ALPINEMACRO
A Unique Mind On The Markets

GLOBAL ASSET ALLOCATION

October 15, 2024

The China Saga: A New Hope

- Chinese policymakers have capitulated, and the odds are high that a pivotal shift has taken place towards more forceful easing.
- Remain positive on EM relative to DM ex-U.S. stocks, and prepare to shift exposure to outright overweight.
- Overall U.S. economic data remains aligned with a soft landing outcome, but there is a rising possibility that firming productivity is sustaining elevated levels of growth.
- While not our baseline, this scenario reinforces our recommendation to overweight stocks and maintain a neutral stance on duration.
- Beyond energy, commodities are catching momentum given solid underlying fundamentals. Remain overweight gold and base metals.

Global Asset Allocation	Underweight	Neutral	Overweight
Equities			●
Bonds		●	
Cash	●		
Equity Regional Allocation (USD Terms)			
U.S.			●
EAFE	●		
EM		●	
Equity Style Allocation			
Defensive		●	
Cyclical		●	
Value	●		
Growth			●
Large Cap	●		
Small Cap			●
Bonds			
Interest Rate Duration		●	
Treasuries	●		
IG & HY Corporates		●	
Securitized Product			●
FX/Commodities			
U.S. Dollar		●	
Gold			●
Materials/Base Metals			●
Oil		●	

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Theme 1
Has The Cavalry Finally Arrived In China?

Chinese policymakers have reached their "pain threshold" in the face of slumping growth and mounting deflationary pressures. Last month, we noted that a major policy reversal was becoming imminent as the cumulative growth and inflation disappointments had reached levels comparable to those of 2009 and 2016.[1]

The slew of stimulus measures announced can be summarized as follows:

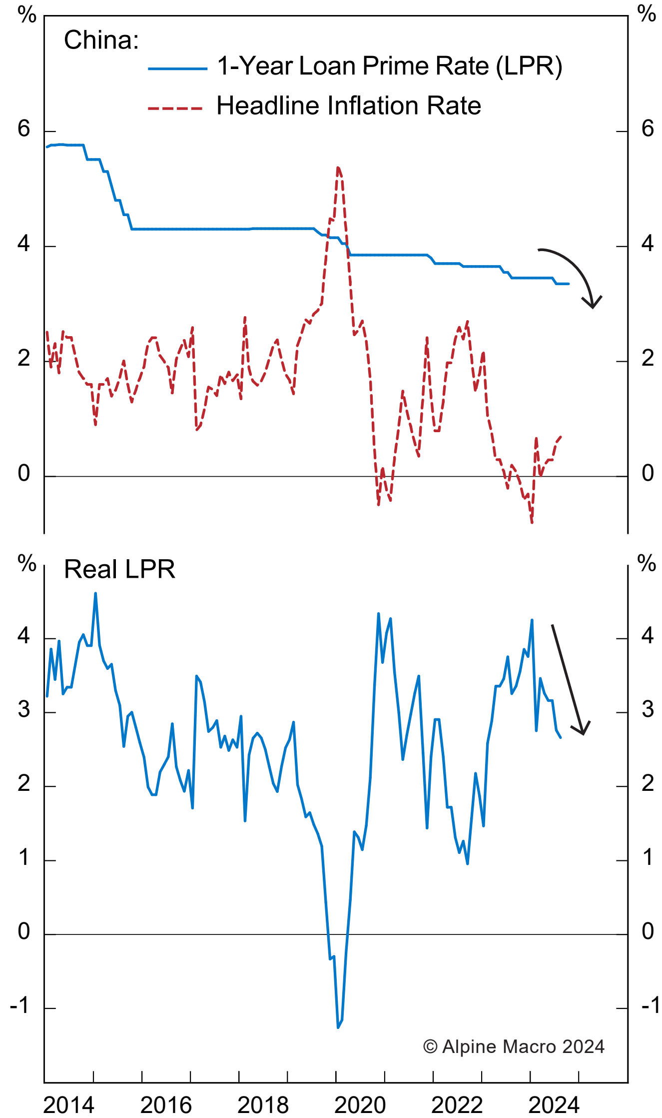
- Monetary easing, delivered *via* cuts to the reserve requirement ratio and the short-term repo rate.
- Housing market relief, through lower average mortgage rates, reduced downpayment requirements, and local government financing to absorb unsold homes.
- Equity market uplift, supported by swap and loan facilities to encourage investing in the stock market and stock buybacks.

Will this easing package be enough to jumpstart growth? Taken on its own, the answer is probably not.

The policy error in recent years has been grave, as dissipating inflation and feeble rate cuts led to a jacking up of real borrowing costs (**Chart 1**). Rates would need to be slashed aggressively in order to truly ease monetary conditions and reflect the deflationary tendency of the economy.

1 Alpine Macro *Global Asset Allocation* "Transition Blips Or Major Shifts?" (September 10, 2024)

Chart 1 Grave Policy Error Needs To Be Rectified



Moreover, China is likely in a liquidity trap, where the absence of loan demand likely hinders credit growth. To achieve a sustainable growth turnaround, any forthcoming stimulus will also need to be fiscal in nature.

Nevertheless, there are highly encouraging signs that Beijing is finally recognizing the severity of the economic situation. The initial exuberant reaction by markets may signal a belief that a pivotal policy shift is truly afoot.

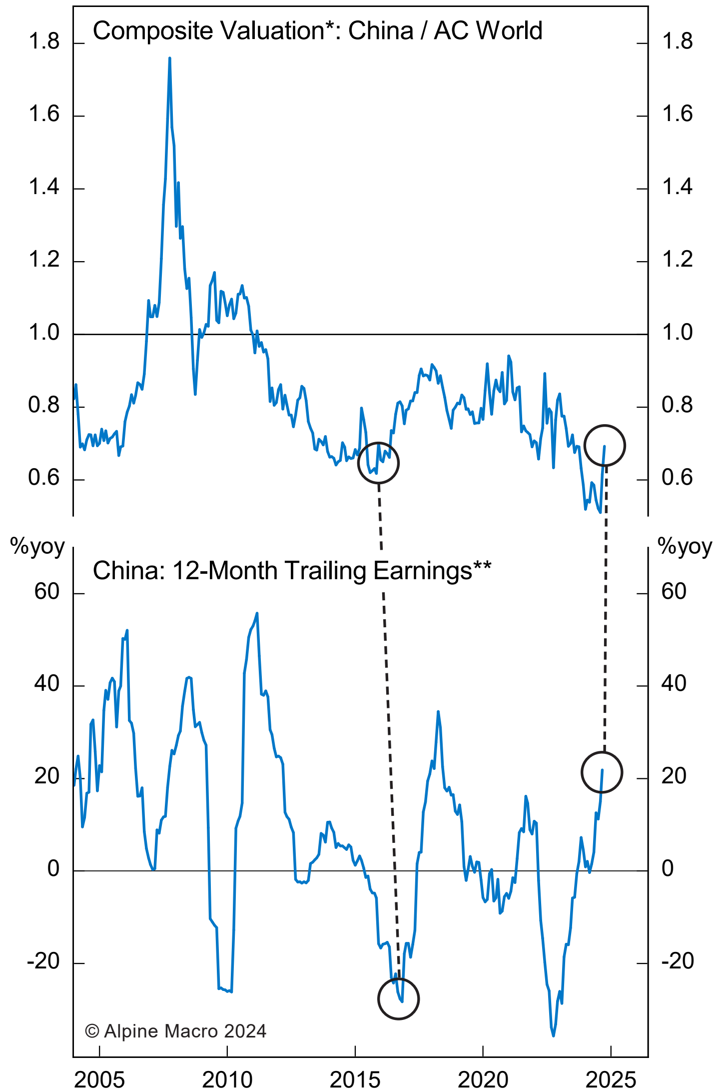
If that is the case, the door is open for further gains in Chinese equities. Despite near-term overbought conditions, domestic stocks remain substantially undervalued. A composite of several valuation indicators shows that China's investable MSCI index still trades at a 30% discount to the global aggregate, reminiscent of the 2014-16 malaise (**Chart 2**, top panel).

The key difference now is corporate profits. Back then, profits were sharply contracting, whereas today they have already surged (**Chart 2**, bottom panel). This underscores the degree to which the Chinese equity market has been burdened by crushed investor sentiment. A meaningful recovery in the latter will be key for unlocking the considerable value that Chinese stocks offer.

We upgraded EM equities to neutral in June, partly on the premise that China had already undergone a significant derating, making it less likely to drag down the broader EM index. On the flip side, any positive policy surprises from China would deliver a fillip to the benchmark. The underlying logic – that EM exposure provides investors with a call option on potential rallies in Chinese stocks – remains intact.

A feature report to be published later this week will outline why asset allocators should continue to favor EM equities over DM ex-U.S. counterparts. We are closely monitoring for additional signs that Chinese policymakers have decisively shifted their stance on reflation before deciding whether to raise our bullishness further and take the EM position to overweight.

Chart 2 **Improved Sentiment Should Unlock Value In Chinese Stocks**



*Average of price/forward earnings, price/trailing earnings,price/cash earnings, and price/book; October data point is estimated
**Expressed in USD terms
Note: MSCI series cover the large/mid/small-cap investable universe; source: MSCI, Alpine Macro calculation

Bottom Line: The Chinese easing announcement may turn out to be a pivotal shift in policy. Remain positive on EM relative to DM ex-U.S. stocks, and prepare to shift exposure to overweight on signs of an open-ended commitment to reflation by Chinese policymakers.

Theme 2

U.S. Growth: Soft Landing Or Gentle Climb?

Positive U.S. data surprises have been rolling in, highlighted by the upward revisions to personal income and the unambiguously strong September employment report. Both GDP "nowcasts" from the Atlanta and New York Fed now peg Q3 growth at around 3%. Talk in some corners of an imminent recession has faded.

We are wary of attaching too much emphasis to the recent numbers. Just in early August, sentiment swung violently toward recession fears after a particularly weak jobs report. Our monthly asset allocation report at the time was titled "Fade The Recency Bias," a cautionary note that feels just as relevant today.

Sorting through the noise, our base case remains that the U.S. economy is on track for a soft landing. Forward-looking indicators continue to point to cooling activity, particularly in the labor market (Chart 3):

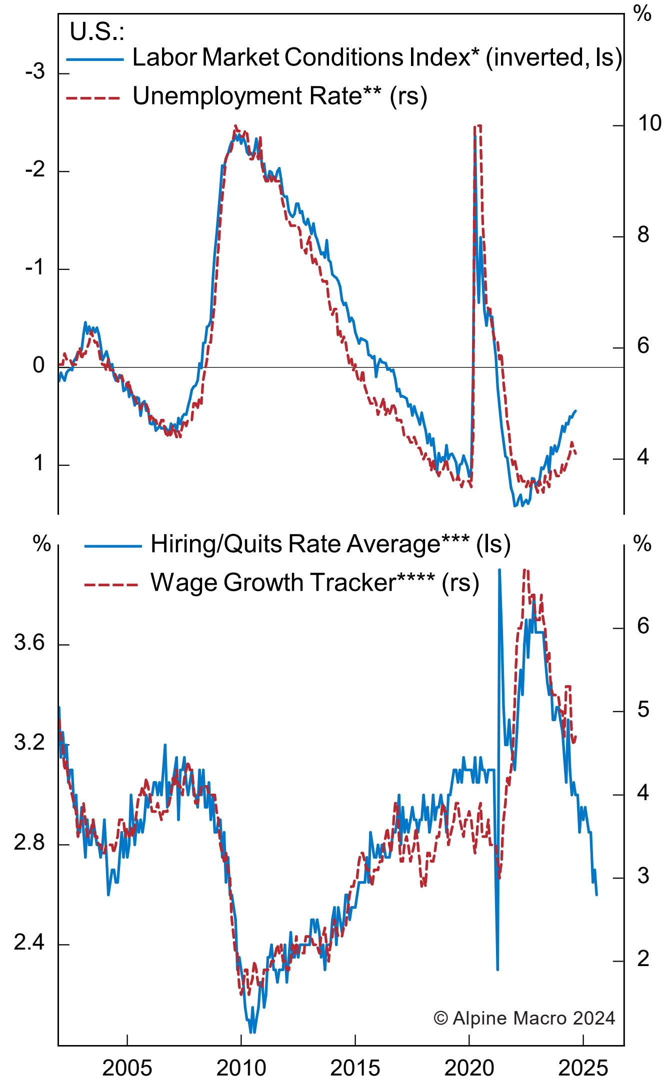
- The reading from the Kansas City Fed's labor market conditions indicator is consistent with an unemployment rate that is closer to 5%.

- Averaging the hiring and quits rate from the JOLTS data suggests that employee bargaining power is materially weakening, and that wage growth should rapidly normalize back to pre-pandemic levels.

The risk to our benign scenario could be that growth does not slow much at all, implying a higher neutral rate and a less restrictive monetary policy stance than widely assumed. An end to household deleveraging, a burgeoning labor force, and an upturn in productivity could all be contributing factors.

While the first two are well understood, there is growing evidence that the latter is also occurring.

Chart 3 More Cooling Ahead For U.S. Labor Market



*Based on level of activity; source: Kansas City Fed
**Truncated at GFC high
***Advanced by 1 year
****Unweighted measure shown as a 3-month moving average; source: Atlanta Fed

Labor productivity typically moves in secular waves, and output-per-hour growth appears to have bottomed in the second half of the last decade. The current pace may even be understated when compared to a proxy measure derived from the gap between the "output" and "employment" components of the ISM survey (**Chart 4**). Unlike the revision-prone official statistics released quarterly, this gauge provides more timely insight into the underlying productivity trend.

The investment implication, to the extent that higher productivity leads to stronger corporate profits, is bullish for stocks. As for bonds, the impact of better productivity growth is less certain as higher potential growth could be offset by subsiding inflation pressures.

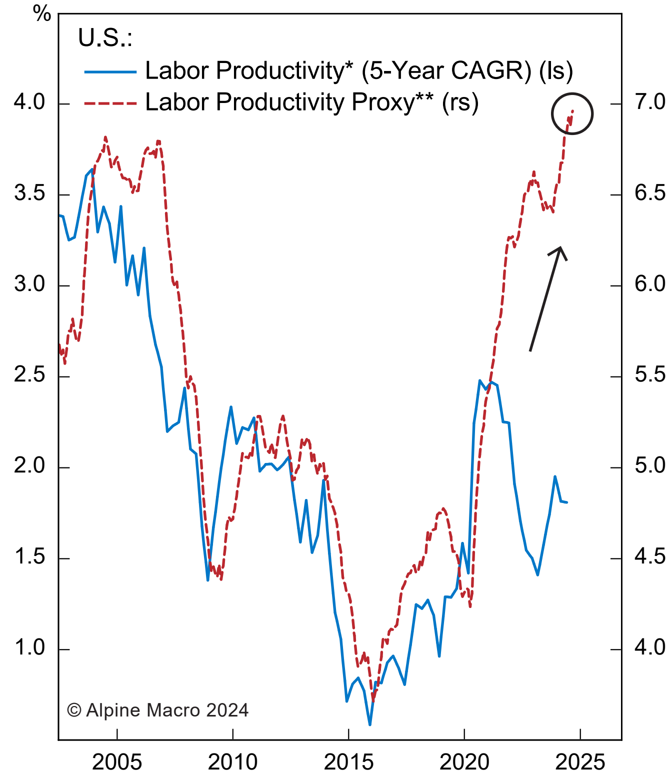
The key point here is that this alterative outcome provides us with a measure of comfort in sticking with an overweight equity and neutral duration stance. Overweighting duration will become warranted only if the 10-year yield moves well above 4%.

Bottom Line: The overall thrust of U.S. economic data remains consistent with a soft landing. However, there is a rising possibility that growth remains resilient on the back of a productivity upturn. Both scenarios support our recommendation to overweight stocks and maintain neutral duration exposure.

Theme 3
Brewing Commodity Momentum

A client recently raised concerns about the apparent sluggishness of commodity prices. They observed

Chart 4 U.S. Productivity Could Be Understated



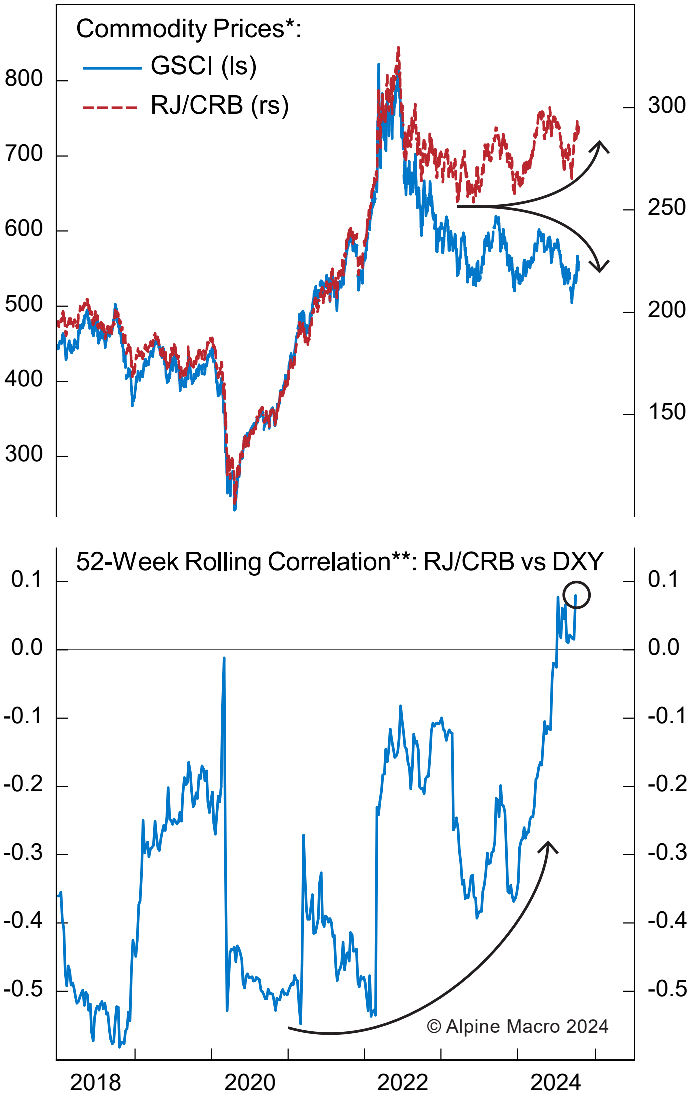
*Non-farm output per hour; source: BLS
**Based on the difference between the 'output' and 'employment' component ofthe ISM survey; proxy is economy-weighted (80% services / 20% manufacturing) and shown as a 5-year average; source: ISM

that the post-pandemic surge was quickly followed by a swift decline, leading to a pattern of lower highs and lower lows. This prompted them to question our overall bullishness on commodities.

It is true that the widely-followed GSCI benchmark has been grinding lower. However, in a rare instance, its trading behavior has materially differed from the less publicized RJ/CRB index (**Chart 5**, top panel).

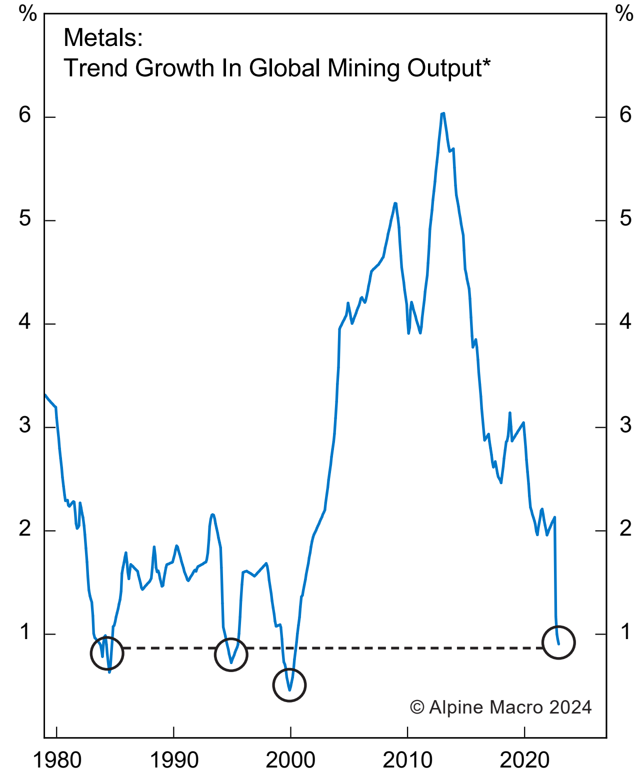
The reason for this divergence is simple. The GSCI is primarily a production-weighted index that reflects the market size of each included commodity. In contrast, the RJ/CRB methodology favors a more

Chart 5 Will The Real Commodity Index Please Stand Up?



*Source: Goldman Sachs, Reuters/Jefferies, Commodity Research Bureau
**Based on percent changes

Chart 6 Mining Production Has Severely Languished



*Expressed as a 10-year CAGR; median of 12 metals; source: U.S. Geological Survey

equal-weighted approach to ensure that no single commodity dominates the index excessively.

This distinction is critical. While crude oil already makes up a substantial 42% of the GSCI, it has accounted for a staggering 85% of the index's movements in recent years owing to its higher volatility. In effect, weakening oil prices have nearly singlehandedly pulled the index down.

We suspect that the RJ/CRB is giving the truer read on the underlying trend for commodities, as it better captures improving market breadth. Notably, commodities have shown zero correlation with the dollar over the past year (**Chart 5**, bottom panel). The strong performance of a wide range of resources, despite a firm greenback, is a fundamentally bullish signal.

Several precious metals and soft commodities have already spiked, and base metals could follow suit. While transitioning to cleaner energy should provide the necessary demand impetus, anemic capital spending and technological bottlenecks cast a shadow over long-term capacity. In fact, global mined production of key metals has grown by less than 1% annually over the past decade, heightening the risk of an impending supply crunch (Chart 6).

Bottom Line: Beyond energy, commodities are catching momentum given solid underlying fundamentals. Clients are encouraged to maintain overweight exposure to gold and base metals.

Bassam Nawfal
Chief Asset Allocation Strategist

	Global Asset Allocation	Underweight	Neutral	Overweight	Rationale for View (3-6 Month Outlook) October 15, 2024
	Equities			●	A mild U.S. growth slowdown coupled with prompt Fed easing is bullish for equities. Easing financial conditions should also reinforce the global manufacturing recovery.
	Bonds		●		Fixed income is fully pricing in a goldilocks growth scenario. This limits the degree to which yields can fall further from current levels and leaves equities with more total return upside.
	Cash	●			The opportunity cost of maintaining a high cash weighting is high as the global easing cycle powers incremental gains for equities and longer duration fixed income assets.
Equity Regional Allocation (USD Terms)	U.S.			●	Despite its high valuation, an expanding productivity gap with the rest of the world reduces the odds of a sustained downturn in U.S. relative earnings growth.
	EAFE	●			Euro area earnings prospects are restrained by contracting exports and a weak credit impulse. Also, a strengthening yen from ultra-cheap levels will likely hinder Japanese common currency equity performance.
	EM		●		A global manufacturing recovery, EM monetary easing, and an ASEAN capital spending boom should bolster EM profits. China's policy pivot could supercharge EM earnings and equity performance.
Equity Style Allocation	Defensive		●		A neutral weighting in defensives provides a valuable hedge against anything more than a benign slowdown in U.S. growth.
	Cyclical		●		With no imminent recession on the horizon and rate cuts on the way, cyclicals should perform reasonably well. However, returns may be tempered if the dollar stays around current levels.
	Value	●			The window for value to outperform growth has likely closed now that rates are heading lower once again. Instead, this style factor should do well in the context of small cap outperformance.
	Growth			●	Growth equities remain on a mania path, with solid earnings growth and declining yields offering key support. Growth stocks outside the Mag 7 could meaningfully contribute in the next performance upleg.
	Large Cap	●			Large caps' relative valuation premium already discounts robust relative margin resilience.
	Small Cap			●	A strong profit revival and a fading of interest rate headwinds should be a catalyst for a relative valuation rerating in small caps.
Bonds	Interest Rate Duration		●		The scope for yields to decline significantly seems limited without a recession, especially as inflation moves closer to target.
	Treasuries	●			Fixed income investors are likely to keep moving out the risk curve given resilient growth and low odds of even a mild recession.
	IG & HY Corporates		●		Potential returns on investment grade and high yield corporates are more limited compared to other credit given the tight starting point for spreads.
	Securitized Product			●	Respectable earnings growth, diminished odds of Fed rate hikes, and a latent capacity/willingness among investors to jump into the fixed income space should favor securitized product.
FX/Commodities	U.S. Dollar		●		Crosscurrents will keep the dollar broadly steady. A reduction in aggressive Fed rate cut expectations should be counteracted by a global cyclical bounce powered by Chinese reflationary efforts.
	Gold			●	The gold bull market will be underpinned by a topping in the dollar and real yields, along with increased hedging demand due to rising geopolitical tensions.
	Materials/ Base Metals			●	The secular uptrend in usage intensity and overall demand via electrification amid weak capacity growth are structurally bullish.
	Oil		●		Crude is likely to be caught in a range as a soft patch in global growth is counteracted by steadfast OPEC+ discipline, peaking U.S. shale output, and depressed global crude and refined product inventories.

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