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.

February 20, 2025

Will higher inflation disrupt portfolio returns?

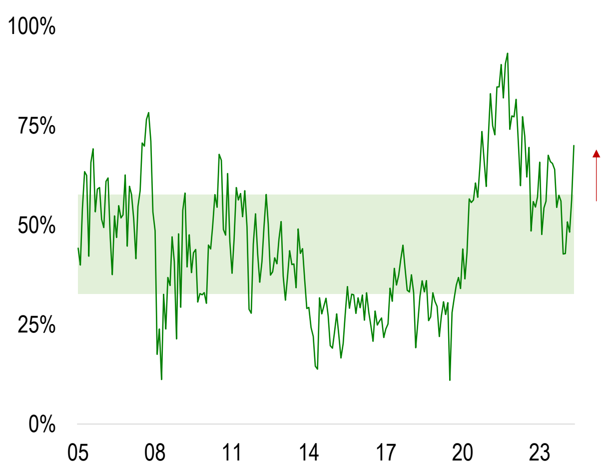
The 60/40 blind spot – President Trump's policy agenda creates uncertainty around global macro prospects. One key source of concern is meaningfully higher inflation owing to protectionist measures. So far, consumers and investors view this largely as a near-term risk, as illustrated by a growing wedge between short and long-term inflation beliefs.

For instance, the latest UofM consumer survey showed a 1-point jump in 12M inflation expectations, but 5-year beliefs remain anchored at their long-term trend. Even if the inflation risks posed by tariffs are moderate, higher inflation beliefs can themselves fuel inflation by encouraging companies to raise prices to limit expected profit losses.

In this context, our US inflation model (built to quantify true inflation risk) now signals a much higher probability of above target inflation than in recent months. We can see this in F1, which tracks model-based probabilities for a 12M horizon. At 70%, the likelihood of above-target inflation is 20 points higher than in Q4/24, and well above its usual range.

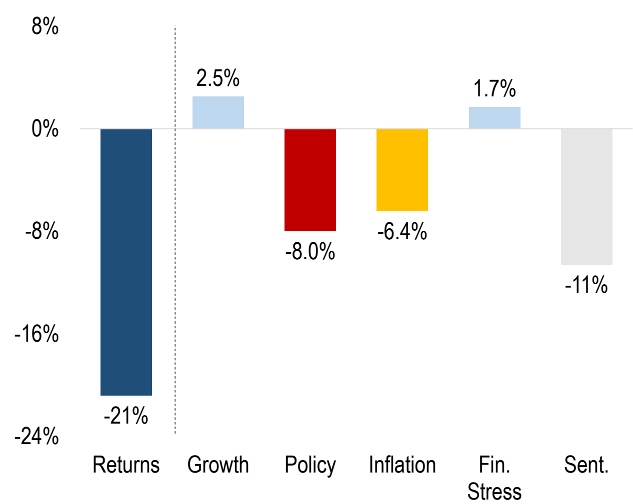
Higher inflation risks are problematic for asset allocators, since equity / bond portfolios are not well equipped to handle inflation surprises. In 2022, our models reveal that high inflation and the subsequent policy response lowered 60/40 returns by neraly 15%, as the surge in long-term yields wiped out the hedging properties of high quality debt (F2).

F1: US inflation risks have increased
Likelihood of above-target inflation - 12M out



Takeaway: Model-based probabilities of CPI inflation exceeding the Fed's target over the next 12M. At 70%, the probability is at its highest level since Q1/23, and well above its normal range. Source: Numera Analytics.

F2: 60/40 does not handle inflation shocks
Drivers decomposition - 60/40 returns (2022)



Takeaway: Global 60/40 porfolios fell 21% in 2022. High inflation and central bank rate hikes alone lowered portfolio returns by around 15%, while bearish investor sentiment amplified losses by an extra 11%. Source: Numera Analytics.

T1: 60/40 AND INFLATION 12M real total returns	Average	US inflation rate			
		<2%	2-4%	4-6%	6-8%
60 / 40 portfolio	6.2%	6.1%	9.3%	5.1%	-8.5%
Stocks	7.1%	6.2%	11%	6.2%	-9.0%
Bonds	3.2%	4.5%	5.0%	2.9%	-4.7%

Note: Table compares real returns on a balanced (60/40) global portfolio during periods of low and high US inflation. Specifically, the columns compare average 12M returns across various inflation ranges since 1978. Source: Numera Analytics.

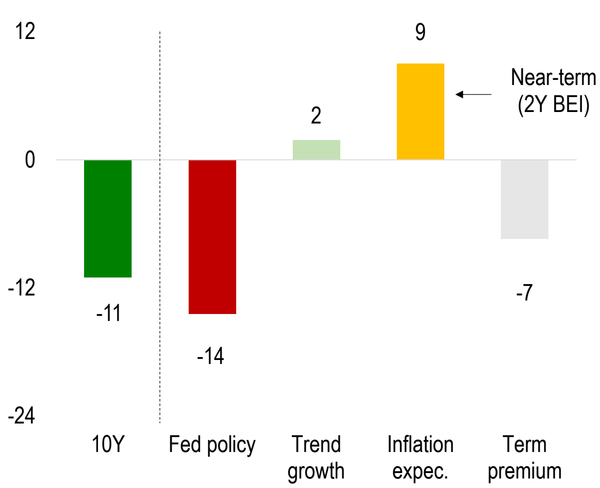
While stocks and bonds both react poorly to higher inflation, the degree of inflation risk matters hugely for positioning. We can see this in T1, which compares portfolio returns across inflation intervals. The 'sweet spot' for the classic 60 /40 mix is the 2-4% range, an environment typically associated with resilient activity and supportive macro policy.

This is exactly the case today, with inflation running at 3%, spending growing well above trend, and Fed rates 100 bps below their peak. Indeed, notice from F2 that 10Y yields are down YTD despite higher inflation risks, as investors price in greater Fed support owing to dovish FOMC communication (specifically, an emphasis on the fact that policy remains 'contractionary'). This has propped up equity valuations, and is allowing for slightly stronger bond returns.

F3*

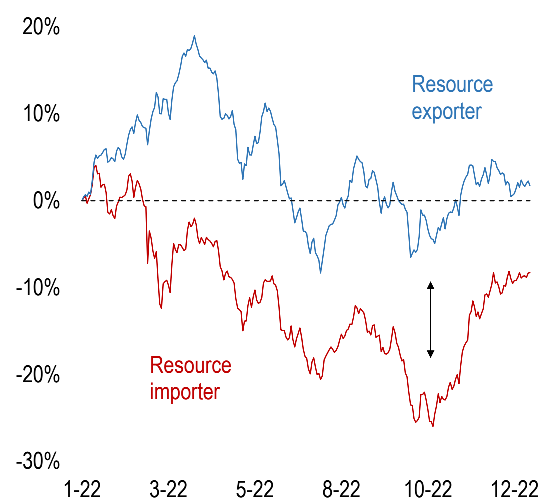
Portfolio returns are typically lower with moderately high (4-6%) inflation, but still not far from their long-term average. It is only when inflation triples G7 central bank targets – as was the case in 2022 – when the strategy fails entirely. This matters because, while our models identify higher inflation risks, 6%+ inflation is still a low probability outcome. Should price growth accelerate, inflation could be as high as 6.2% this year, and 4.7% for full-year 2025.

F3: Yields down despite inflation worries
10Y term premium decomposition - 2025 YTD



Takeaway: Higher near-term (2-year) inflation expectations have lifted 10Y yields by ~10 bps YTD, but yields are still down owing to expectations of greater Fed easing and a lower term premium. Source: Numera Analytics.

F4: Geographic rotation helps mitigate risk
EM equity returns by country profile - 2022

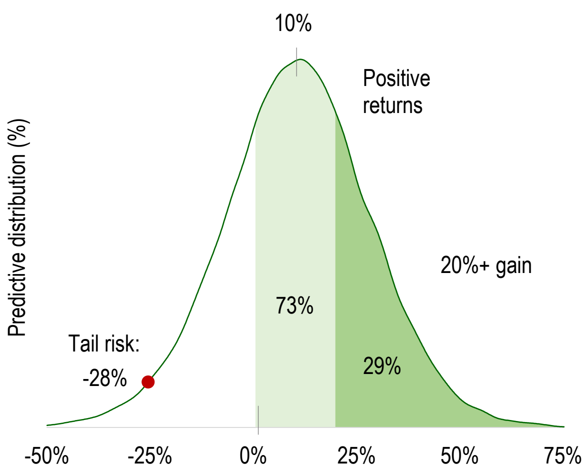


Note: 2022 performance of an equally weighted index of MSCI EM countries, split by resource exporters and importers. Source: Numera Analytics.

Resilient global activity calls for a tactical OW on stocks versus bonds, while we suggest a more conservative stance on 12M holdings, as US growth should decelerate by late 2025. In the near-term, stocks are a better choice against moderate inflation risks, as robust demand should allow firms to increase prices and preserve their margins. With inflation on the rise, a simple hedge is to OW resource exporting countries, much less vulnerable to inflation shocks.

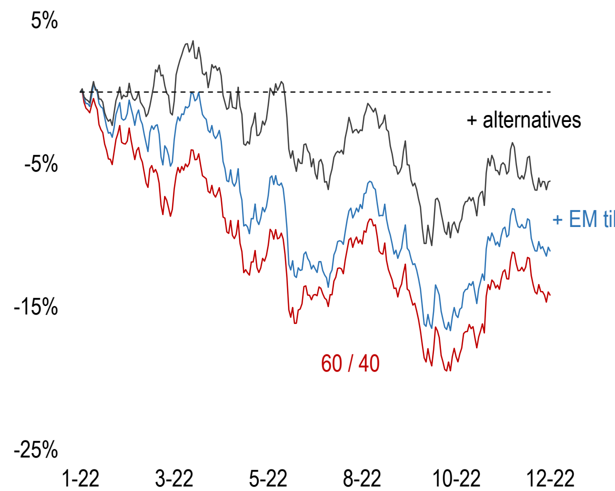
For example, F4 plots EM equity returns during 2022, but split between resource exporters and importers. Both indices are equal-weighted to abstract from size. While importers took a heavy hit, equities in commodity exporting countries showed extraordinary resilience, benefiting from a rotation in EM fund flows and improved terms of trade.

F5: Resource exporters have good upside
MSCI EM Latin America - 12M outlook (%)



Takeaway: There is a 73% probability that LatAm equities deliver positive real returns this year, and a 29% chance of 20%+ gains (recovering last year's losses). The worst potential outcome would be a 28% drawdown. Source: Numera Analytics.

F6: What about expanding asset universe?
Cumulative returns on global portfolios - 2022



Note: Chart compares cumulative returns between a 60/40 global benchmark versus: a) an equity-bond portfolio with a 30% EM resource export tilt, and b) a global portfolio with 30% on commodities and private real estate. Source: Numera Analytics.

Besides their hedging properties, resource exporters offer a variety of additional advantages. At the macro level, the group is benefiting from 'dollar fatigue', as evidenced by a slight pullback in net long dollar positions against G7 currencies this past month. Resource exporters have a high dollar beta, so this shift improves their near-term upside.

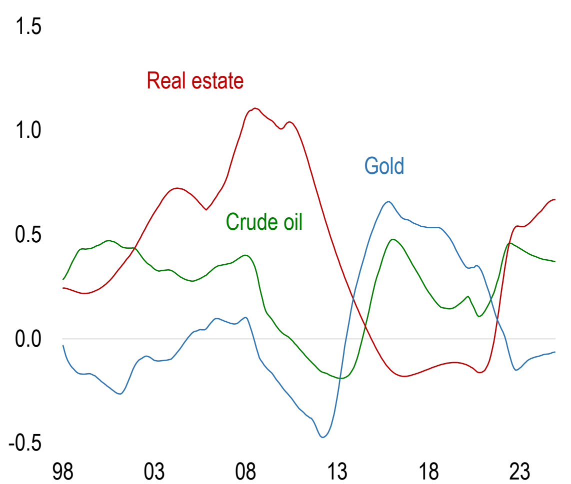
In addition, many resource exporters are trading at attractive valuations. As we discussed in a recent *Percentage Play* on inflation protection, entry point is a crucial element in assessing an instrument's true hedging ability. Battered LatAm equities are (by far) the most attractive option in this respect. F5 shows our updated 12M equity outlook for the region. We find a 29% chance that LatAm delivers 20%+ gains, the highest such probability across equity regions.

Getting creative – One important limitation for portfolio construction is that resource exporters make up a small share of the equity space. Within DMs, Canada, Australia and Norway represent just 6.5% of the MSCI World. LatAm and EMEA have a higher EM weight, but EMs make up a small share of multi-asset portfolios. Since many funds face limits in their degree of rotation, this curbs their ability to act as an effective hedge (blue line in F6).

To overcome this limitation, investors can diversify their asset base by including alternatives. The grey line in F6 shows the 2022 performance of an augmented global portfolio with a 30% weight on industrial commodities, precious metals and private real estate (the NCREIF index). While this 'macro' portfolio also posted yearly losses, these were a lot more modest than the 60/40, and even versus an equity-bond portfolio with a heavy EM resource export tilt.

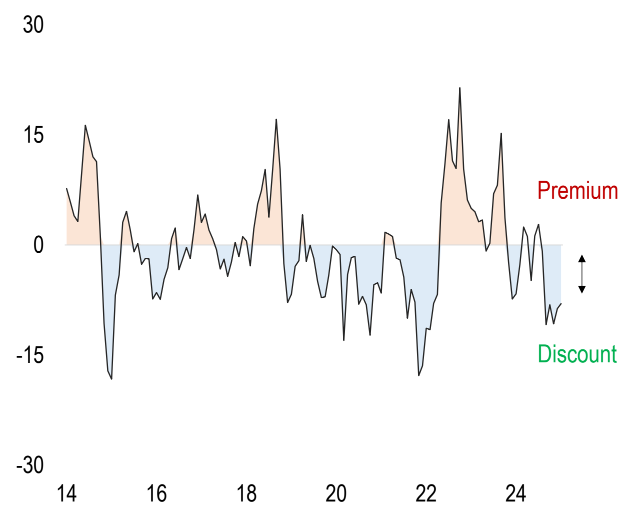
But while hard assets are more resilient to inflation shocks than stocks and bonds, their hedging ability varies over time. We can see this in F7, which tracks time-varying 'betas' for real estate, crude oil and gold. The first two proved effective hedges in 2022, but bullion offered limited protection as aggressive Fed hikes weighed on prices.

F7: Hedging ability fluctuates over time
US inflation 'surprise' time-varying betas



Note: Chart tracks the time-varying link between asset price movements and US inflation surprises, controlling for activity. Betas are Kalman filter estimates from multivariate state-space models. Source: Numera Analytics.

F8: Commodities are trading at a discount
Brent crude oil estimated risk premium



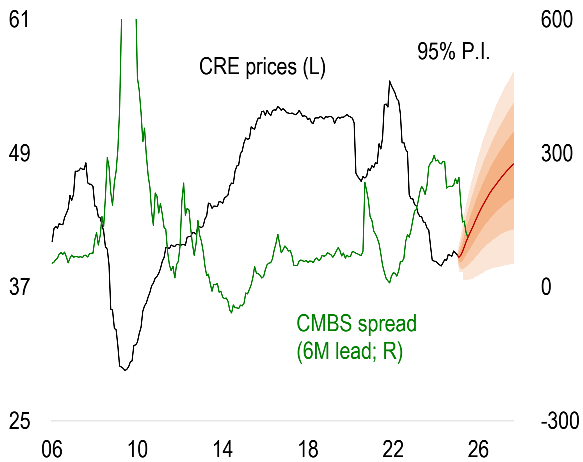
Takeaway: When the risk premium is positive, oil prices are trading above the level implied by macro and industry fundamentals. Conversely, a negative risk premium suggests oil is trading at a discount. Source: Numera Analytics.

In setting portfolio strategy, therefore, it is crucial to assess the underlying macro context and valuations when choosing across alternatives. In the case of industrial commodities, prices stand to gain stronger domestic demand in China and potentially a weaker dollar. Oil in particular should also benefit from weak supply growth (see our *Commodity Outlook* for details), and the fact that weak speculative purchases are keeping prices well below 'fair' value (F8).

Raw materials are an excellent hedge against demand-side inflation shocks, but offer limited protection against supply-side surprises that also hurt activity. Since tariffs are stagflationary in nature (at least in the near-term), adding precious metals helps mitigate downside risk. Gold is the obvious choice, but speculative buying has pushed bullion above 'fair' value. Silver is currently a better alternative, as recent price gains reflect tight market conditions.

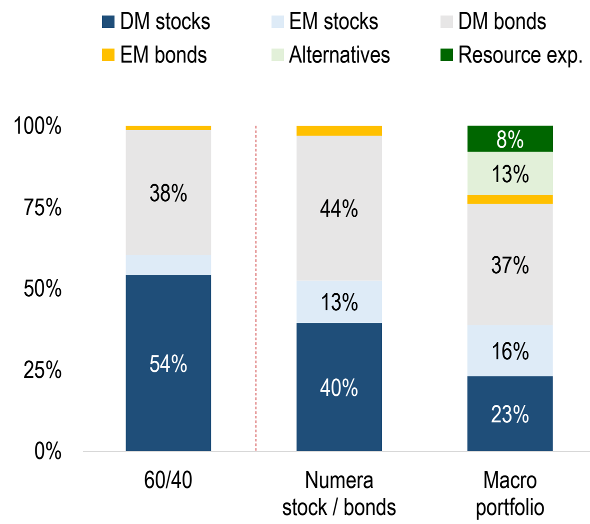
Besides commodities, private real estate also has sound inflation hedging properties, owing to the direct link between rents and inflation. US real estate posted double-digit gains in H1/22, when inflation hit 8%. Its performance reversed the next year as Fed hikes and supply growth weighed on CRE prices, but this is unlikely to occur in 2025.

F9: Real estate has plenty of catch-up
US real CRE price outlook vs. CMBS spread



Takeaway: We find a 95%+ probability that commercial real estate prices increase over the next 3 years (91% for 2025). Falling default risks point to a strong near-term recovery. Source: Numera Analytics, BofAML.

F10: Adding alts improves risk-reward
12M optimal portfolio weights vs. 60/40



Takeaway: Chart compares optimal weights for a global portfolio over a 12-month holding period. 'Macro portfolio' includes commodities, US private real estate, and allows for a rotation towards resource exporters. Source: Numera Analytics.

F9 shows our updated CRE price outlook. We find a 90%+ that prices rebound this year, boosting real estate valuations. A sharp drop in CMBS spreads is a strong near-term predictor, reflecting reduced solvency concerns. The sector also stands to benefit from a slowdown in new construction, especially if growth in the foreign workforce slows.

Does the inclusion of real assets improve the risk-reward profile of global portfolios? F10 shows optimal weights for 12M holdings, relative to a 60/40 benchmark. The first is our standard stock / bond optimization, while the second one incorporates commodities and real estate, while allowing for a greater weight on resource exporters.

The inclusion of these assets noticeably improves the portfolio's expected performance. We can see this in T2, which compares expected returns, the likelihood of positive returns, and left-tail risk for all three choices. The standard equity-bond optimization boosts expected returns by 30 bps, while lowering tail risk by 1 point. Adding alternatives, however, delivers greater 'alpha' potential while significantly reducing downside risk, owing to greater diversification.

T2: Portfolio outlook 12M risk-reward metrics	60/40	Stocks	Bonds	Optimal weights	
				Classic	Macro
Expected returns	5.6%	7.1%	3.3%	5.9%	6.1%
Positive returns	81%	76%	75%	83%	88%
Left-tail risk	-8.5%	-15%	-7.4%	-7.5%	-5.0%

Note: Selected risk-reward metrics from our updated global asset allocation model, for a 12M holding period. Last two columns show metrics for our suggested (optimal) allocation across stocks and bonds, and including commodities and real estate. Source: Numera Analytics.

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.

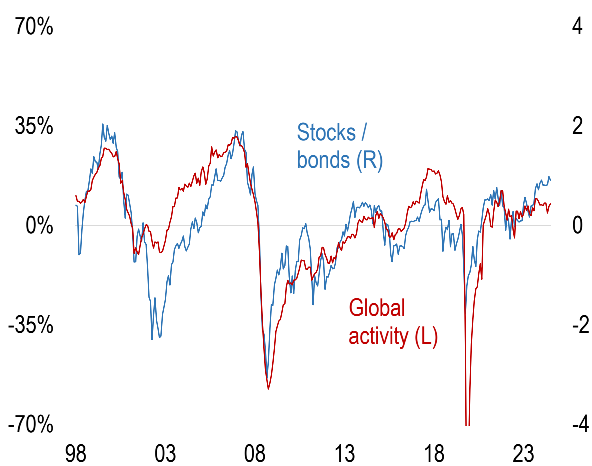
- **US vs. offshore stocks** – *Neutral*. US stocks retain a tactical edge, benefiting from a strong dollar and resilient activity. The upside is lower at longer holding periods, as negative US growth surprises should weigh on valuations and contain USD risks. Across offshore markets, we favour Japan 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.

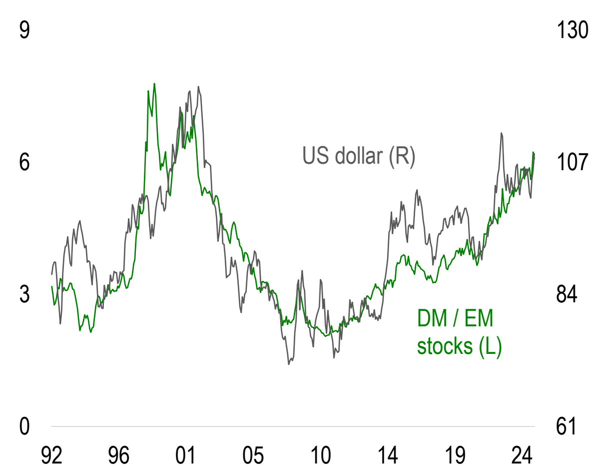
- **DM vs. EM bonds** – *OW EM*. EM debt far outpaced DM bonds last year, benefiting from high coupon rates and narrow spreads amid global macro optimism. This should continue in 2025 even if risk appetite weakens, since resilient EM growth should prevent spreads from widening enough to offset their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

F11: Stocks / bonds vs. global activity
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.

F12: DM / EM equities vs. US dollar index
Relative performance and price index



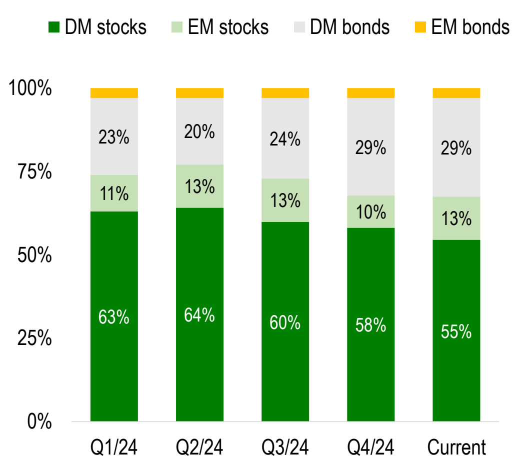
Note: Chart plots the relative performance of DM to EM equities against the tradeable US dollar index (USDX). Source: MSCI, ICE; Numera calculations.

T3: Asset allocation Optimal weights (%)	Benchmark[a]	Positioning[b] Current	Strategic	Longer-term
DM stocks	54%	55%	40%	48%
United States	36%	42%	27%	41%
DM ex. US	18%	13%	13%	7%
EM stocks	6%	13%	13%	10%
DM bonds	38%	29%	44%	42%
United States	33%	24%	40%	41%
DM ex. US	5%	5%	4%	1%
EM bonds	1%	3%	3%	1%
Stocks	60%	68%	53%	58%
Bonds	40%	32%	47%	42%
United States	69%	66%	67%	81%
DM ex. US	23%	18%	17%	8%
EMs	7%	16%	16%	11%

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

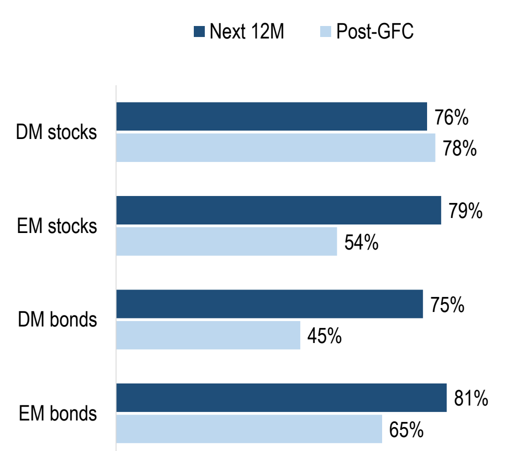
b. Weights maximize risk-adjusted returns for current macro context, over the next 12M, and over the next 5 years.

F13: Numera suggested positioning
Optimal portfolio weights over time



Note: Weights chosen to maximize risk-adjusted portfolio returns for the current global macro environment (see T4 for details). Source: Numera Analytics.

F14: 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
●	●	●

T4: Strategic allocation Positioning by asset	Asset allocation[1]	Country rotation[2]	Key macro factors
DM stocks	Neutral	-	Currently neutral, but reduce exposure as US growth slows
United States	Neutral	Neutral	Tech correction improved entry point; risk of growth slowdown
DM ex. US	Neutral	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	-	Underweight	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	-	Neutral	Downgraded to neutral after recent rally
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	Neutral	-	Gradually increase exposure as G10 easing cycle continues
United States	Neutral	-	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.

2. OW/N/UW relative to DM and EM equity benchmarks. Contact us for individual model details.

Top Conviction Calls & Scorecard:

Global Investment Ideas Top Conviction Calls	Action	Open date	Recently closed	Trailing stop-loss[1]	P&L	Report
AU / DM ex. US stocks	OW	27-Nov-23	31-Dec-24	2.8%	2.8%	PDF
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
Mexico stocks	Short	4-Nov-24	23-Jan-25	2.3%	2.3%	PDF
AUD / GBP	Long AUD	4-Nov-24	-	-4.5%	-0.8%	PDF
US / EM stocks	OW	6-Nov-24	-	4.9%	5.4%	PDF
Germany stocks	UW	13-Nov-24	20-Jan-25	-6.0%	-6.0%	PDF
UK sovereign bonds	Long	18-Nov-24	-	-5.0%	0.6%	PDF
CA sovereign bonds	Long	20-Nov-24	-	-4.0%	2.6%	PDF
EM stocks	Long	8-Jan-25	-	-6%	5.2%	PDF
JPY / USD	Long JPY	8-Jan-25	-	-1%	4.2%	PDF
Japan stocks	Long	27-Jan-25	-	-7%	1.4%	PDF
MXN / USD	Put option	3-Feb-25	-	-65.0%	-57.0%	PDF
Brent futures	Call option	17-Feb-25	-	-70.0%	2.5%	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.