POSITIONING FOR AN UNCERTAIN WORLD

Our US Asset Allocation report discusses optimal positioning for US stock / bond portfolios, and a rigorous assessment of how changes in the US and global macro outlook affect the risk-reward of US equity styles and sovereign and corporate debt.

February 25, 2025

Positioning against elevated policy uncertainty

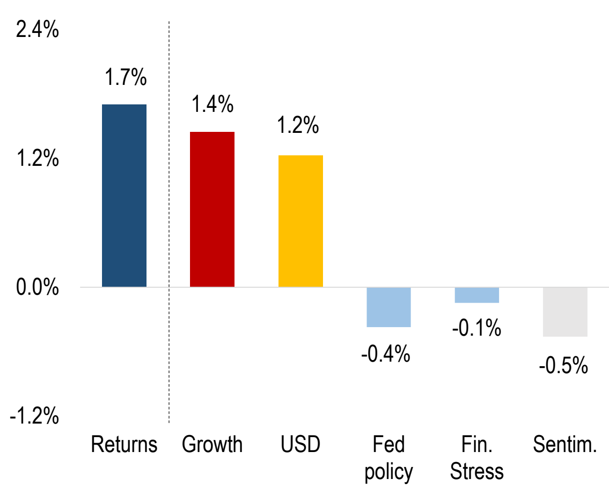
A trickier narrative – US equities last year benefited from a very favourable macro backdrop, as resilient activity drove profit growth and fueled valuations via soft landing optimism. This year, however, is proving more challenging for equity investors: while demand conditions remain supportive, sentiment has normalized, capping overall returns.

We can see this in F1, which splits the contribution of selected drivers to real S&P 500 returns so far this year. A strong economy remains an important tailwind, while stocks are now also benefiting from a weaker US dollar. Yet these factors have been mitigated by weaker speculative purchases, as illustrated by e.g. a pullback in the bull-bear spread.

Reduced optimism, in turn, reflects two key factors: concerns over big tech earnings following the DeepSeek affair and a disappointing earnings season, and uncertainty over the impact of President Trump's protectionist agenda. The latter is having real implications by reducing households' propensity to spend, and delaying investment decisions.

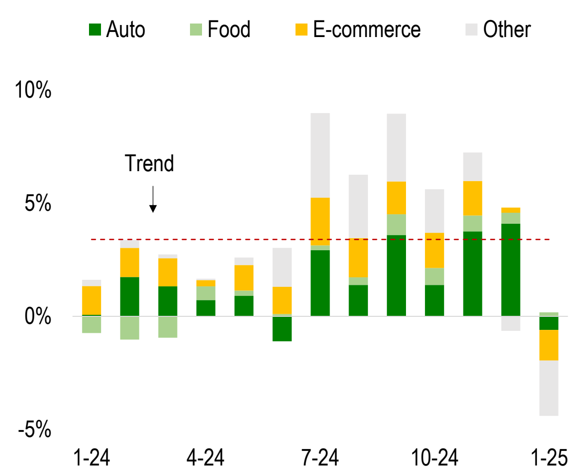
The most noteworthy indicator, in this respect, was a sharp decline in retail sales in January despite strong household balance sheets and resilient job creation (F2). This is consistent with a noticeable drop in the expectations component of the UofM consumer survey, as households worry that tariffs will reignite inflation, eroding their purchasing power.

F1: Investors less optimistic than in 2024
Drivers decomposition - S&P 500 (2025 YTD)



Takeaway: The S&P 500 is up 1.7% in real terms so far this year. All of the gains stem from resilient activity (including strong tech demand) and a weaker dollar. Weaker sentiment has lowered returns by 0.5%. Source: Numera Analytics.

F2: Uncertainty is weighing on spending
Real retail + food service sales (3M run rate)



Takeaway: The real retail sales run rate (annualized growth over the last three months) turned negative following a very weak January reading. All major retail segments posted losses. Source: US Census Bureau; Numera calculations.

T1: S&P 500 outlook Probability forecast	2025 returns by source: Real returns	Real earnings	Valuations	Dividends
Expected returns	5.8%	4.2%	0.2%	1.4%
Positive returns (%)	76%	76%	54%	22%
Left-tail risk	-14%	-11%	-18%	0.8%

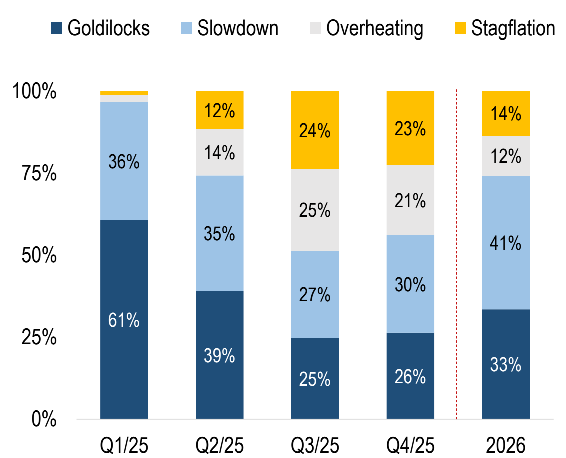
Note: Table shows projected returns by source for the S&P 500 in 2025. Rows compare real expected returns, the likelihood of positive returns, and left-tail risk by S&P component. Source: Numera Analytics.

Wall Street expects the US economy to remain in a 'goldilocks' environment indefinitely, a key factor behind lofty earnings expectations. Policy uncertainty, however, creates deep uncertainty around the macro outlook. For example, earlier this month we found that duties on China, Canada and Mexico (if these remain) would raise unemployment by as much as 0.8 points through reduced confidence, narrower business margins and weaker global activity.

F3 tracks the likelihood that the economy stays in this goldilocks interlude, derived from our flagship US macro forecast model. A regime shift is unlikely for now, favouring an OW equity stance. But the probabilities change meaningfully at longer horizons. High inflation regimes are a distinct possibility in H2 now that inflation expectations have risen. Notice, in turn, that adverse growth scenarios (stagnation, recession) dominate over goldilocks in 2026.

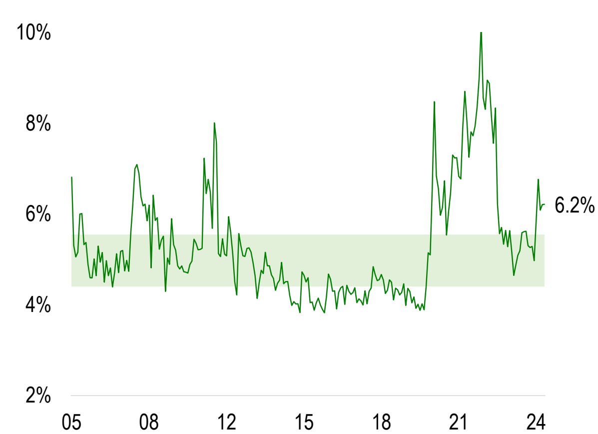
The fact that negative growth surprises remain contained this year should allow for further profit growth. Valuations, in contrast, have considerably less upside, curbing the broad equity outlook (T1). This, in turn, reflects a high probability that earnings growth – while positive – disappoints, and that rising inflation risks weigh on investor sentiment.

F3: Goldilocks is by no means a given
US macro regime probabilities by quarter



Takeaway: The probability the US remains in a goldilocks regime falls noticeably past Q1/25. High inflation regimes become more likely during the end of the year, while weak growth scenarios are dominant in 2026. Source: Numera Analytics.

F4: We cannot *discard* elevated inflation
Maximum projected inflation - 12M ahead (%)



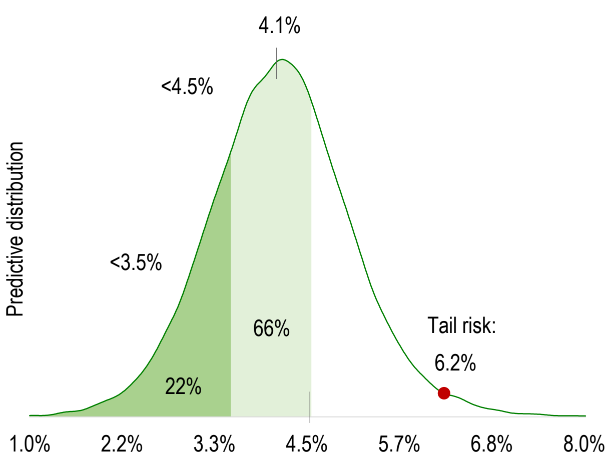
Takeaway: Based on our models, inflation could be as high as 6.2% one year from now. This is considerably higher than the historical range, but still much lower than inflation risks between 2020 and 2022. Source: Numera Analytics.

More generally, ‘sticky’ inflation alters the risk-reward profile of equity-bond portfolios. As we discussed in this month’s *Global Asset Allocation* report, the degree of inflation risks matters for positioning. Rising inflation worries make above-target inflation a likely outcome, but the extent of inflation surprises is considerably lower than in 2021/22. We can see this in F4, which tracks the highest potential inflation rate 12M out, based on our forecast models.

At 6.2% YoY, this is certainly higher than average, but much lower than two years back. When paired with a growing probability of slowing activity and contractionary Fed policy, the inflation outlook still points to more cuts than ‘priced in’ by the market. F5 shows our updated 10Y yield forecast. We find a two-in-three chance that yields trade below current levels one-year out, 15 points lower than at the start of the year, but still well above average.

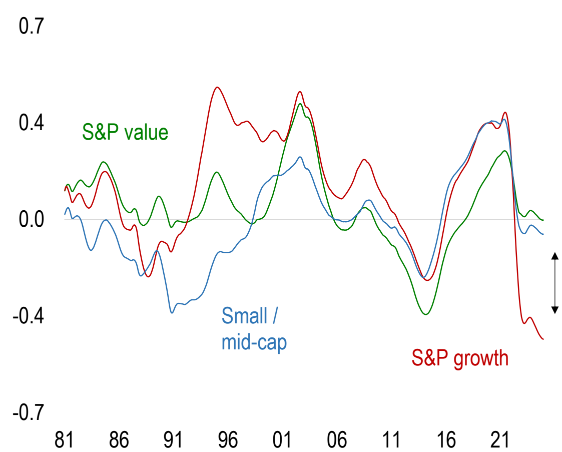
From a multi-asset standpoint, the upside on high quality debt is still high enough to merit a gradual rotation away from riskier assets over the course of the year. Yet given higher inflation risks, TIPS are a better macro hedge than nominal bonds, while duration is less attractive than a few months back, particularly for shorter holding periods.

F5: Long-term yields should still decline
10Y Treasury yield outlook - 12M ahead



Takeaway: There is a 66% probability that 10Y yields fall from their current level (4.5%), and a 22% chance they trade below 3.5% 12M out. The worst potential outcome would be yields at 6.2%. Source: Numera Analytics.

F6: Value offers better inflation protection
Time-varying betas to high + rising inflation



Note: Chart tracks the time-varying link between equity prices and high (above Fed target) and rising inflation, controlling for activity. Betas are Kalman filter estimates from multivariate state-space models. Source: Numera Analytics.

What about the equity mix? Normalizing investor sentiment has pushed tech-heavy growth stocks closer to ‘fair’ value, improving the entry point. Yet we continue to find that value retains an edge at longer horizons, due to a lower sensitivity to adverse inflation surprises (F6) and a higher defensive weighting (a useful feature as spending loses momentum). We find a 65% chance that value outperforms 12M out, compared to 30% over the post-GFC period.

Similarly, notice from F6 that small and mid-cap stocks are less sensitive to high and rising inflation than large-cap growth. Both trade at attractive valuations, improving their upside. However, heightened macro uncertainty and the likelihood of negative growth surprises call for a more cautious stance (hence our suggested neutral stance on T2).

Strategic Asset Allocation:

- **Asset mix** – *Balanced*. In a late cycle, the broad asset mix depends on underlying economic strength. Resilient activity still calls for OW positions on stocks versus bonds (F7). Bonds regain appeal at longer horizons, given a high probability that growth and earnings will disappoint. Yet their upside is weaker than in previous months, as greater inflation risks curb the likelihood of sharp declines in long-term yields, even if these are above 'fair' value.

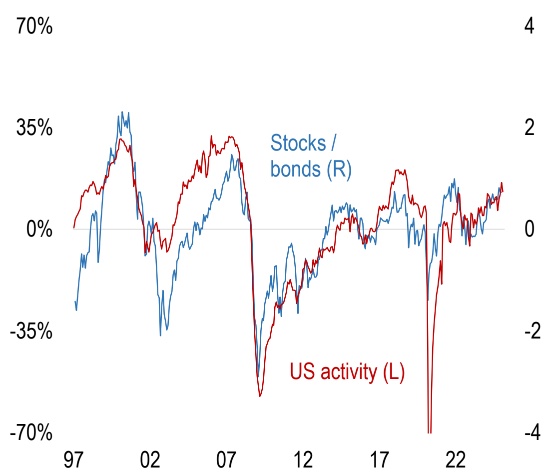
- **Equity style** – *OW value*. The DeepSeek sell-off prompted a rotation away from big tech, pushed growth stocks closer to 'fair value'. This improves their near-term upside, amid resilient activity and strong tech demand. At longer horizons, however, value stocks become increasingly attractive, for two key reasons: they are less vulnerable to adverse inflation surprises, and their higher defensive weighting makes them less sensitive to a mild slowdown.

- **Equity size** – *Neutral*. Small-caps are trading at lower valuations than the S&P 500. However, policy uncertainty and high probability that the economy transitions away from a goldilocks environment dampen their appeal. We do not find that small or large-cap have a distinct edge over a 12M holding period, calling for a neutral stance.

- **Bond quality** – *OW Treasuries*. Corporate (especially high yield) debt has fared much better than Treasuries over the past two years. Risk appetite and resilient activity still favour riskier corporate bonds. However, narrow spreads, Fed cuts and slower growth should allow sovereign debt to make up for lost ground by late 2025.

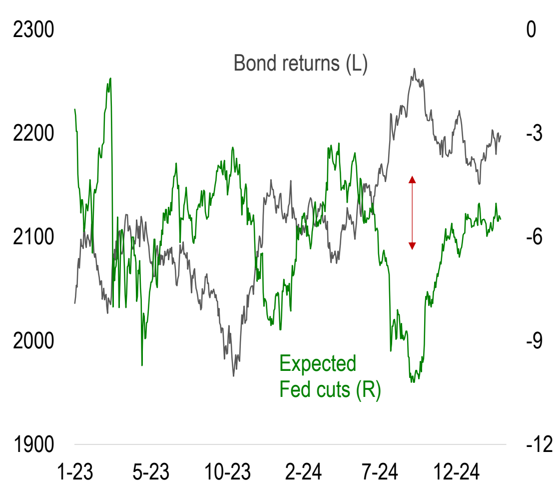
- **Bond duration** – *Neutral*. Markets are pricing higher-for-longer Fed policy. In contrast, our research points to a lower terminal rate. As investors downgrade rate expectations, this would benefit long-maturity bonds. Nevertheless, higher inflation risks offset this tailwind, since long duration debt is also more sensitive to inflation surprises.

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



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

F8: Fixed income vs. Fed expectations
Total returns and cuts by December 2025

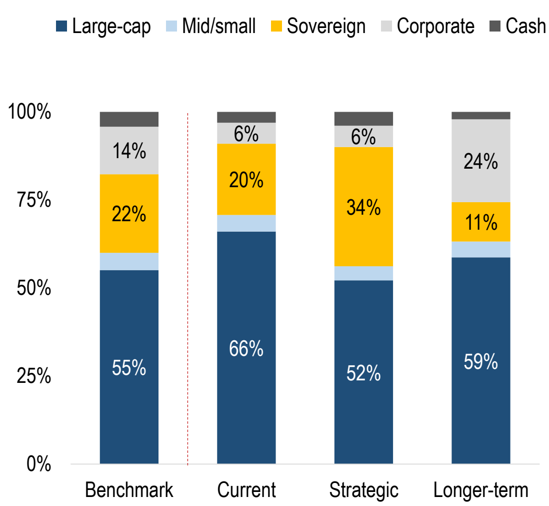


Note: Chart plots total returns on US bond investments against expected number of Fed cuts by Dec. 2025. Source: ICE BofAML, CBOT; Numera calculations.

T2: Asset allocation Optimal weights (%)	Benchmark	Positioning[a] Current	 Strategic	 Longer-term
Large-cap stocks	55%	66%	52%	59%
Growth	30%	39%	22%	26%
Value	25%	27%	30%	32%
Mid-cap stocks	3%	3%	3%	2%
Small-cap stocks	2%	1%	1%	3%
Sovereign bonds	20%	16%	29%	10%
Corporate bonds	14%	6%	6%	24%
Investment-grade	11%	4%	6%	23%
High yield	2%	2%	1%	1%
Inflation-linked bonds	3%	5%	5%	1%
Money market	4%	3%	4%	2%
Stocks	60%	71%	56%	63%
Bonds	40%	29%	44%	37%

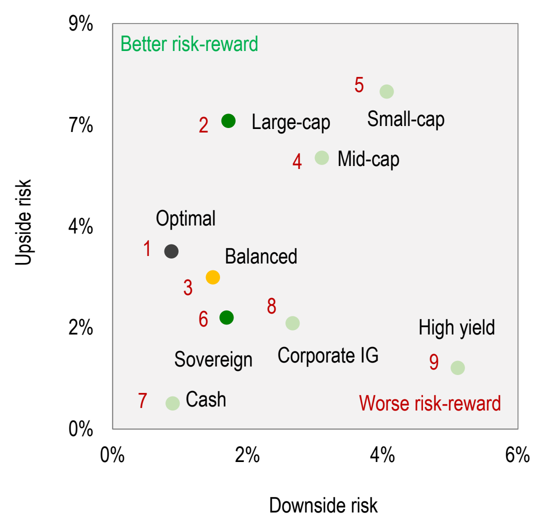
a. Optimal weights maximize risk-adjusted portfolio returns across stocks and bonds for the current US and global macro context, over the next 12M (strategic), and over the next 5 years (longer-term).

F9: Numera suggested positioning
Optimal weights by investment horizon



Note: Optimal weights maximize risk-adjusted returns for the current macro context, over the next 12M, and over the next 5 years. Source: Numera Analytics.

F10: Strategic US asset allocation
Risk-reward comparison by asset



Note: Chart compares ratio of upside to downside risk across US stocks and bonds over a 12-month holding period. Source: Numera Analytics.

Top Conviction Calls & Scorecard:

US Investment Ideas Top Conviction Calls	Action	Open date	Recently closed	Trailing stop-loss[1]	P&L	Report
Materials stocks	Long	3-Oct-24	18-Dec-24	-8.0%	-8.0%	PDF
Real estate stocks	Long	21-Oct-24	-	-9.0%	-2.4%	PDF
S&P equal weighted	Long	30-Oct-24	-	-5.0%	2.7%	PDF
US aerospace & defense	Long	6-Nov-24	-	1.0%	2.8%	PDF
US refiners / E&P	OW	6-Nov-24	-	-8.0%	1.4%	PDF
US diesel	Call option	20-Nov-24	15-Jan-25	66%	66%	PDF
US gasoline	Call option	20-Nov-24	15-Jan-25	47%	47%	PDF
US semiconductors	OW	11-Dec-24	27-Jan-25	5.0%	5.0%	PDF
OW defensives	OW	8-Jan-25	-	-5.2%	1.7%	PDF
Long duration	Long	8-Jan-25	-	-2.0%	3.1%	PDF
UW high yield	UW	8-Jan-25	-	-4.1%	0.1%	PDF
US inflation-linked bonds	Long	3-Feb-25	-	-3.0%	0.3%	PDF
US semiconductors	Long	3-Feb-25	-	10.0%	14.1%	PDF
US comm. serv.	Long	5-Feb-25	-	-5.0%	-0.7%	PDF

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

Benchmarks:

- **Stocks**: Large-cap: S&P 500 (growth + value); Mid-cap: S&P midCap 400; Small-cap: Russell 2000
- **Bonds**: ICE BofAML US Treasury, US Corporate and US High Yield, US TIPS; Money market: 3-month T-bill