ALPINEMACRO
A Unique Mind On The Markets

GLOBAL ASSET ALLOCATION

December 17, 2024

Cyclicality Trimmings Heading Into 2025

- Equity sentiment is frothy, and stretched positioning weakens the market's ability to absorb negative surprises in earnings, data, or policy.
- The risk of an equity pullback will rise if the Fed hesitates on rate cuts.
- While the equity bull market's cyclical foundations remain solid, trimming overweight exposures and holding off on new risk-on allocations is prudent.
- U.S. energy deregulation, cracks in Saudi Arabia's commitment to production cuts, and drawn-out Chinese stimulus all point to downside for oil prices. Cut positioning to underweight.
- Euro area earnings and multiples will be capped by insufficient policy action and a challenging external environment.

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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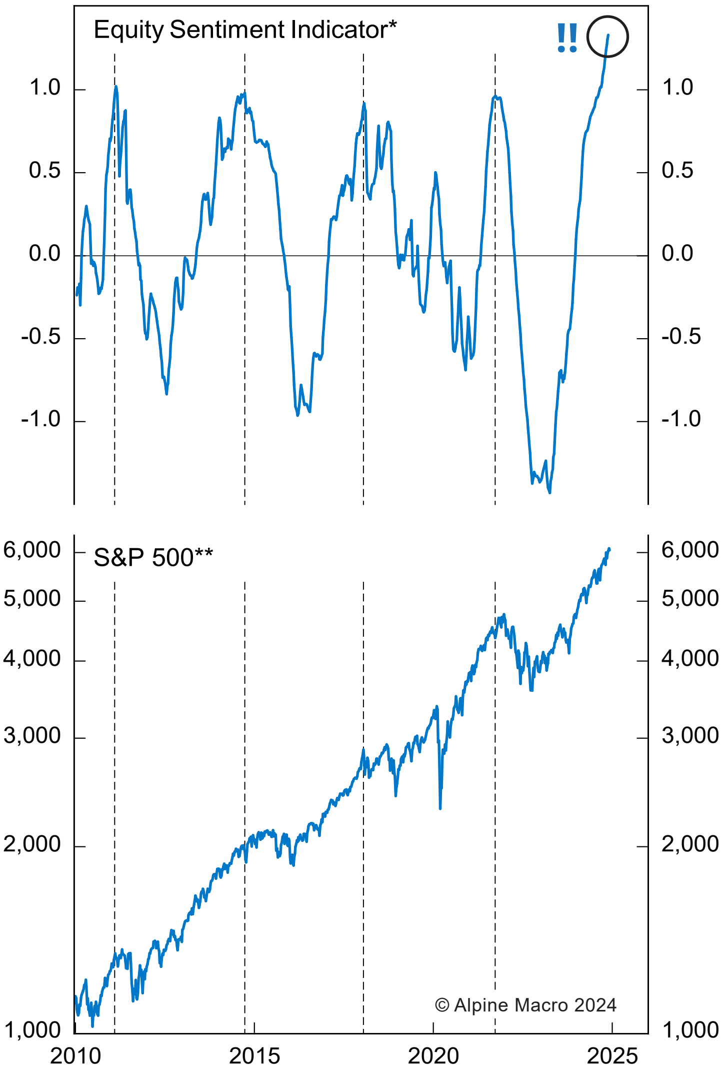
Theme 1
Equity Vulnerability As Sentiment Runs Hot

Our pro-risk stance throughout 2024 yielded exceptional results. We have consistently maintained that a Fed rate cut cycle, coupled with the absence of recession, would be a bullish set-up for stocks, evoking parallels to the second half of the 1990s. Meanwhile, the sweeping Republican victory should act as a force multiplier, provided that policy priorities center on supply-side initiatives rather than trade protectionism.

Nevertheless, risk management dictates a more measured approach heading into the new year. Recent market moves have been swift and pronounced, with additional equity gains likely requiring validation through sustained earnings growth and greater policy clarity.

Sentiment metrics underscore the crowded positioning. Spanning both retail and institutional investors, these indicators have steadily trekked higher and are now uniformly stretched. In fact, our summary statistic has moved well beyond the peak readings of the last 15 years (**Chart 1**). The cyclicals-to-defensives equity ratio provides further pause for reflection after logging its fastest quarterly rise since the dataset's inception a decade ago (**Chart 2**).

Chart 1 Stocks Face Period Of Consolidation Given Overheated Sentiment...



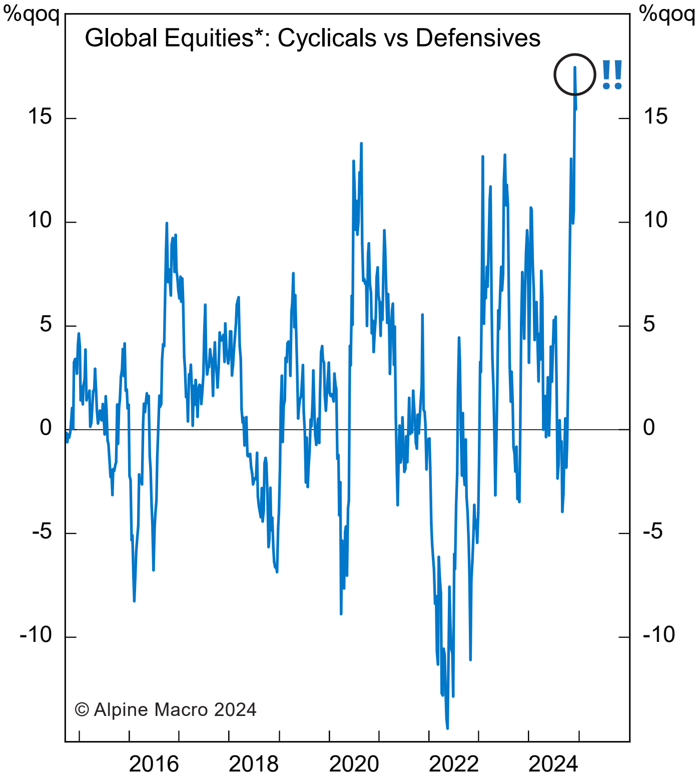
*Comprised of individual investor bullish/bearish spread, advisor bullish/bearish spread, equity put/call ratio, consumer survey of stock price expectations, S&P 500 E-mini net long positioning among asset managers & institutions, and the VIX; shown standardized; source: AAII, Investors Intelligence, CBOE, Conference Board, CFTC, Alpine Macro calculations
**Shown in a log scale

In of themselves, these indicators should not prompt panic. Frothy sentiment says little about the magnitude of pullbacks, if one were to occur at all. However, it does signal a weakening of the market's ability to absorb negative surprises – be it in earnings, economic data, or policy – given elevated expectations.

What could be the adverse triggers?

Contrary to widespread concerns, it is unlikely to be Trump-induced. Our *Geopolitical Strategy* service

Chart 2 ...And Overstretched Cyclicals/ Defensives Ratio



*Large and mid-cap index; source: MSCI

contends that his first year in office will feature headline risks but that he will otherwise govern in a pragmatic and market-friendly manner.[1] This moderation will be shaped by economic and market incentives and constraints, narrow congressional majorities, and institutional hurdles.

A greater risk lies with the Fed. If the disinflationary process continues to stall, any hesitation to deliver expected rate cuts could unsettle markets. Such a scenario would raise concerns over a deteriorating growth-inflation trade-off, providing a pretext for an equity correction.

1 Alpine Macro *Geopolitical Strategy* "Geopolitical Outlook 2025: Risks, Opportunities, And Surprises" (December 12, 2024)

Bottom Line: While the cyclical underpinnings of the equity bull market remain intact, sentiment has outpaced the anticipated tailwinds. Trimming overweight exposures and avoiding fresh risk-on allocations is prudent at this juncture.

Theme 2

Oil Weakness Ahead

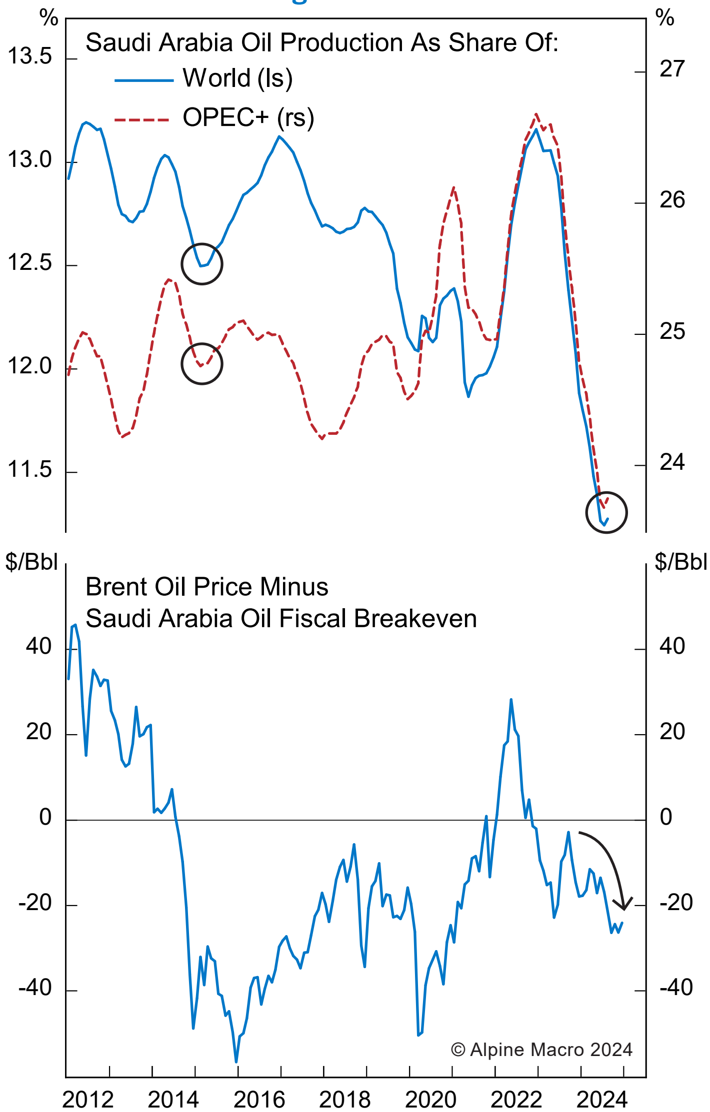
Our oil overweight was downgraded to neutral back in September in light of sluggish Chinese activity and a disconcerting technical backdrop. We resisted the urge to move all the way to underweight, reasoning that $70 Brent oil would act as a price floor given OPEC+ production discipline, the expected rebuild of the U.S. Strategic Petroleum Reserve, and depressed global stocks of crude and refined product.

This call proved to be correct as Brent has remained range-bound between $70-75 since. However, our conviction is wavering as downside risks begin to mount.

First, forthcoming deregulation of the U.S. energy sector could boost oil production. The incoming administration has made it clear that it intends to streamline the permitting process for drilling on federal lands and offshore sites. With most shale basins displaying signs of depletion, such measures could unlock previously untapped reserves that are more cost-effective to develop. Additionally, advancing pipeline projects would alleviate transportation bottlenecks and facilitate the flow of additional oil supply to market.

Second, prices are increasingly irresponsive to OPEC+ extensions of production cuts, the third of which occurred in early December. Therefore,

Chart 3 Saudi Arabia's Pain Threshold Is Getting Tested



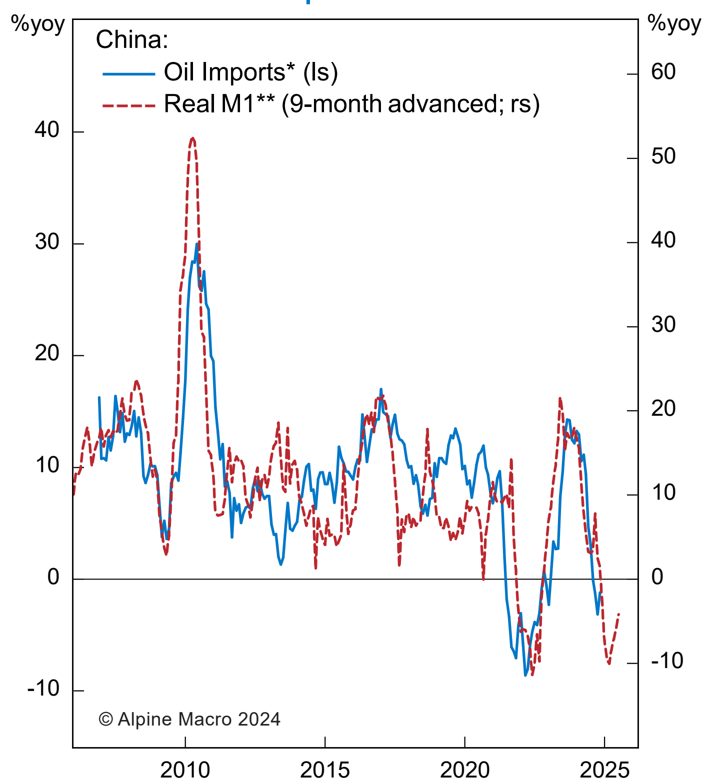
Source: EIA, IMF

there is a growing risk that Saudi Arabia throws in the towel on its output restraint strategy as its pain threshold gets tested (**Chart 3**):

- Saudi Arabia's market share has fallen precipitously in recent years, both globally and within OPEC+. Although some erosion was to be expected, its share is now well below levels seen in late 2014, when it chose to abandon production cuts amid fierce competition from U.S. shale.

- The inability to engineer higher prices is exacerbating the gap between oil revenues and Saudi Arabia's fiscal breakeven. $100 Brent oil is needed to cover the ambitious development projects tied to the country's Vision 2030 economic program.

Chart 4 No Imminent Rebound In Chinese Oil Imports



*Shown as a 12-month moving average
**Deflated by PPI

Finally, it is becoming clear that Chinese policy reflation, though likely to be cumulatively substantial, will be administered in measured doses. This leaves crude import demand vulnerable to weakness in the coming months as the lagged impact of contracting narrow money supply plays out (**Chart 4**).

Bottom Line: The risks for oil are skewing to the downside. Asset allocators should shift to an underweight position, aligning with the modest reduction in portfolio cyclicality discussed in Theme 1.

Theme 3

No Clear Respite For Euro Area Stocks

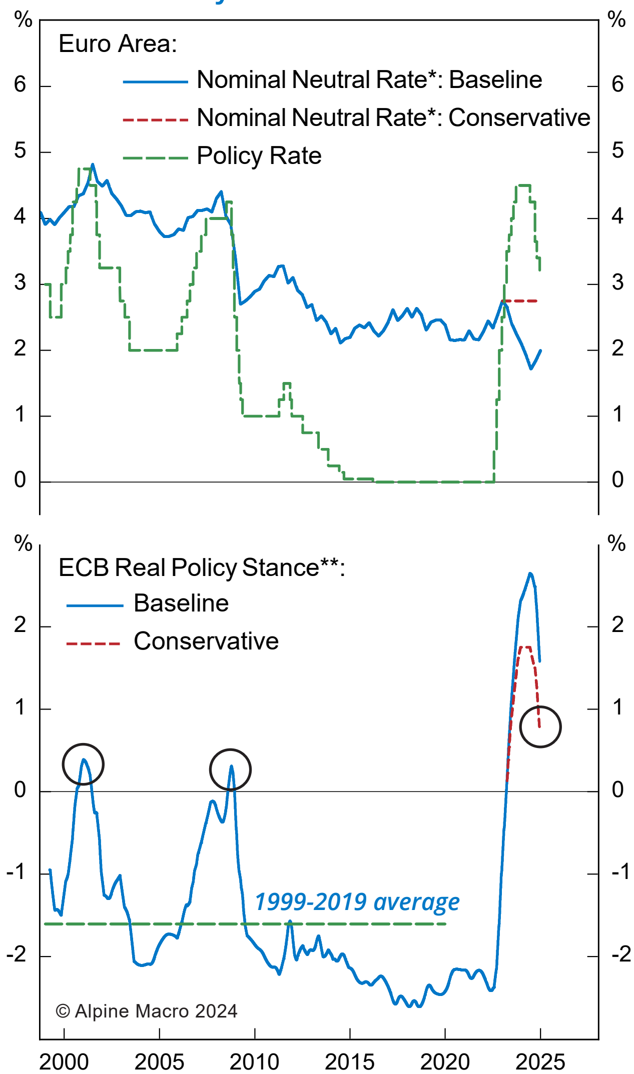
While U.S. stocks face no immediate challenge to their cyclical outperformance, regional allocation decisions elsewhere are more nuanced. We turned more positive on EM equities in June and have since fleshed out why EM firms' profits are poised for a healthy cyclical rebound, irrespective of Chinese reflation.[2]

The euro area holds the short end of the stick as it is stuck in a morass of structural challenges and policy inertia. Although the former will take time to resolve, the latter risks stifling growth further and worsening competitiveness.

For one, monetary policy remains too restrictive given current economic conditions. Chart 5 shows how the ECB is holding benchmark rates well above even a conservative assumption for the region's neutral rate. Given the wide uncertainty around the level of such estimates, it is important to focus on how the real policy rate compares to historical readings. Doing so suggests that the ECB will need to slash rates more than the currently priced-in 125 bps in 2025 to bring policy back to merely a neutral setting.

2 Alpine Macro *Global Asset Allocation* "EM Equities Are Primed To Rally" (October 17, 2024)

Chart 5 ECB Remains Late In Its Easing Cycle



*Based on Holston-Laubach-Williams estimate of the real natural rate of interest, plus 2% to arrive at a nominal figure; conservative estimate assumes neutral rate remains steady from 2023 onwards
**ECB policy rate minus nominal neutral rate estimates
Source: New York Fed, Alpine Macro calculations

Of course, the central bank has been held in check by what it deems to be sticky inflation. This is likely to prove misguided, as the median trend inflation across the bloc has settled around 1.5% for several months. It will only be a matter of time before the headline rate crosses below the ECB's 2% target.

The prospects for a loosening of fiscal policy are also low:

- Despite rising hope that Germany's "debt brake" will be relaxed once a new center-right government is formed early next year, political fragmentation and constitutional barriers will likely make swift reform unlikely. Moreover, fully dismantling the rule appears off the table, with the political discourse primarily focused on making minor adjustments.[3]

- Efforts to rein in France's significant budget deficit, currently at 6% of GDP, recently felled the government. Nevertheless, a potential bond market riot could compel the adoption of fiscal austerity, particularly as the ECB has yet to give any indication that it would step in to support French bonds.

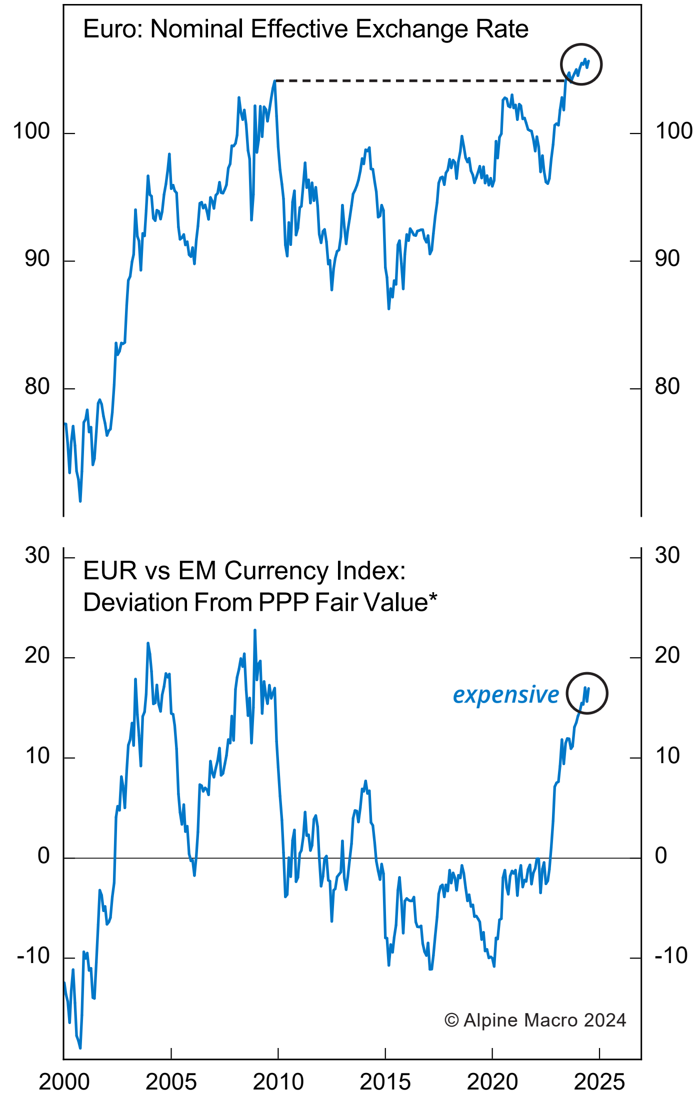
The odds of cyclical relief are further hindered by a difficult external environment. A still-contracting Chinese credit impulse and an arguably overvalued euro (Chart 6) will drag on eurozone exports. Additionally, the mere threat of tariffs could dampen business confidence and discourage investment across the bloc.

Bottom Line: Insufficient policy action and an uninspiring external environment will cap euro area earnings and multiples. A weaker euro could be one release valve, although that will further weigh on common currency returns. Maintain a firm underweight in EAFE stocks.

Bassam Nawfal

Chief Asset Allocation Strategist

Chart 6 Expensive Euro Adds Another Drag To Exports



*Based on relative changes in consumer prices
Source: BIS, MSCI, World Bank, Alpine Macro calculations

3 Alpine Macro *Global Strategy* "Germany: No Early Discharge For The Patient" (December 2, 2024)

	Global Asset Allocation	Underweight	Neutral	Overweight	Rationale for View (3-6 Month Outlook)
	Equities			●	While the equity bull market's cyclical foundations remain solid, stretched positioning warrants a trimming of overweight exposures and holding off on new risk-on allocation.
	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	●			Insufficient policy action and an uninspiring external environment will cap euro area earnings and multiples. A weaker euro could be one release valve, although that will further weigh on common currency returns.
	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		●		Cyclicals, although supported by steady growth and rate cuts, should see their performance tempered by recent outsized gains and a firming dollar.
	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 a broad topping in yields offering key support. Growth stocks outside the Mag 7 could meaningfully contribute to the next performance upleg.
	Large Cap	●			Large caps' relative valuation premium already discounts robust relative margin resilience.
	Small Cap			●	Small cap outperformance is premised on easing financial conditions, brightening earnings prospects, and a potential unlocking of a substantial valuation discount.
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, modest spreads, and a latent capacity/willingness among investors to jump into the fixed income space should favor securitized product.
FX/Commodities	U.S. Dollar			●	The dollar is poised to strengthen on the back of Trump's anticipated policies, which should further shift economic momentum from the rest of the world to the U.S.
	Gold			●	The gold bull market is structurally underpinned by rising geopolitical fault lines, exemplified by the insatiable demand for bullion from non-Western central banks.
	Materials/ Base Metals			●	The secular uptrend in usage intensity and overall demand via electrification amid weak capacity growth are structurally bullish.
	Oil	● ←	○		**U.S. energy deregulation, cracks in Saudi Arabia's commitment to production cuts, and drawn-out Chinese stimulus all point to downside for oil prices.**

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