further unwinding of Fed rate cut expectations will both reduce rollover risk for short-dated securities on a 6-12 month horizon,

Chart 7 **Conditions Don't Support Aggressive Fed Cuts**



* Re-standardized; truncated above 1.5; source: Chicago Federal Reseerve
** Source: Congressional Budget Office
Note: Shaded for NBER-designated recessions

Chart 8 **DM Rate Expectations Still Moving Together**



* Source: Bloomberg

4 MRB "*Absolute Return Strategy: The Return Of The Term Premium*", October 31, 2024
5 MRB "*What You Need To Know About The U.K. Budget And Fiscal Outlook*", October 29, 2024
6 MRB "*U.S. Treasurys: Reality Bites Again*", October 9, 2024

and trigger capital losses on longer-dated issues. For perspective, a 50 bps rise in the U.S. 10-year Treasury over the next year would almost fully offset the coupons received, resulting in a ***near zero nominal total return***.

- **Yield Curve (Steepener):** While we expect yields at the front-end of the yield curve to drift higher as central bank rate cut expectations unwind further (albeit unevenly across markets), we expect 2/10 curves to steepen in response to sturdy economic growth, sticky inflation, and higher term premium given fiscal and other long-term inflation uncertainty.

- **Inflation Protection (Overweight):** Investors are overly complacent about long-run inflation risks, with the U.S. 10-year CPI swap rate still toward the lower-end of its post-pandemic range. Even short-term inflation expectations are vulnerable to the upside if crude oil prices rise in the year ahead, as we expect. A rise in inflation expectations/compensation will translate into the outperformance of inflation-protected bonds versus their nominal counterparts.

- **Regional Positioning (Underweight U.S.):** A widening gap between U.S. and other DM central bank rate expectations and economic growth underpins our underweight stance on U.S. Treasurys in a DM currency-hedged bond portfolio[7]. More generally, U.S. Treasurys typically underperform when Treasury yields are rising, which we expect on a 6-12 month horizon.

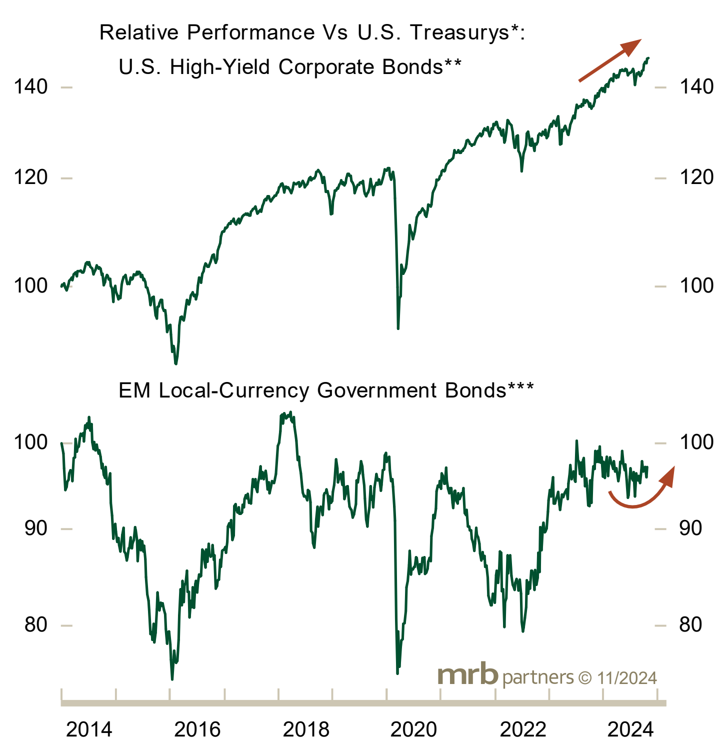
- **Corporate Bonds (Overweight):** Relative valuations are uncompelling given tight spreads, but corporate bonds should still outperform given

[7] MRB "*Divergence Re-Emergence: Opportunities In Regional Bond Markets*", October 1, 2024 and MRB "*Government Bonds: Upgrade The Euro Area & Downgrade Japan*", October 18, 2024

Chart 9 **Stay Short Duration**

* Rebased; source: Bloomberg, MRB calculations
** Source: Bloomberg

Chart 10 **Still Opportunities In Credit**



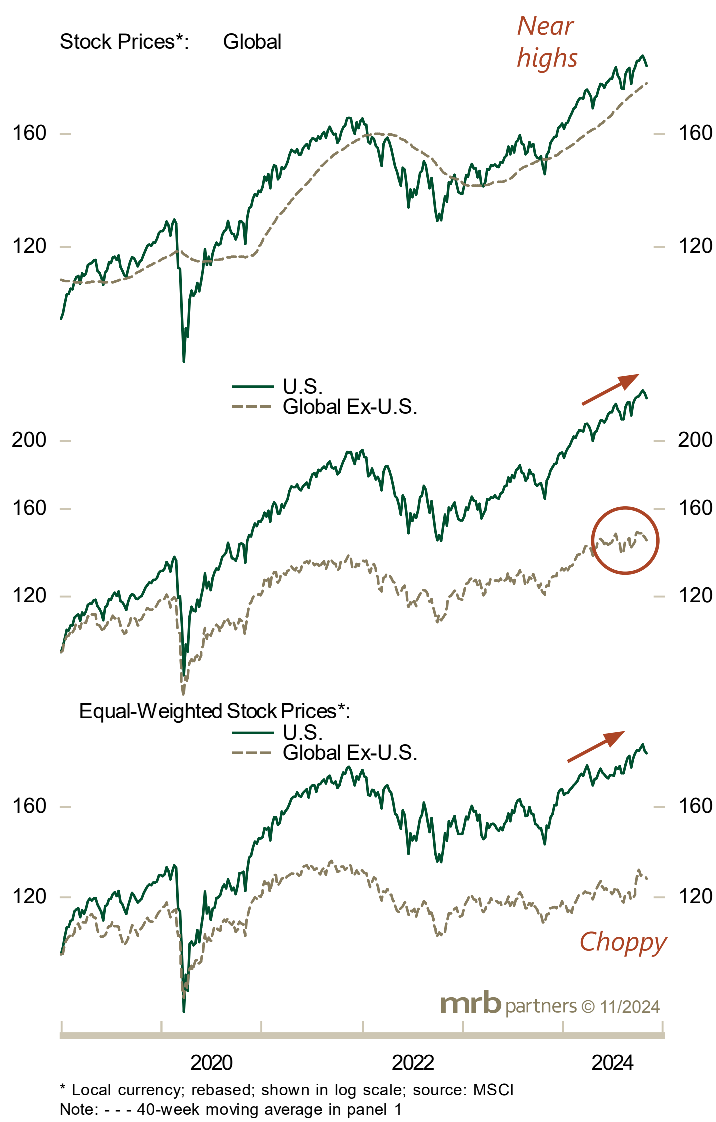
* Local currency; versus similar duration U.S. Treasury; rebased
** Source: ICE Data Indices, LLC, Bloomberg
*** Source: Bloomberg, MRB calculations

the supportive underlying economic and policy backdrop. We favor high-yield over investment-grade debt given the yield advantage, shorter duration and low default risk outlook (**chart 10**)[8].

- **Emerging Market Bonds (Overweight):** An improving global trade cycle, easing EM monetary policy and superior yields underpin our overweight recommendation versus DM or U.S. bonds. EM policy easing and an expected appreciation of EM currencies versus the U.S. dollar warrant a preference for local-currency debt.

Final Word: *Stay underweight government bonds in a fixed-income portfolio, with yields poised to climb further on a 6-12 month horizon, while corporate and other credit will continue to benefit from a supportive economic growth environment. Remain short duration and overweight inflation protected bonds, while positioned for a further steepening of G7 yield curves.*

Chart 11 U.S. Still Leading The Equity Pack



Equities

A continuation of the global economic expansion and non-threatening central banks is positive for equities on a 6-12 month horizon. At the same time, the overconcentration of equity risk in expensive tech- and tech-related U.S. stocks tempers the risk-reward on global equities.

The U.S. continues to provide the main impetus to equities

The global equity benchmark is in a solid uptrend and near a cyclical high (**chart 11**). The U.S. market continues to provide the main impetus, continuing its robust advance. Meanwhile, the global ex-U.S. benchmark is also in an uptrend, albeit more muted than that of the U.S.

There is a more marked divergence between the equal-weighted measures in the U.S. and global ex-U.S. The U.S. version has powered to a new high, indicating improving breadth. The global ex-U.S. equal-weighted measure got a sizeable recent lift from the big China bounce, but the underlying uptrend is only modest.

[8] **MRB** "***U.S. Corporate Bonds: Solid Fundamentals Will Keep Spreads Tight***", October 21, 2024

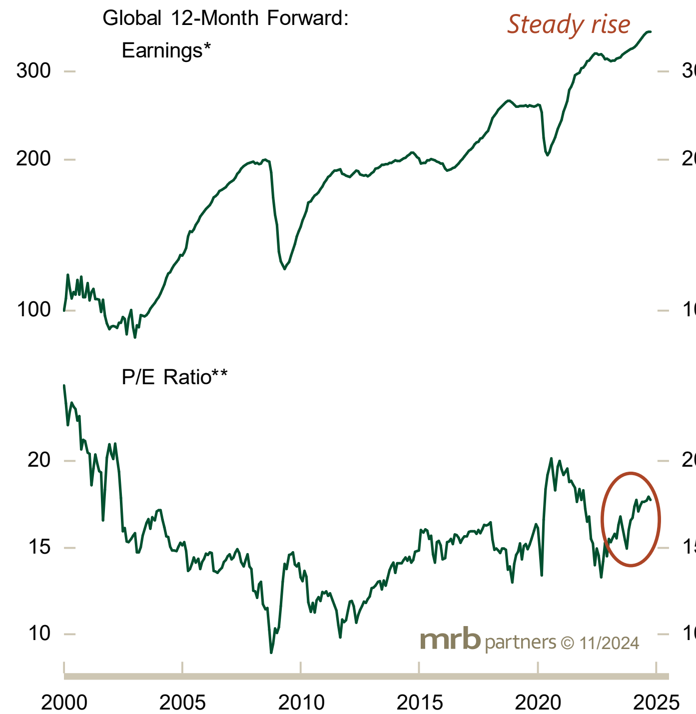
Rising earnings expectations remain a key driver of the global equity trend, but the gains from re-rating over the past year have contributed more to overall stock prices gains (**chart 12**). Global 12-month forward earnings in local-currency terms have risen by 8% over the past year, while the forward P/E ratio has risen by 7%. While there is no clear short-term relationship between the forward P/E ratio and bond yields, there is limited scope, if any, for valuations to expand much further in the year ahead if G7 government bond yields are also moving higher.

The U.S. market has benefitted this year in relative terms from both rising ***relative*** forward earnings and a higher P/E ratio (**chart 13**). U.S. 12-month forward earnings have risen by 11% YTD, while the increase in the forward P/E ratio has provided an 8% boost to stock prices, compared with 6% and 4%, respectively, for the global ex-U.S. aggregate.

Consensus U.S. earnings growth over the next 12 months is a stiff 14% in view of a domestic and global economy likely to grow at less than half that rate in nominal terms. Moreover, U.S. profit margins are already high by historical terms, but are projected to widen materially again in the year ahead, which we view as overly optimistic. Regardless, our expectation of rising bond yields implies that the U.S. 12-month P/E ratio will be under downside pressure that would eat into the benefits that a further rise in earnings would have on share prices.

The earnings and valuations hurdles are lower for global ex-U.S. stocks, albeit contingent on our moderately upbeat economic outlook. Consensus forward earnings for global ex-U.S. stocks are projected to rise approximately 10% in the next

Chart 12 **Earnings And Re-Rating Boosting Stocks**



* Local currency, rebased; shown in log scale; source: MSCI
** Source: MSCI

Chart 13 **Big Re-Rating Advantage For U.S. Stocks**

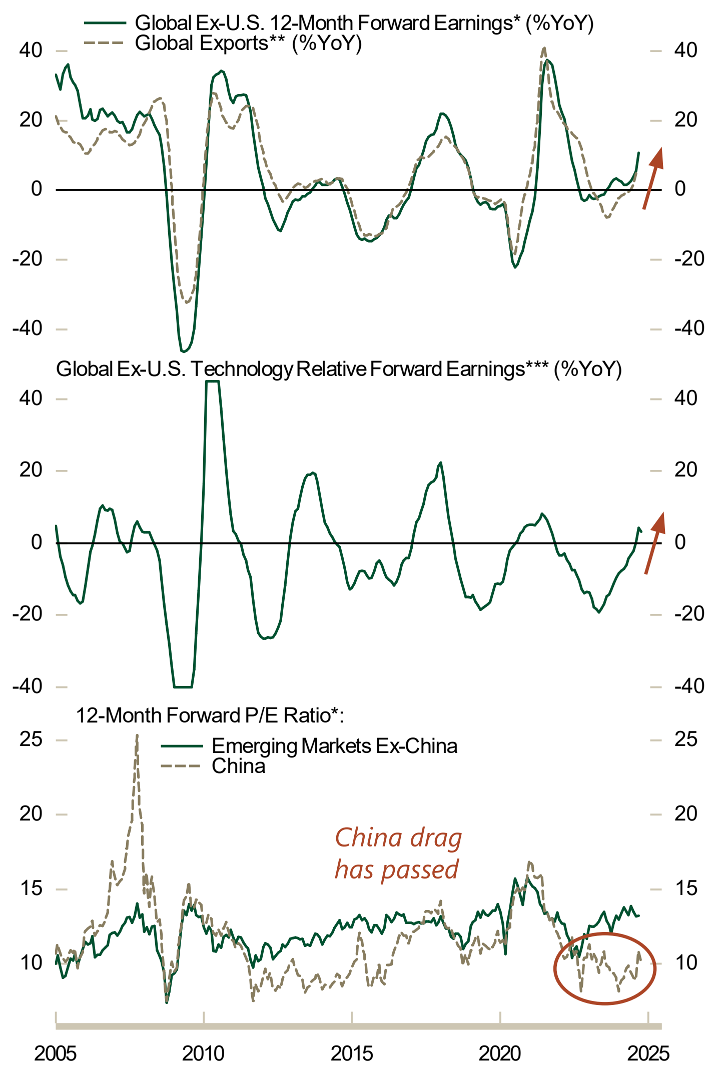
* Source: MSCI
Note: Earnings are in local currency and rebased

year, reflecting anticipated margin expansion that would be broadly consistent with an expected improvement in non-U.S. growth momentum and global trade. There is scope for upside earnings surprises for non-U.S. earnings. There is also less valuation risk since the global ex-U.S. benchmark is trading at an undemanding 12-month forward P/E ratio of 14. In contrast with the U.S., the corresponding forward earnings yield for the global ex-U.S. benchmark is well below the global ex-U.S.10-year government bond yield.

The much higher earnings and valuation hurdles for the U.S. than non-U.S., combined with our forecast that global growth momentum outside the U.S. will improve, underpins our continued recommendation to have a modest tilt in favor of non-U.S. equities in aggregate on a 6-12 month horizon. This corresponds with a slight underweight in U.S. stocks relative to their 65% weight in the MSCI global benchmark, offset by recommended overweight exposures to EM (mainly ex-China)[9], Japan and the euro area within a global equity portfolio[10].

Key additional factors supporting our recommended overweight exposures include (**chart 14**):

Chart 14 **Is The Tide Turning For Global Ex-U.S.?**



* U.S. dollars; source: MSCI
** U.S. dollars; source: Netherlands CPB
*** 12-month forward earnings versus U.S. technology; truncated above 45% and below -40%; U.S. dollars; smoothed

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- We expect the global trade cycle to continue to strengthen, even if only modestly (non-U.S. economies and earnings are more dependent than the U.S. on global trade). By extension, we assume that any increase in U.S. tariffs will be delayed or less aggressively.

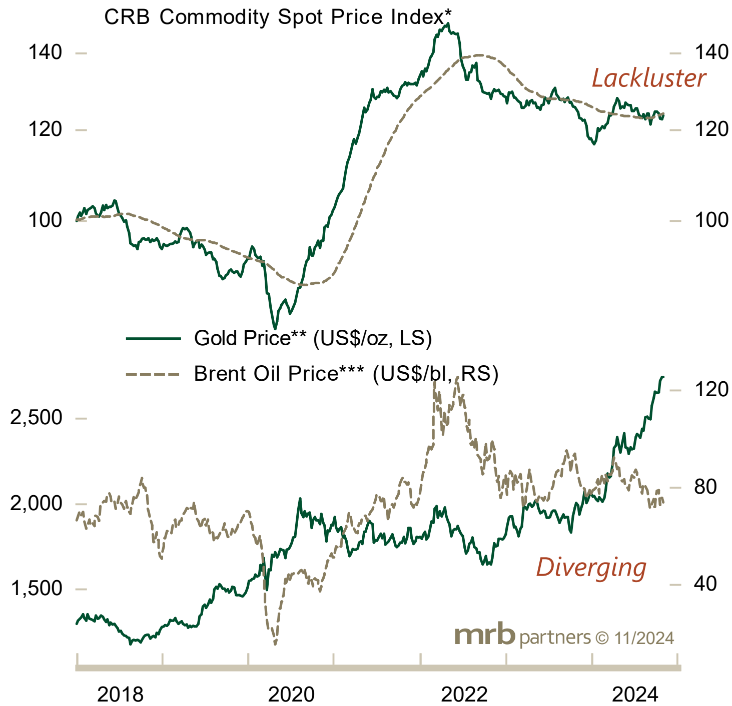
- The semiconductor upcycle has further to run (as global factory output improves) and should be especially beneficial for EM ex-China earnings (semiconductor stocks have a large weight in EM ex-China and have significant earnings leverage to rising global semiconductor sales)[11].

[9] **MRB** "*China: PBoC Fires Its Bazooka, Banks Will Suffer The Collateral Damage*", September 27, 2024
[10] **MRB** "*Regional Equities: Policy Tailwinds For A Gradual Rotation*", September 24, 2024
[11] **MRB** "*Why We Prefer EM Over U.S. Semiconductor Stocks*", October 3, 2024

- Recent policy stimulus should help put a floor underneath Chinese equity valuations, thereby removing a major drag for overall EM stocks.

- Japanese and euro area economic growth momentum will gradually firm, driven by improving consumer fundamentals, a rebound in manufacturing activity from depressed levels, and a pick-up in export growth. Japan has the highest weight among major markets in pro-cyclical sectors. A caveat for the euro area is that while the earnings in the key financials and industrial sectors are strong, consumer discretionary (autos and luxury) earnings are constrained by weak demand in China.

Chart 15 Commodities Not Participating In Risk On



* - - - 40-week moving average; rebased; source: Bloomberg
** Rebased; source: London Metal Exchange
*** U.S. dollars; rebased; source: MSCI
Note: All panels are in log form

Our regional equity recommendations balance the high risk-reward on U.S. stocks with a more favorable risk-reward on select non-U.S. markets, while recognizing that any rotation away from the U.S. awaits clearer evidence that our forecast of a pick-up in non-U.S. economic growth is more clearly in train. We expect the latter to develop, but it is likely to be gradual. Moreover, the tail risk of damaging protectionist measures in the U.S. could develop and mandate changes in regional equity positioning.

Final Word: *The global equity backdrop remains supportive, with earnings headed higher in the year ahead while monetary policy eases modestly. That said, equities will be vulnerable to any pronounced rise in bond yields, with a breach of the 2023 peak in U.S. yields likely a stumbling block. The high earnings and valuation bars for the U.S. market, combined with our expectation that growth will broaden outside the U.S. underpin our recommended mild underweight stance on U.S. equities and overweight stance on EM (favoring ex-China), Japan and euro area stocks within a global equity portfolio.*

The global equity backdrop remains supportive

Commodities And Currencies

Commodities

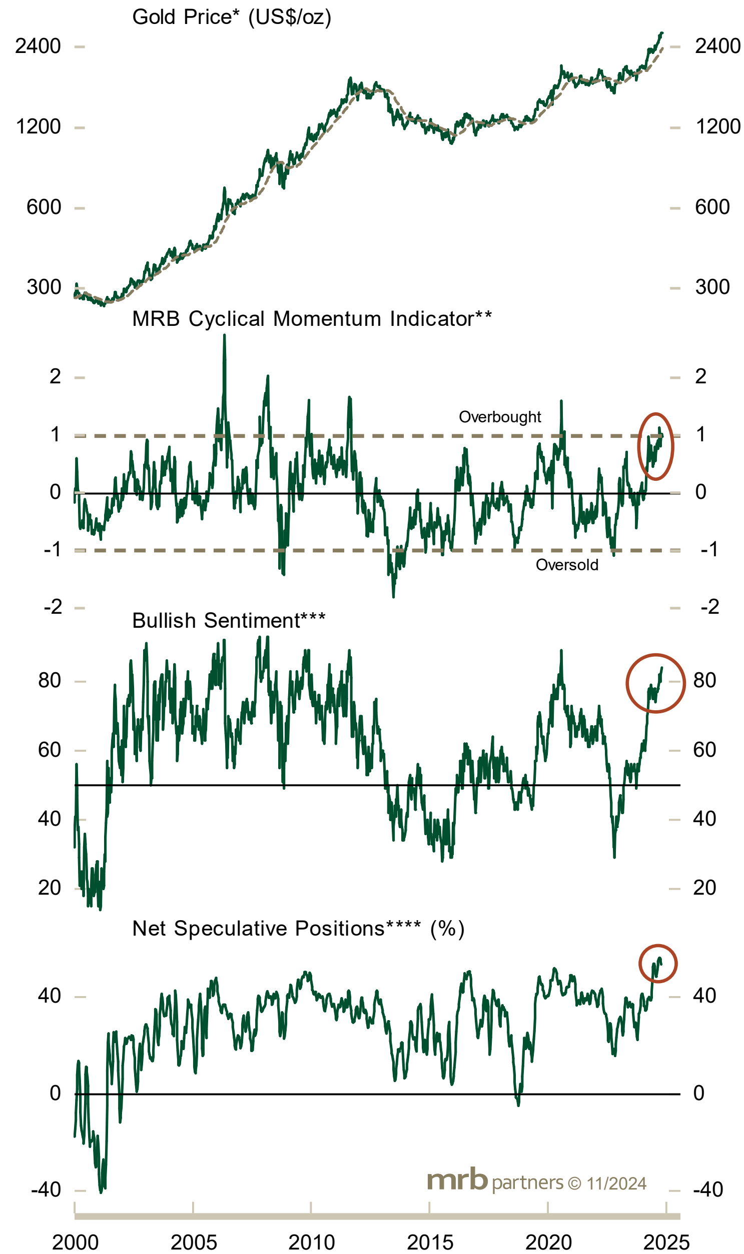
Commodity prices have not participated in the risk-on climate that has prevailed over the past year, with key benchmarks in a trading range (**chart 15**). Gold and crude oil are clear exceptions, with gold rising sharply over the past three months, while crude oil prices have slumped.

The lackluster performance of commodity benchmarks over the past year has occurred despite an ongoing global economic expansion and easing monetary policy, which would normally be commodity bullish. Ongoing concerns about the Chinese economic outlook have weighed on industrial commodity prices such as iron ore, while an earlier copper short-squeeze continues to unwind and has dragged down copper prices over the past month. That said, copper prices are still materially above their year ago levels, consistent with an expanding global economy. Given our constructive global economic outlook, we expect industrial commodity prices to rise moderately over the next 6-12 months.

Gold, and precious metals more generally, have been beneficiaries of the current monetary easing, and have risen over the past month even as global bond yields and the U.S. dollar have also moved higher. Gold is getting support from ongoing central bank reserve diversification, lax DM fiscal policies, and heightened geopolitical tensions and the uncertain policy outlook in the U.S. around the election.

Gold is expensive and will eventually be sensitive to the further rise in bond yields that we expect on a 6-12 month horizon. Moreover, gold is overbought based on the *MRB Cyclical Momentum Indicator*, and sentiment and speculative positioning are elevated, which are contrarian warning signs (**chart 16**). Nonetheless, there is no obvious headwind until the risk of an upside breakout in U.S. bond yields and/or the dollar intensifies materially. Eventually, we expect the former to occur, but it could take time before U.S. bond yields break out decisively.

Chart 16 Gold: Overbought, Overloved, Overowned

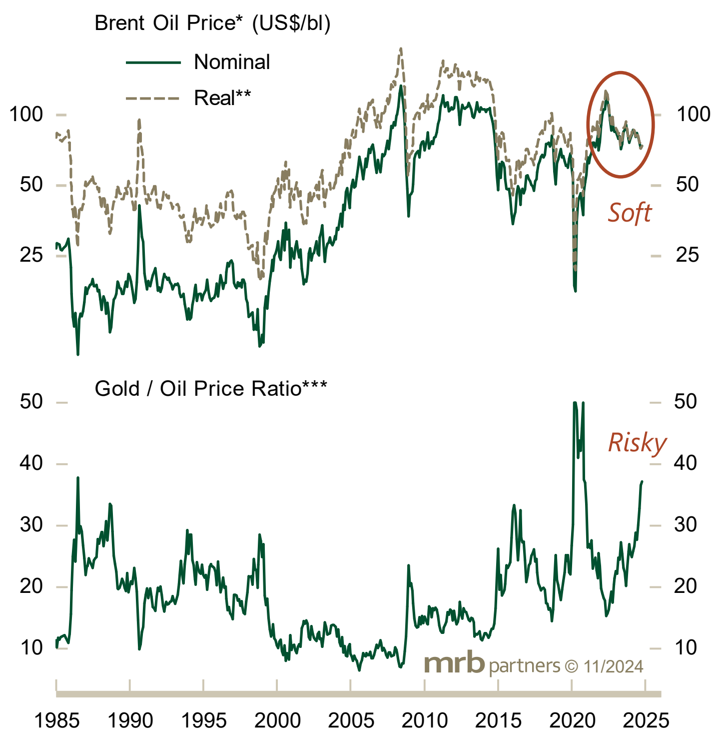


* - - - 40-week moving average; shown in log scale; source: Bloomberg
** Standardized
*** Smoothed; source: Marketvane
**** Net long positions as a percent of open interest, smoothed; source: Commitment of Traders Report

While gold has been flying high, crude oil prices have been under pressure from persistent concerns about weak demand as well as an unwinding geopolitical risk premium over fears of an escalation of Israeli-Iranian tensions. While there is a potential supply overhang in 2025 (contingent on decisions by OPEC+), our economic outlook suggests the consensus is overly bearish about prospective demand, especially following China's commitment to sustain growth in the 4.5-5% range in the year ahead. Brent prices in real terms are not elevated by the standards of the past two decades and in our view have little sustainable downside and an upward fundamental bias in a backdrop where global growth firms (**chart 17**).

In relative price terms, gold is extremely expensive relative to crude oil, implying that a reversion-to-mean tendency looms down the road. History suggests that gold would bear the brunt of the reversion.

Chart 17 **Gold Is Very Expensive Relative To Oil**



* Source: Bloomberg
** Deflated by U.S. CPI; sources: Bloomberg, U.S. Bureau of Labor Statistics
*** Truncated at 50; source: Bloomberg

Overall, we expect commodity prices to rise moderately in the year ahead, but to perform at best only in-line with equities and other risk assets. Thus, we continue to recommend neutral exposure to commodities within a multi-asset portfolio.

Currencies

The U.S. dollar (DXY) is pushing toward the upper-end of a 2-year trading range, rallying on the back of an unwinding of Fed rate-cut expectations and a rise in relative interest rates versus those of other major currencies (**chart 18**).

The relative growth gap in favor of the dollar will narrow in the next 6-12 months

Amidst the current dollar rally we stress that it has been range bound for two years despite a clear relative economic growth and interest rate advantage. The fact that it has not steadily advanced with such a favorable backdrop comports with our conviction that the U.S. dollar is expensive, as measured by the real trade-weighted U.S. index or the crosses versus the euro and yen.

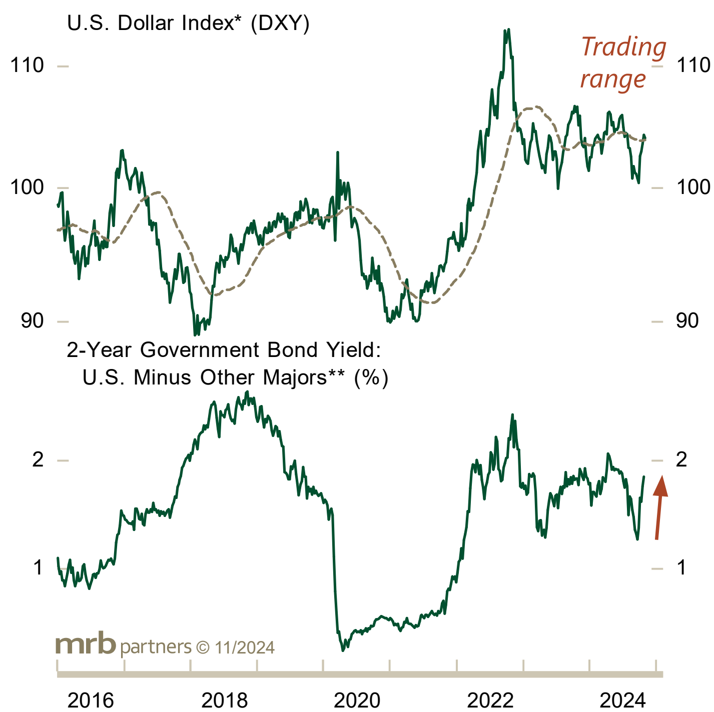
Looking ahead, the dollar's interest rate advantage is likely to persist since Fed rate-cut expectations are likely to be unwound more than those of its major counterparts. Yet an expected modest slowing in the U.S. economy and pick-up in

[12] **MRB**: "***Global Foreign Exchange: Fed-Induced U.S. Dollar Weakness For Now***", September 5, 2024

the rest of the world (including the euro area and Japan) will narrow the relative growth gap. With the dollar elevated, we expect a narrowing of the growth gap to cause the dollar to weaken moderately over the next 6-12 months[12].

The dollar may also have benefited recently from market expectations of a Trump victory and Republican sweep next week. Not only did the dollar initially rise after Trump won in 2016, but the consensus appears to be that the U.S. application of broad-based tariffs would be dollar positive. We take a contrarian view, since the U.S. economy would generally be a net loser from the imposition of Trump's proposed tariffs. Although other countries are more export-oriented than the U.S. and thus could see their exports to the U.S. hurt, their domestic consumers would not suffer the adverse inflationary and growth consequences that the U.S. would face (with the exception of China). The dollar could enjoy a knee-jerk benefit if Trump's tariffs were implemented, but we would expect it to be only temporary.

Chart 18 USD Is Just Following Rates



* Source: Bloomberg
** Other majors based on the DXY weights
Note: - - - 40-week moving average in panel 1

We are skeptical that Trump will quickly implement his tariff proposals, but we view the yen, Swiss franc and Singapore dollar as fundamental safe-havens for those looking to hedge-out dollar risk. More generally, on a 6-12 month horizon, we recommend overweighting the euro, yen, Singapore dollar and an EM currency basket against the U.S. dollar.

The dollar may have benefited from expectations of a Trump victory

Final Word: *Commodity prices should trend moderately higher in response to ongoing global economic expansion, but a major upleg is not on the horizon. Stay neutral within a multi-asset portfolio. We do not expect the U.S. dollar to breach the upper-end of its 2-year trading range and instead expect it to drift moderately lower against select major currencies over the next 6-12 months as the U.S.' relative economic growth advantage over trading partners diminishes.*

Peter Perkins
Partner, Global Strategy

Please see the following pages for highlights of this week's research

This Week's Research

U.K. Policy: What You Need To Know About The Budget And Fiscal Outlook

The shift in the U.K. fiscal target to the public sector's net financial liabilities from net debt may provide Chancellor Reeves with additional borrowing capacity for investment, but it will simultaneously increase the gilt supply that the private sector will have to absorb (**chart 19**). Ultimately, that shifts the supply-demand balance for gilts less favorably and toward higher yields.

Key highlights included:

Public sector borrowing, not the mandate, is the key for fiscal policy.

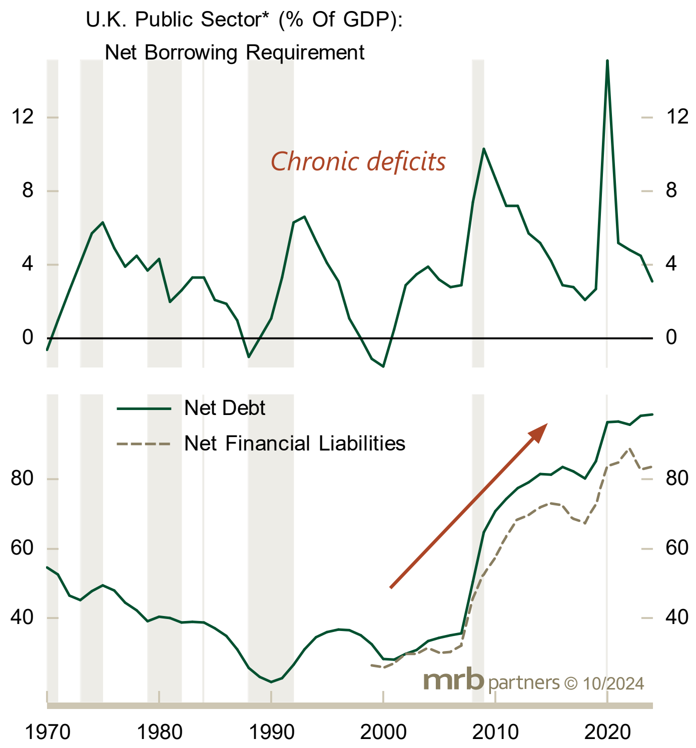
More adjustment will be needed to restore fiscal sustainability.

Bringing down the debt/financial liabilities ratio requires faster economic growth.

Bond investors are the final arbiter of fiscal policy.

A challenging year looms for gilts.

Chart 19 A Big Surge In Debt Since The Great Recession



* Fiscal years; source: Office for Budget Responsibility
Note: Shaded for U.K. recessions

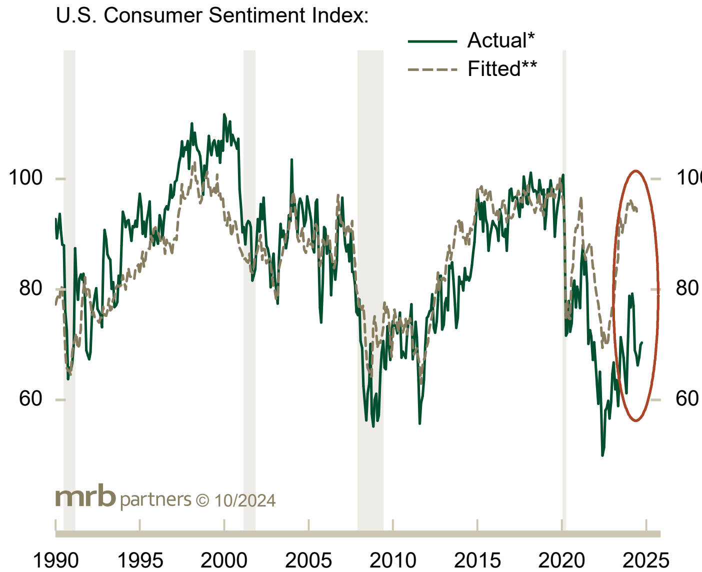
Why Is U.S. Consumer Sentiment Downbeat?

The current U.S. business cycle has seen a unique and sharp divergence between economic activity and surveys of economic sentiment (**chart 20**). MRB's view has been, and remains, that investors should give more importance to actual economic activity, which has been more consistent with the strong underlying fundamentals of the economy, than survey-based consumer and business sentiment gauges. Tepid consumer sentiment is reflective of consumers' dissatisfaction on inflation and does not portend weak consumer spending.

Highlights included:

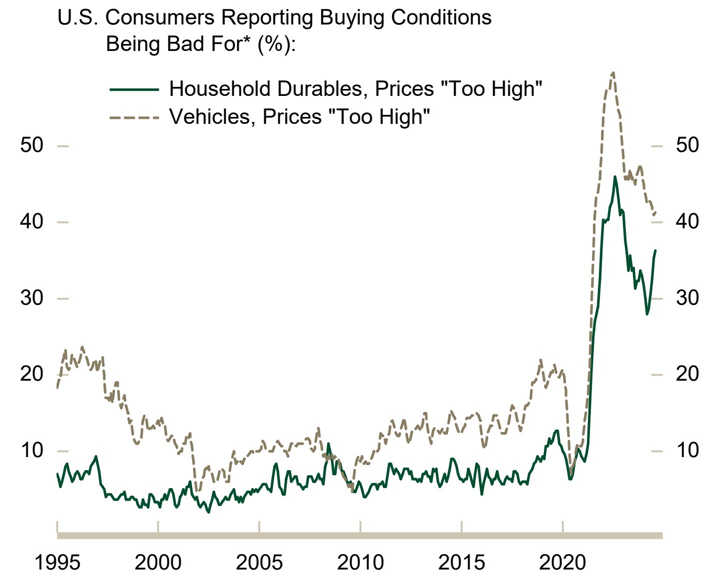
- Downbeat consumer sentiment likely reflects the lingering effects of the post-pandemic rise in inflation.
- The rate of inflation has slowed, but surveys indicate that consumers also care about the level of prices, which remains high (**chart 21**).
- Consumer sentiment also embeds political biases, and it may shift meaningfully depending on the outcome of next week's election.
- So far, weak sentiment has not translated into weak spending. So long as the labor market remains resilient (as we expect), investors should continue to downplay consumer sentiment signals.

Chart 20 **Sentiment Diverged From Its Historical Drivers After 2020**



* Source: University of Michigan
** Generated by regressing sentiment on the unemployment rate, annual growth of stock prices & home prices, and current & expected annual consumer inflation
Note: Shaded for NBER-designated U.S. recessions

Chart 21 **Consumers Are Still Feeling A Sticker Shock**



* Smoothed; source: University of Michigan
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Why We Are Still Overweight Indian Equities

Indian equities have been on a tear since 2020, leaving valuations stretched, the market overbought and amplifying the negative reaction to the recent slowdown in earnings momentum and shift in sentiment that ensued from China's stimulus announcement.

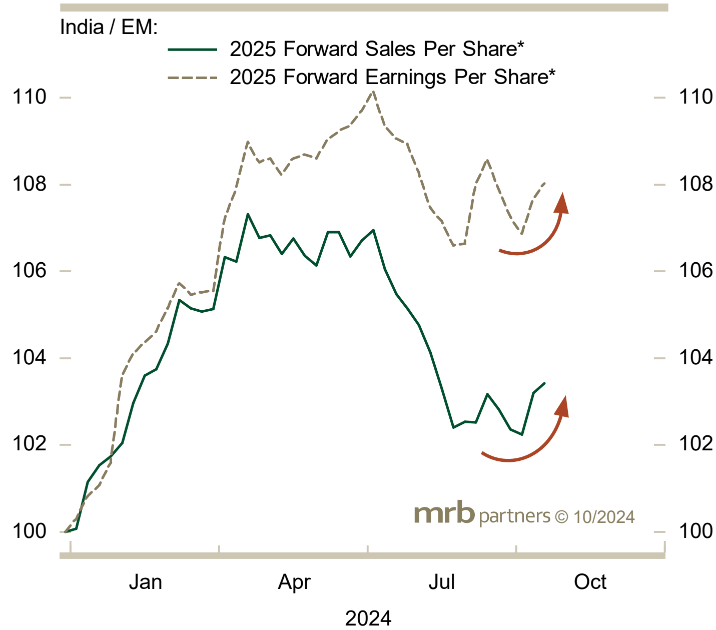
However, the worst has passed for India's economic and earnings growth (**chart 22**), and furthermore, the continuation of China's outperformance is by no means assured. As a result, we see further upside for Indian stocks relative to EM peers over the next 6-12 months.

Still, India's valuations are very extended by most measures, implying that despite the favorable structural outlook, future returns and outperformance are unlikely to match the averages seen since 2020.

Highlights included:

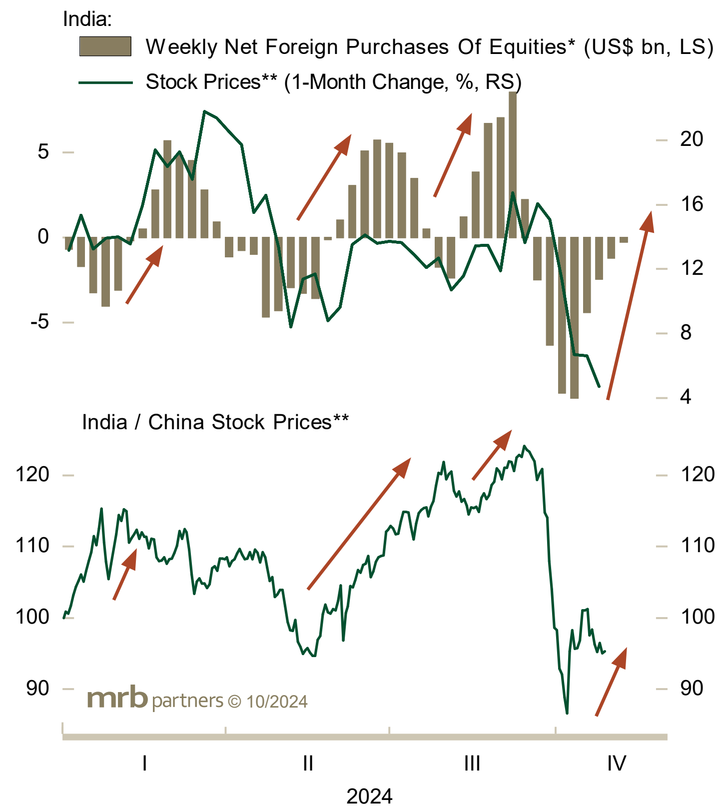
- After several years of outperformance, slowing earnings momentum and China's stimulus announcement have recently weighed on India's equity market.
- However, earnings momentum will firm anew, and a continuation of China's equity market rally is by no means assured. This should help Indian equities resume outperformance over the next 6-12 months (**chart 23**).
- Still, stretched valuations imply that upside (absolute and relative to EM) over the next 12-24 months will be limited compared to the gains seen over the past several years.

Chart 22 2025 EPS Estimates Are Firming Relative To EM Peers



* FY2 estimates; U.S. dollars; rebased; source: I/B/E/S Global Aggregates

Chart 23 Capital Outflows Are Subsiding



* Source: Securities and Exchange Board of India
** U.S. dollars; source: MSCI
Note: Panel 2 is rebased

Absolute Return Strategy: The Return Of The Term Premium

The term premium for U.S. Treasurys could be one of the most important investment issues over the next year, with implications across all asset classes. This report analyzes the potential for a material rise in the term premium and thus bond yields, along with the ramifications for multi-asset strategy.

The key takeaways were:

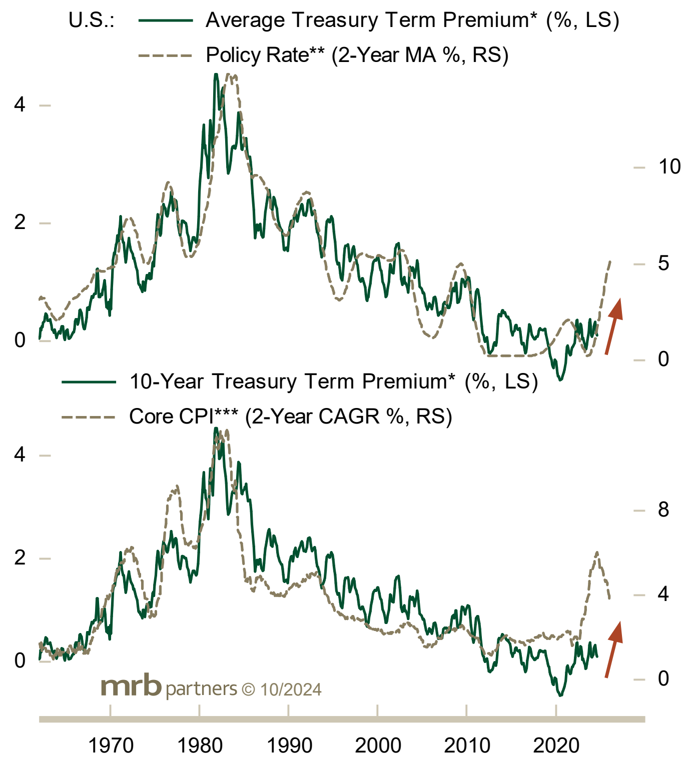
- U.S. Treasury yields have risen steadily since the Fed began its easing cycle, partially unwinding misplaced rate cut expectations. However, bond yields have further upside.

- U.S. bond investors are still far too complacent about major issues such as inflation, budget deficits, post-election policies including protectionism, and the level of the long-term neutral Fed funds rate. All these items have the potential to drive the term premium on U.S. Treasurys much higher (**chart 24**).

- We expect the benchmark 10-year yield to ***eventually*** retest its October 2023 high of roughly 5%, despite a dovish Fed. Stay short/underweight U.S. Treasurys.

- A strong U.S. economy and solid earnings provides support for equities and corporate debt, but elevated valuations and tight spreads provide limited cushion to absorb a spike in U.S. Treasury yields and/or disruptive trade policies. For now, we are maintaining a pro-growth stance, but stay tuned.

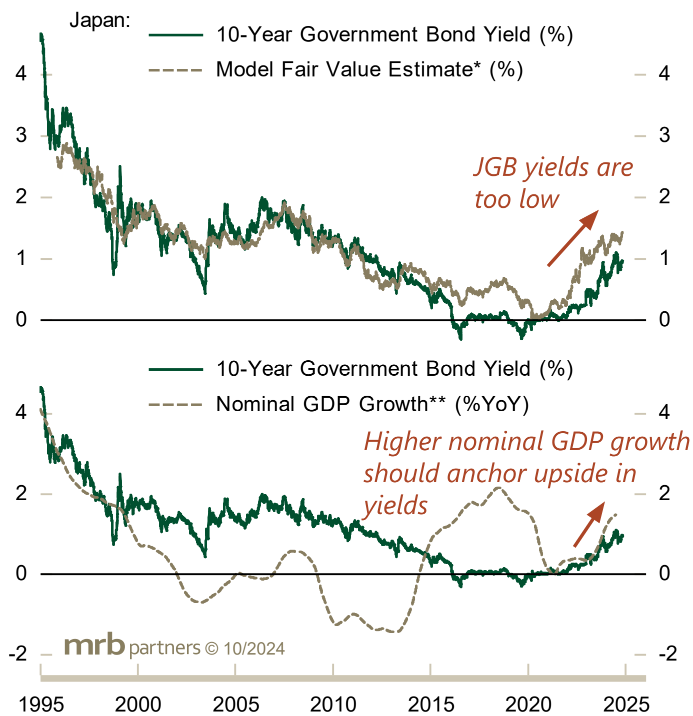
Chart 24 U.S. Treasury Term Premium Is Poised To Rise



* Average of D'Amico, Kim, & Wei (2018) No-Arbitrage Term Structure Model and Kim-Wright (2005) Three-Factor Nominal Term Structure Model; smoothed; back data is ACM term premium; sources: Federal Reserve, NY Federal Reserve
** Advanced 18 months
*** Advanced 18 months; source: U.S. Bureau of Labor Statistics

Bank Of Japan: A Hawk In Dove's Clothing

Chart 25 Japan Yields Have An Asymmetric Tilt To The Upside



* Based on financial market variables
** 5-year moving average; source: Japan Cabinet Office

Japanese monetary policy is very accommodative and the BoJ will soon resume its tightening campaign. We believe that Japan's nominal neutral policy rate is much higher than perceived by bond investors, especially now that Japan has escaped its deflationary funk. In turn, we expect a more hawkish BoJ in the months ahead and see considerable upside in the 10-year JGB yield (**chart 25**).

This report analyzes the outlook for BoJ policy rates and Japanese government bonds. The key takeaways included:

- The Bank of Japan left its policy rate unchanged but hinted that it may soon resume "normalizing" policy. We think this could be as soon as this December. With the U.S. and global economy resilient, we expect the BoJ to hike rates by 25 bps every 3- to 6-months until eventually reaching at least 1.75% (consistent with our estimate of the nominal neutral policy rate).

- The BoJ will continue to be sensitive to the yen as it has explicitly tied fluctuations to the inflation outlook. When the currency is weak, expect to see the BoJ move ahead with its tightening campaign by ramping up hawkishness and potentially following through with a hike. Intervention risk is also more likely.

- We remain underweight Japanese duration and favor curve steepeners in 2s/10s and in the forward market.

- As the BoJ normalizes and reduces its footprint in the local bond market, the aging Japanese population will increasingly become a natural backstop to a severe yield melt-up. While FX-hedged yields have improved for Japanese investors, they still remain inferior to local 10-year JGB yields. This reduces the risk of investment away from JGBs.

- The Lower House General Election delivered a blow to the Liberal Democratic Party, but it is likely to remain the main party in a coalition. There are risks to this but such a scenario suggests for a more expansionary fiscal policy, which will ultimately reinforce the BoJ's tightening campaign.

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