NUMERA ANALYTICS

ASSET ALLOCATION

US EDITION

EMBRACING UNCERTAINTY

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.

January 23, 2025

Will bond spreads remain ‘narrow-for-longer’?

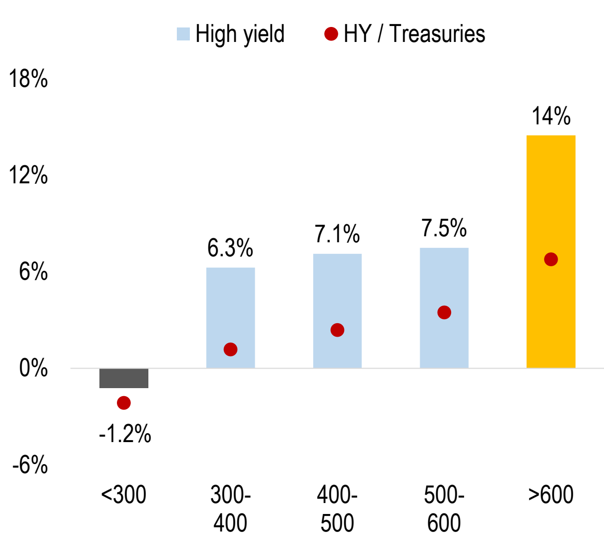
All about growth – 2024 proved very favourable to risky assets, with large-cap stocks delivering 20%+ gains for the second consecutive year. In contrast, fixed income instruments continued to struggle, despite lower inflation risks and the start of the Fed easing cycle. In real terms, bond investments fell 1.5% on aggregate and are 20% below their pre-2022 levels.

But while most FI categories fared poorly, high yield debt once again proved an exception. High yield outpaced the total fixed income universe by 5.6% last year, following excess returns of 8.4% in 2023. In fact, high yield has even posted similar returns than value and small/mid-cap stocks during this period, with about half the monthly variability.

OW high yield therefore helped dampen portfolio volatility, even if it has a higher correlation to stocks than other bonds. In deciding whether to keep favouring yield over quality, it helps to understand the factors behind strong returns. At the most basic level, their strong showing reflects attractive coupon payments and a sharp compression in spreads.

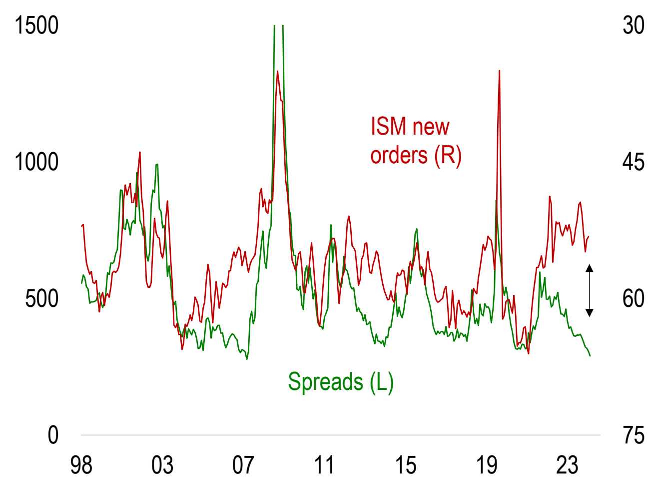
The spread between HY and 10Y Treasury yields currently stands at 225 bps, far below the typical range observed even in the most benign macro regimes. Much like high P/E ratios for equities, tight spreads make for a bad entry point. We can see this F1, which compares forward returns by spread level. When these are lower than 300 bps, HY bonds usually underperform.

F1: Tight spreads precede lower returns
12M forward bond returns by spread range



Note: Average returns on high yield bonds since 1986 in the 12M following spreads falling within a certain range. Source: Numera Analytics.

F2: Dynamics defying conventional links
High yield bonds spreads vs. ISM new orders

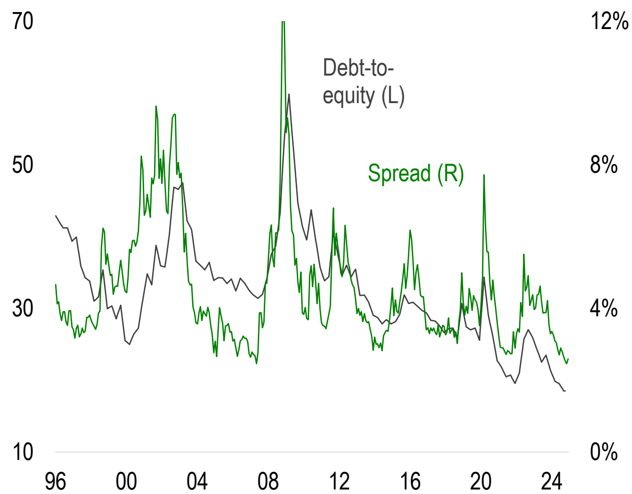


Note: Chart plots high yield bond spreads versus a weighted average of the ISM new orders manufacturing and service indices. Source: BofAML, ISM.

As is the case with P/Es, however, spreads are not a great timing tool. Spreads were already close to 300 bps this time last year, but narrowed even further. Still, it is rare for them to stay this low over a sustained period. Indeed, the only time that they traded at such low levels for more than a year was in 2006/07, preceding their highest-ever jump.

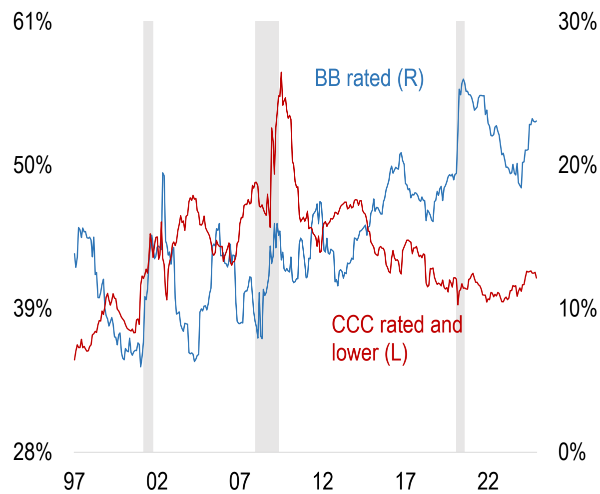
Will spreads break this historical pattern, and remain 'narrow-for-longer'? Spreads reflect a combination of liquidity and default risk, so their level depends on financing costs and growth prospects. Most leading activity indicators imply much higher levels than those observed today. For example, there is a clear break with the ISM new orders index (F2). When large gaps arose in the past (e.g. 2006, 2013), HY usually posted weak returns over the next 12M.

F3: Refinancing helped reduce default risk
Debt-to-equity ratio vs. high yield spreads



Note: Chart compares the debt-to-equity ratio for non-financial corporations to the spread between high yield bonds and Treasury yields. Source: BEA, ICE BofAML.

F4: Improved debt quality also beneficial
High yield bonds by credit rating (share %)



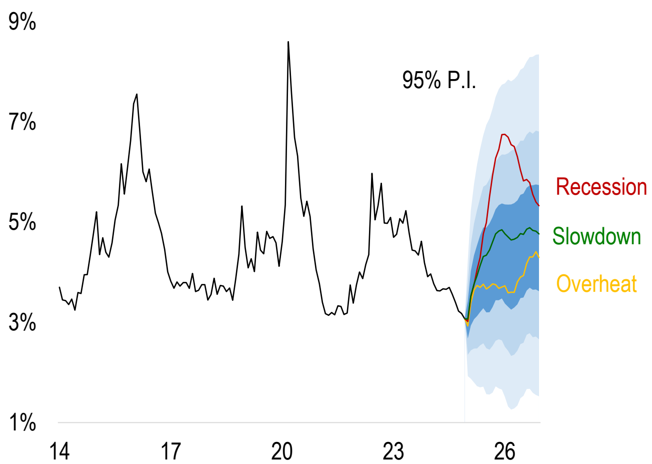
Note: Market cap share of corporate debt rated BB and CCC and lower in the ICE BofAML high yield bond index. Source: ICE BofAML; Numera calculations.

Yet even if leading indicators point to weaker conditions ahead, the economy has proven remarkably resilient to a high rate environment. This has fueled 'soft landing' optimism, boosting investor sentiment and easing solvency concerns. In addition, there are at least two fundamental factors keeping spreads tight. One key source of support has been a sharp reduction in debt levels relative to corporate assets, partly due to mass refinancing in 2020/21 (F3).

Another factor containing default risk is a significant improvement in creditworthiness. We can see this in F4, which plots the share of non-IG debt rated BB and CCC and lower. Firms with weak balance sheets make up a small share of the HY universe, as many defaulted in 2020. Conversely, the BB share is much higher than in past late cycles.

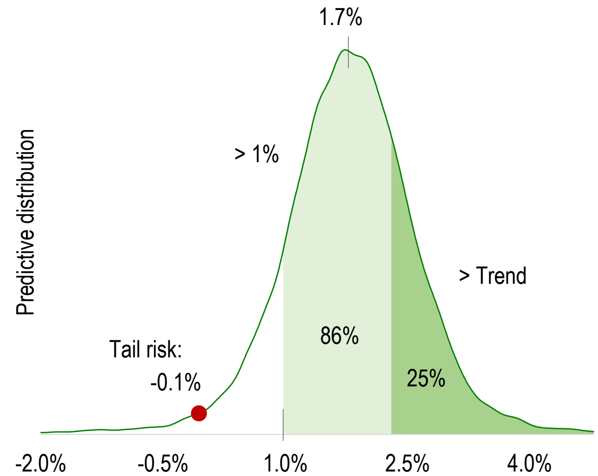
One potential challenge this year is that many issuers will have to refinance their debt at higher rates, since the average maturity of HY debt has fallen drastically since COVID (it is now less than 4.5 years, two less than pre-2020). As long as growth remains resilient, however, strong cash flows should temper fears that firms will struggle to meet their interest payments. Ultimately, this means that the attractiveness of HY debt depends on US growth prospects.

F5: Growth prospects crucial for high yield
HY bond spreads scenarios, 2025-27 (%)



Note: Probability forecast for HY bond spreads. Coloured lines show expected spreads conditional on the US economy overheating, slowing below trend, or experiencing a recession in H2/25. Source: Numera Analytics.

F6: Spending is unsustainably strong
US consumer spending outlook, 2025 (%)



Note: There is an 86% probability that consumer spending grows above 1%, and a 25% chance that it grows above trend in full-year 2025. The worst potential outcome would be a marginal (-0.1%) correction. Source: Numera Analytics.

F5 illustrates the sensitivity of HY spreads to various growth scenarios. If the economy keeps overheating (the yellow line), spreads should remain tight. This scenario is associated with a 70% chance of positive real returns. Conversely, if activity slows spreads would widen as firms encounter solvency challenges. In the event of an outright recession (red line), the likelihood of positive real returns on HY this year collapses to 14%, far lower than even for equities.

While a downturn remains improbable, it is also unlikely that private spending will maintain its current pace of growth. For example, we find only a one-in-four chance of above-trend growth in consumption (F6) now that households have exhausted their excess savings, and job security concerns have increased as labour demand normalizes.

This worsens their relative appeal, while calling for a gradual rotation to higher quality debt (F3). Much lower maturities also makes HY less sensitive to Fed easing, putting it at a disadvantage to long duration bonds if slower growth results in more cuts than expected. Excluding the 'soft landing' episodes of 1995 and 1998, HY always underperformed in the year following a Fed pivot, while sovereign and corporate IG debt usually posted above-trend returns (T1).

T1: Bonds after Fed pivot 12M forward returns (%)	Fed funds	10Y yields	Sovereign	Corporate IG	High yield
Average	*-197*	*5*	*5.3%*	*4.2%*	*0.9%*
Recession	*-270*	*-40*	*7.5%*	*5.5%*	*-2.2%*
'Soft landing'	*-50*	*95*	*0.9%*	*1.4%*	*7.1%*

Note: Table compares average returns on sovereign, corporate investment grade (IG) and high yield bonds in the year following a Fed pivot, since 1986. The second and third row split distinguishes between recessionary and non-recessionary episodes. Source: Numera Analytics on Federal Reserve, BofAML data.

Strategic Asset Allocation:

- **Asset mix** – *OW bonds*. In a late cycle, broad asset choice largely depends on underlying economic strength. Resilient activity still calls for OW positions on stocks versus bonds (F7). Bonds, however, have an attractive risk-reward profile 12M holidngs, reflecting a high probability that spending (and earnings) will grow less than markets anticipate. High quality debt is also trading at a significant discount, improving their upside as the Fed cuts rates.

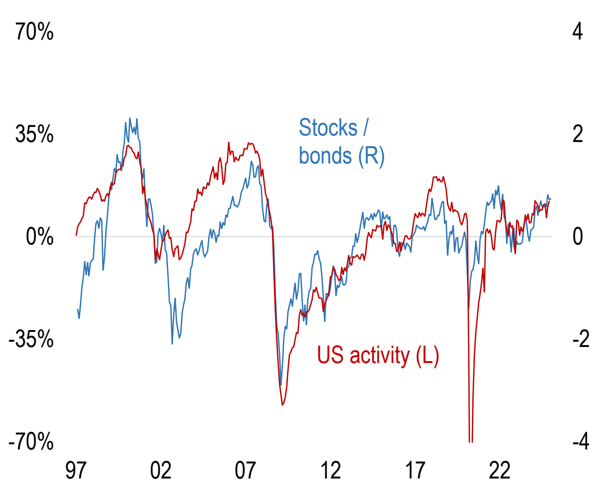
- **Equity style** – *OW value*. Tech-heavy growth stocks have fared much better than value since 2023. Normally, growth should also outperform at the start of an easing cycle, due to its higher interest rate sensitivity. However, macro and AI optimism have pushed large-cap tech well above' fair' value, weakening their relative appeal. As activity slows, this would also encourage a rotation towards battered defensive stocks, which also favours 'value'.

- **Equity size** – *OW large-cap*. Small-caps are trading at much lower valuations than the S&P 500. However, they are also more sensitive to US growth surprises, so a high probability of a slowdown by H2 worsens their relative appeal. In a multi-asset setting, we favour a gradual rotation towards large-cap value given lower downside risk.

- **Bond quality** – *OW Treasuries*. Corporate (especially HY) debt has fared much better than Treasuries over the past two years. Risk appetite and resilient activity still favours corporate bonds in the near-term. Yet extremely tight spreads, Fed cuts and slower growth should allow sovereign debt to make up for lost ground later this year.

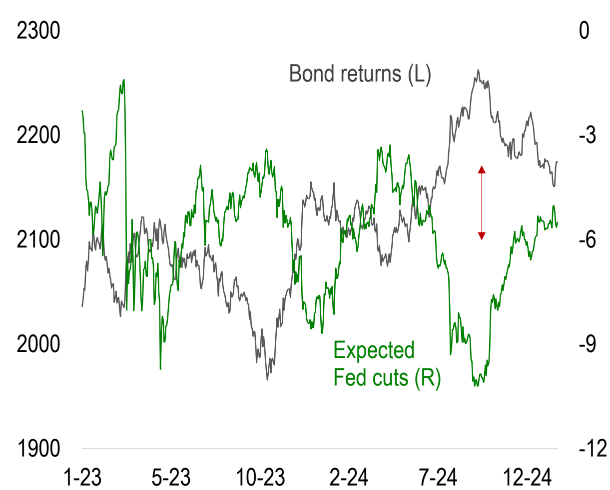
- **Bond duration** – *OW duration*. Markets are pricing 'higher-for-longer' Fed policy (F8). In contrast, we predict a much lower terminal rate, mainly due to higher unemployment. As investors downgrade their rate expectations, this would benefit bonds with longer maturities, much more sensitive to shifts in Fed policy expectations.

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

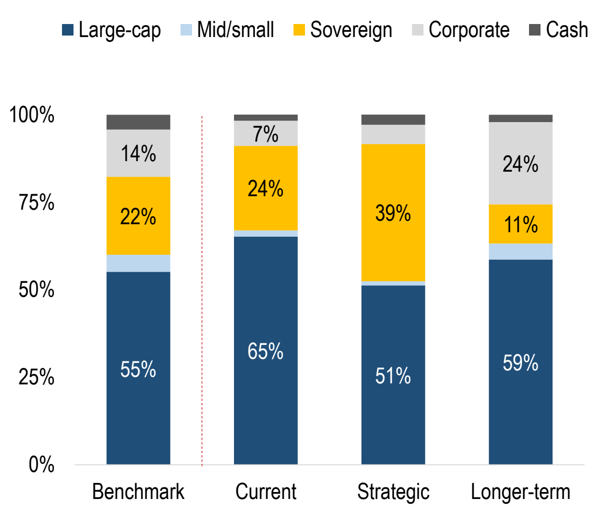


Note: Chart plots total returns on US bond investments against expected number of Fed cuts by Dec. 2025. Source: ICE BofAML, CBOT; Numera calculations.

T2: Asset allocation Optimal weights (%)	Benchmark	Positioning[a]		
		Current	Strategic	Longer-term
Large-cap stocks	55%	65%	51%	59%
Growth	30%	32%	21%	26%
Value	25%	33%	30%	32%
Mid-cap stocks	3%	1%	1%	2%
Small-cap stocks	2%	0%	0%	3%
Sovereign bonds	20%	19%	34%	10%
Corporate bonds	14%	7%	5%	24%
Investment-grade	11%	5%	5%	23%
High yield	2%	3%	1%	1%
Inflation-linked bonds	3%	5%	5%	1%
Money market	4%	4%	3%	2%
Stocks	60%	67%	52%	63%
Bonds	40%	36%	48%	37%

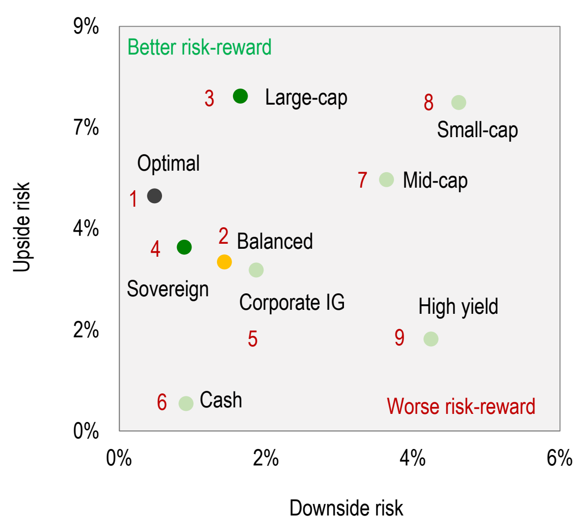
a. Optimal weights maximize risk-adjusted portfolio returns across stocks and bonds for the current US and global macro context, over the next 12M (strategic), and over the next 5 years (longer-term).

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
US small-cap stocks	Long	16-Sep-24	18-Dec-24	6.2%	6.2%	PDF
US energy stocks	OW	18-Sep-24	4-Dec-24	2.0%	2.0%	PDF
Materials stocks	Long	3-Oct-24	18-Dec-24	-8.0%	-8.0%	PDF
Real estate stocks	Long	21-Oct-24	-	-9.0%	-5.7%	PDF
S&P equal weighted	Long	30-Oct-24	-	-9.0%	1.0%	PDF
Regional banks	Long	6-Nov-24	11-Dec-24	7.1%	7.1%	PDF
US aerospace & defense	Long	6-Nov-24	-	-4.0%	0.6%	PDF
US refiners / E&P	OW	6-Nov-24	-	-8.0%	-6.2%	PDF
US diesel	Call option	20-Nov-24	15-Jan-25	-24%	66%	PDF
US gasoline	Call option	20-Nov-24	15-Jan-25	-33%	47%	PDF
US semiconductors	OW	11-Dec-24	-	3.0%	4.6%	PDF
US defensives	OW	8-Jan-25	-	-5.2%	1.0%	PDF
Long duration	Long	8-Jan-25	-	-8.0%	1.1%	PDF
UW high yield	UW	8-Jan-25	-	-7.7%	-0.2%	PDF

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