Cleared to land?

A soft landing is coming into view, but with potential pockets of turbulence ahead, we are neutral on risk assets.

Emiel van den Heiligenberg
Head of Asset Allocation

Tim Drayson
Head of Economics

The US economy continues to show remarkable resilience and appears to have decent momentum heading into year end. There have been a number of headwinds, including actual hurricanes, but so far they have done little to restrain growth. As a result, there is a heavy consensus the US is on track for a soft landing.

We acknowledge the Federal Reserve's (Fed's) 50 basis point (bps) cut in September increases the chance of a soft landing, especially since the easing cycle has commenced as the US labour market still looks healthy. We'll never know if the Fed would have cut as aggressively if it had seen the strong September payrolls, but concerns that the Fed might be too slow to remove some of the policy restraint have receded.

There have also been some favourable developments to national income, which suggests private sector balance sheets are in a stronger position than previously thought. The household saving rate has been revised up, hinting at a less stretched consumer. The national account measure of corporate profits has also been marked higher, closing some of the gap with the more timely company earnings. The opening of this gap has historically flagged a late cycle.

Together with broadly favourable inflation developments, despite core CPI prints firming in August and September, our recession indicators have improved.

LGIM

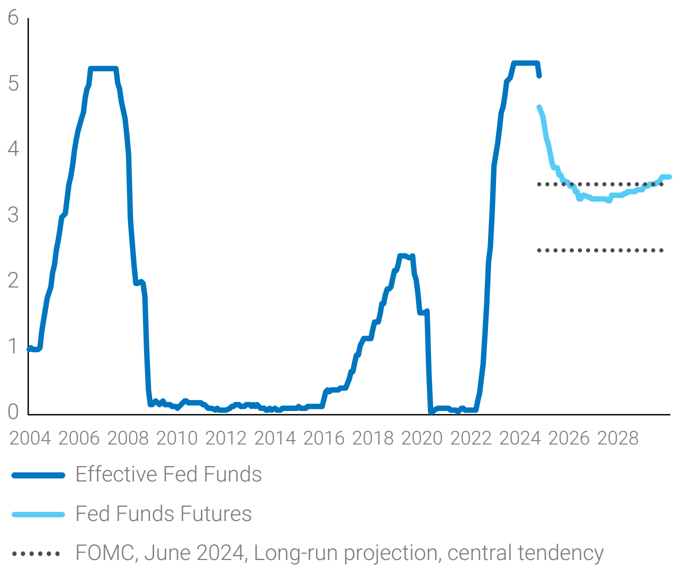
Please remain seated

Polls suggest the US presidential election race remains extremely tight, but so far the political uncertainty does not seem to be undermining business or consumer confidence. The escalating conflict in the Middle East is another concern, but the main channel of transmission is via higher energy prices, and so far the reaction of oil has been relatively muted.

The next few months are critical as the landing comes into view. Markets have scaled back some of the Fed easing without any adverse impact on risk asset prices. However, there is still significant easing priced alongside expectations for strong earnings growth. This does not leave much room for either inflation to surprise to the upside or an ability to cope with fresh shocks and a growth disappointment.

Outside the US, demand has been subdued, but China has delivered some monetary easing and is developing a broader range of fiscal support. Together, this should at least put a floor under China's growth even if we are not convinced the measures will be sufficient to address the country's structural challenges. Europe remains sluggish amid political uncertainty, budget pressure and Germany's uncompetitive manufacturing sector. The UK appears to be slowing again after a better first half of the year as a tax raising budget comes into view. So, the US consumer once again remains the critical driver of global growth.

Back to neutral by the end of 2025?



Source: Bloomberg, LGIM as at 14 October 2024.

How we're positioned

We believe the vulnerability argument we had to remain short risk in portfolios is now less valid. Inflation is trending down, and the positive growth momentum means it will likely take more than a few data points before recession fears drive markets. We express our neutral view on risk by being long equities and short credit as we believe at these tight spread levels credit has similar downside but significantly less upside than equities.

Within equities, we are enthusiastic about the prospects for non-China emerging markets (EMs). The spillover effects of any Chinese stimulus are likely to be felt in other EM nations, without the geopolitical/tariff risk that comes with allocating directly to the Middle Kingdom.

We've had a long-standing enthusiasm for US treasuries and reappraised that view as pricing became increasingly extreme at the front end. As policy rates fell below 3% we felt the implied 250bps of rate cuts by September 2025 without a recession would be unprecedented. It is possible, but tough to envision. Yields have subsequently moved back up in October. The case for owning duration now is that it offers good insurance value as long as the market keeps believing in the disinflation story.

For example, during August's growth-driven market jitters, bonds demonstrated their worth by moving in the opposite direction to equities. We think that helpful correlation is set to continue with inflation worries receding.

This quarter's articles

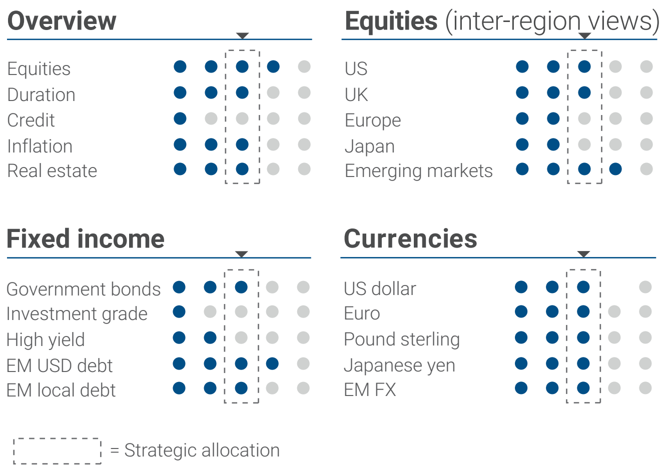
In his article, James considers the root causes of populist policy making, and the long-term economic implications.

In his section, Martin explores private markets, and the potential benefits for investors of new ways of accessing these assets.

In our previous quarterly update, Robert gave his verdict on the dizzying ascent of the Magnificent 7. He returns to the subject this quarter, arguing hopes of an 'immaculate broadening out' are misplaced.

Tim rounds out this update with his regular CAMERA feature showing our long-term return expectations across a range of assets, this time with a focus on emerging markets.

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 30 September 2024. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question.
Regional equity views should be read in conjunction with the overall equity view. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested.**

The economic consequences of populist politics

Populist leaders can deliver short-term economic benefits via fiscal largesse, but research finds economic growth suffers in the long term.

James Carrick
Global Economist

Plato worried about the dangers of democracy over 2,000 years ago. He foresaw the rise of demagogues: charismatic leaders who manipulate public opinion with false promises, prioritising personal power over the common good.

Today, there are concerns that far-right parties in France and Germany could replicate the rise of extreme parties in the Netherlands, Austria, Italy and across Eastern Europe.

If populist leaders continue to gain ground, what economic impacts should investors anticipate?

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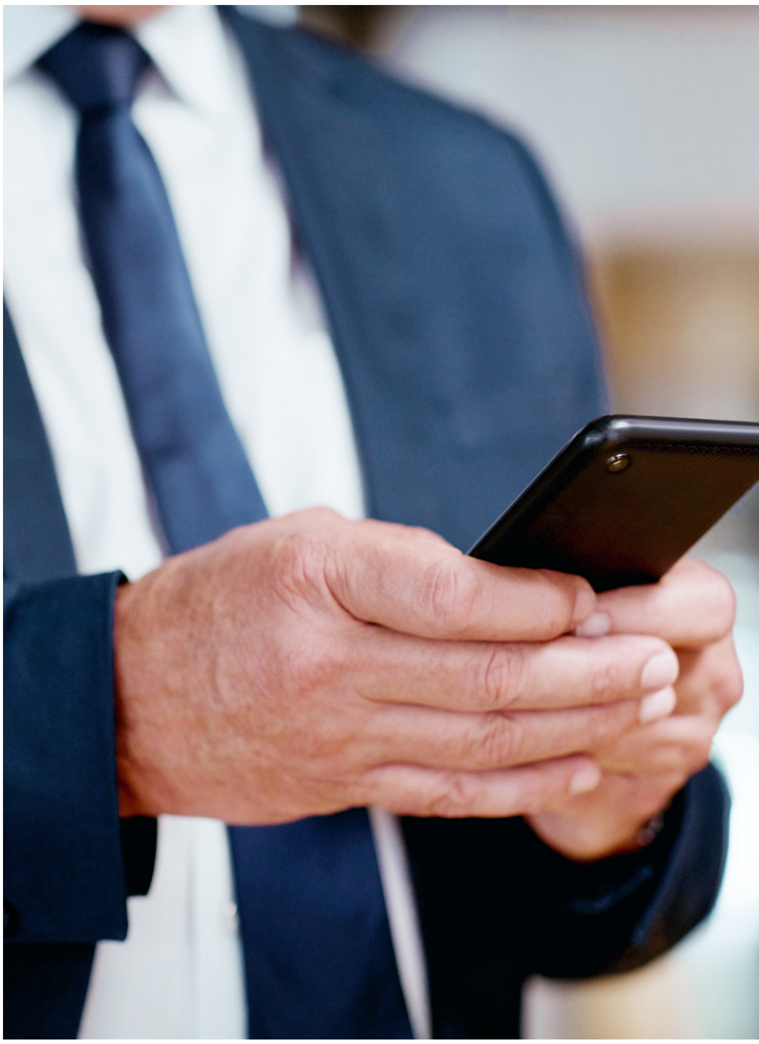
What's the cost?

On the one hand, the impact of government policy on the economy is the most important short-term driver for markets. To the extent to which extremism leads to expansive fiscal policy, it will impact growth, inflation and central banks' reaction function. That could easily become the dominant driver for markets. In a weaker economy, that might be great for the stock market.

Against the current backdrop, with limited slack in the economy, fiscal expansion could drive inflation and interest rates up and equity markets down if markets convince themselves central banks are committed to offsetting the fiscal effect on inflation.

An article in the American Economic Review in 2023 shows that the long-term economic cost of populism is high. Based on a sample of 51 populist presidents and prime ministers from 1900 to 2020, after 15 years GDP per capita is 10% lower than it would have been in a plausible non-populist scenario. The study found the end result of populist rule has tended to be a budget deficit and restrictions on trade with lower-than-expected trend growth.



The medium is the message

One way of understanding the rise of populist politics is through the lens of the mass media, with its constant evolution shaping voting behaviour.

There was a convergence in US politics from the 1930s to the 1960s. This has been linked to the rise of network radio and television by academics who analysed the data at a local level given the gradual roll out of these technologies.[1] Unlike newspapers, which often had clear political affiliations, network radio and TV provided more uniform and less partisan news coverage, and politicians moderated their voices before joining shows.

However, the advent of cable TV in the early 1980s and the subsequent rise of the internet and social media have been linked with a reversal of this trend. These platforms can create 'echo chambers' where individuals are exposed primarily to information that reinforces their existing beliefs.

Arguably, this has led to a rise in political extremism, distrust, and a 'them vs. us' mentality, with less appreciation for opposing viewpoints and a decline in consensus. Leaders can today use social media and cable TV to shape public opinion, leading to increasingly polarised environments where 'experts' are dismissed. Social media also has more potential for foreign interference, using automated or human-operated accounts to spread misinformation and exacerbate divisions.

This is likely a secular trend. Older generations who still use and trust newspapers and TV are passing away, replaced by younger generations who are more trusting of social media.

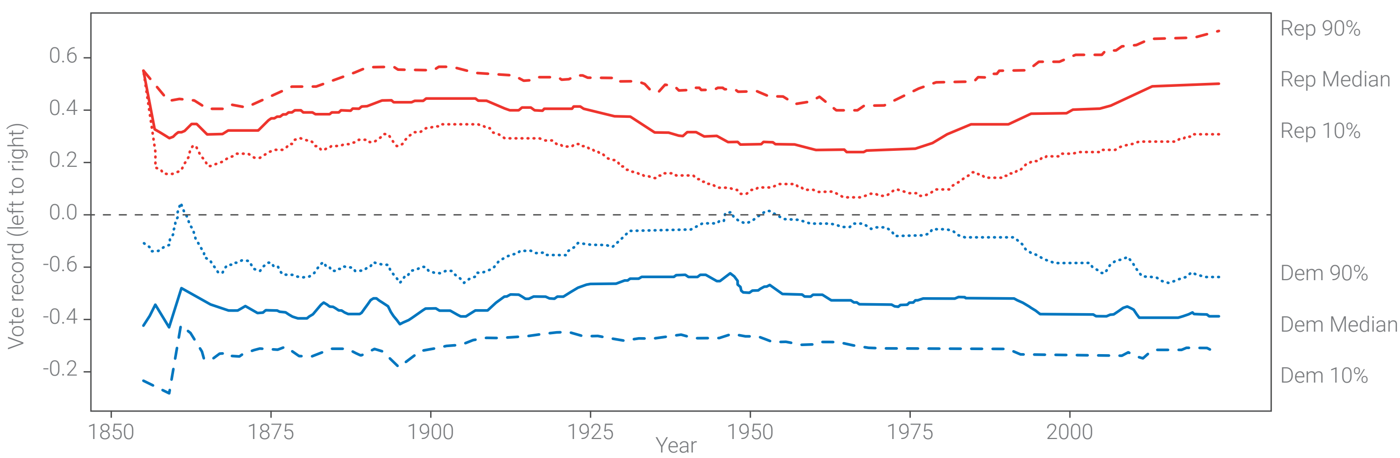
The new political landscape

What does this trend towards extremism mean in practice? Elections and referendums pose bigger risks than before as political views become more extreme. This is particularly the case in 'first-past-the-post' systems where a minority of votes can take a majority of seats. Proportional representation systems are more nuanced, particularly because the 'extreme left' is countering the 'extreme right'.

But centrists become squeezed and previously taboo topics become acceptable (as per the 'music market' experiments,[2] people associate quantity with quality, and so the more 'likes' something has, the more people will think it's good).

This suggests today's mainstream views on balanced budgets, free trade, independent central banks, tackling climate change and immigration will be challenged.

Republican vs. Democrat vote divergence



Source: voteview.com as at September 2024

1. rcampante_media_polarization.pdf (harvard.edu)
2. Experimental Study of Inequality and Unpredictability in an Artificial Cultural Market, 2006

The evolution of private markets

Private markets are an increasingly visible part of the investment landscape. Although global assets under management (AUM) in private markets remain a fraction of those in public markets, they're growing fast.

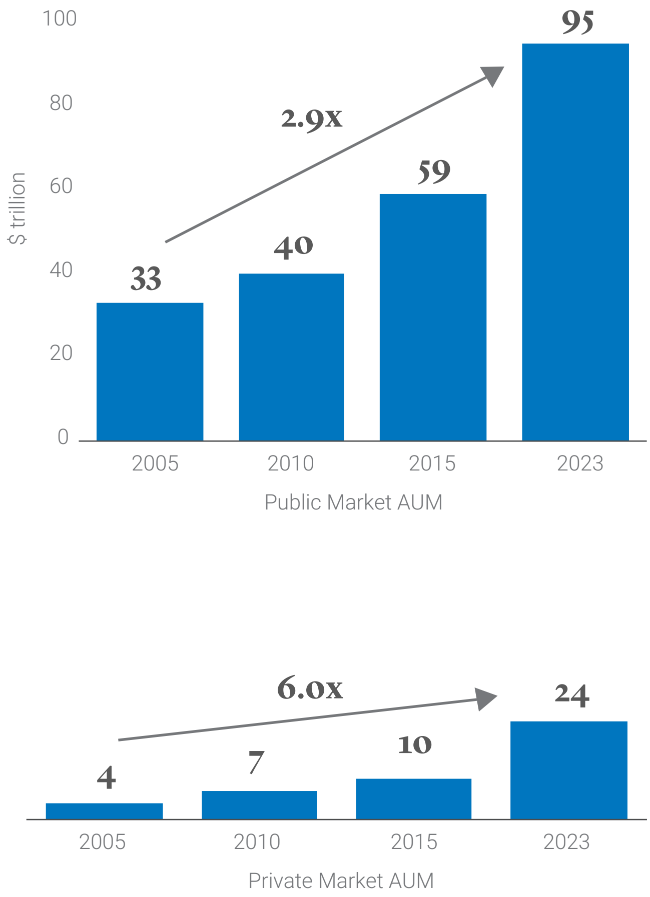
Martin Dietz
Head of Diversified Strategies

Hard and fast private markets data can be hard to come by, but between 2003 and 2019 it's estimated that private markets AUM has grown by around five times – double the rate of growth seen in public markets.[3]

Unsurprisingly, this rise in AUM has been driven by increasing allocations to private markets from large institutional investors, at the expense of traditional asset classes.[4] As the asset class grows, more access options are becoming available, putting the potential advantages of private markets within reach of a wider range of investors.

Given this backdrop, it seems like an appropriate time to revisit the underlying arguments for private market assets.

Public markets are far bigger, but private markets are growing faster



Source: InvestCorp and BCG as at 2023.

3. InvestCorp, BCG, CEM Benchmarking.
4. CEM Benchmarking data from 2008-2019 shows institutional investors' allocations to private equity rising from 4% to 6%.

Would you say no to a free lunch?

Although we've argued that Harry Markowitz's best-known quote overlooks the psychological cost of rational investment decisions, we are staunch believers in diversification.[5]

But what exactly do we mean by diversification? It may be easier to define what it's not: a diversified portfolio shouldn't be significantly overweight single securities, single geographies, or single sectors. And it shouldn't rely on equities alone for growth.

While diversifying across the familiar traditional asset classes goes a long way towards achieving diversification, we believe the introduction of alternative asset classes can improve risk/reward outcomes.

Alongside other alternatives, private market assets can help diversify portfolios further. And the typically long-term, illiquid nature of private market investments means they're well suited to financing large, long-term projects such as renewable energy facilities, affordable housing, and transportation infrastructure. Adding these types of underlying assets can help smooth out returns given their typically stable cash flows.

Illiquidity as a source of returns

In addition to diversification, potential returns are another appeal of private market assets. Unlike public assets that can be bought and sold by virtually anyone, private assets are available to a much shallower pool of investors, often requiring investors to commit capital for longer periods, and to perform in-depth due diligence.

The flipside of this is the illiquidity premium associated with unlisted assets, which should compensate investors for the long-term commitment and additional complexity they take on with these investments. The pursuit of this premium partially explains the increasing allocation to private assets among institutional investors.

Arguably, there are also behavioural reasons for investors interest in private market assets in addition to the potential for an illiquidity premium. The illiquidity of private assets and infrequent pricing can help investors to disregard short-term price fluctuations and focus onto the longer-term return potential. This may obviate the need for steely rationality – a tall order for any human investor – following a decline in asset values.

5. **It should be noted that diversification is no guarantee against a loss in a declining market.**

Full-fat private markets versus listed alternatives

As noted above, the historical difficulty of accessing private markets is slowly easing amid the rapid growth of the asset class. But this raises an important question: can listed alternatives provide the same potential diversification benefits without the illiquidity?

We've explored this question in depth before, but in brief, investors should expect similar long-term outcomes when investing in direct and listed property alternatives. Over the short term, listed alternatives respond more quickly to changes in their underlying assets and as a result, unfortunately, trade in line with the changing risk-on/risk-off pattern of other risky assets.

Intuitively, listed and direct exposure have the same underlying economic exposures and so they naturally should provide the same outcomes over the long term. Research supporting this claim is scarce though and so this remains an active topic for sometimes heated debates.

As private markets expand and an increasing variety of investors are drawn to the space, it will be interesting to see if the growing availability of comparable data provides more insights into this question. Watch this space.

An 'immaculate broadening out'? We don't think so

Hopes are building around US small caps, but we believe valuations could make the vulnerable if the economy slows.

Robert Griffiths
Global Equity Strategist

For 18 months beginning in January 2003, the Magnificent 7 group of US stocks became the dominant investment theme, rising by over 100% in 2023 and a further 50% in the first half of 2024.[6]

While their outsized returns were obviously good news for those who owned the group, it felt like their dominance was storing up danger for the future as the S&P became ever more reliant on a small group of companies.

Indeed, as we discussed in our previous quarterly update, the outperformance of momentum as an investment style – buying the winners – can often be punctuated by sharp reversals. As investors crowd into a theme, the risks of the exits being equally crowded on the way out, creating disorderly price action, rise commensurately.

6. Bloomberg as at 17 September 2024.

When it came in July, the proximate cause of the reversal wasn't found in Silicon Valley, but in Tokyo. The Bank of Japan's decision to raise interest rates undermined popular carry trades – borrowing in low-yielding yen to invest elsewhere – leading investors to scramble for cash by selling the largest, most liquid elements of their portfolios. In July, at which point the Magnificent 7 still accounted for over a third of S&P 500 market cap,[7] it felt like this event would portend a deeply damaging phase for US equities.

What happened next was strange, therefore. The Magnificent 7 initially declined by around 18%, settling around 10% off their peak.[8] At the same time, the S&P 500 went on to touch its prior high. In that respect, it appeared that the S&P 500 managed, against the odds, to achieve an 'immaculate broadening out', with leadership shifting away from the Magnificent 7 without paying a price in overall index points. What happened, and will it continue?

Out with the new, in with the old

Through the volatility, two things changed the market narrative. First, expectations for the Fed Funds rate fell sharply, with rate expectations for the end of 2024 declining by 70bps from the end of June. Second, the oil price fell by nearly 20% over the same period[9] as worries about demand grew, and supply remained strong. For consumers, the cost of money and the cost of energy are perhaps the two most critical prices, and accordingly the market's mood toward 'old economy' consumer-facing areas improved.

Can this broadening out continue, perhaps led by the resurgent small cap Russell 2000? We're not convinced.

It is worth noting that US small caps are not especially cheap. According to Bloomberg data, the 12-month forward price-to-earnings multiple of the small cap Russell 2000 is currently ahead of tech-heavy Nasdaq. The expected earnings growth for next year before exceptional items is similar for the two indices at around 20%. That's despite the small cap index tending to exhibit greater earnings cyclicality, with its members more exposed to US macro conditions and generally offering a lower quality credit profile than the megacap tech names.

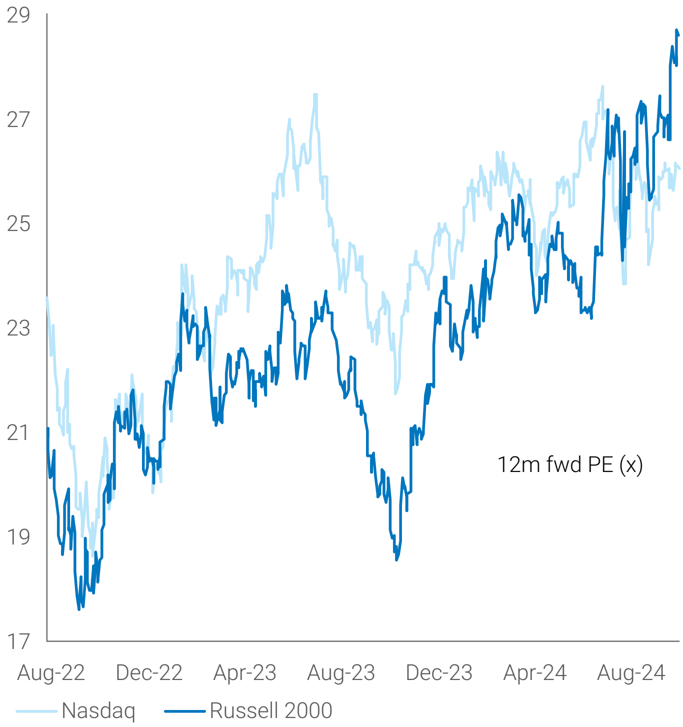
Going cheap?

That makes us somewhat sceptical that the broadening out will gain momentum. Tech has become cheaper relative to the market at a time when its earnings delivery has remained steady.

Small caps, meanwhile, appear somewhat expensive relative to their history and vulnerable should the US economy slow further from here.

The Magnificent 7 may not be as magnificent as they once appeared, but strong earnings delivery, less over-ownership and a less demanding valuation suggests it's too early to count the group out.

Could valuations leave small caps vulnerable?



Source: Bloomberg as at 14 October 2024.

7. ibid. 8. ibid. 9.ibid

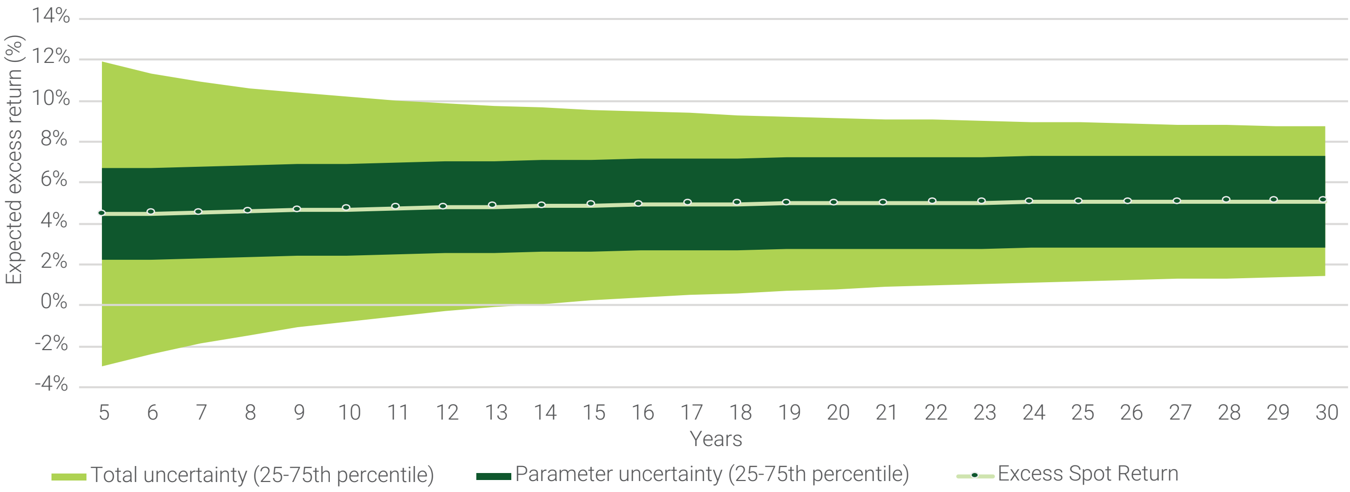
CAMERA: our capital market assumptions update

This time around, we focus on the outlook for emerging markets.

Tim Armitage
Multi Asset Fund Manager

Earlier this year, we introduced CAMERA, our capital market assumptions framework. CAMERA combines two sources of return expectations – those from an equilibrium model that is primarily risk-based, and those from a model that is primarily valuation-based – to form a sensible blend of expected returns over a range of time horizons. The framework is based on the premise that in the long run, expected returns should converge to some equilibrium level, while over shorter horizons we may expect some deviation from equilibrium assumptions as a function of market valuations.

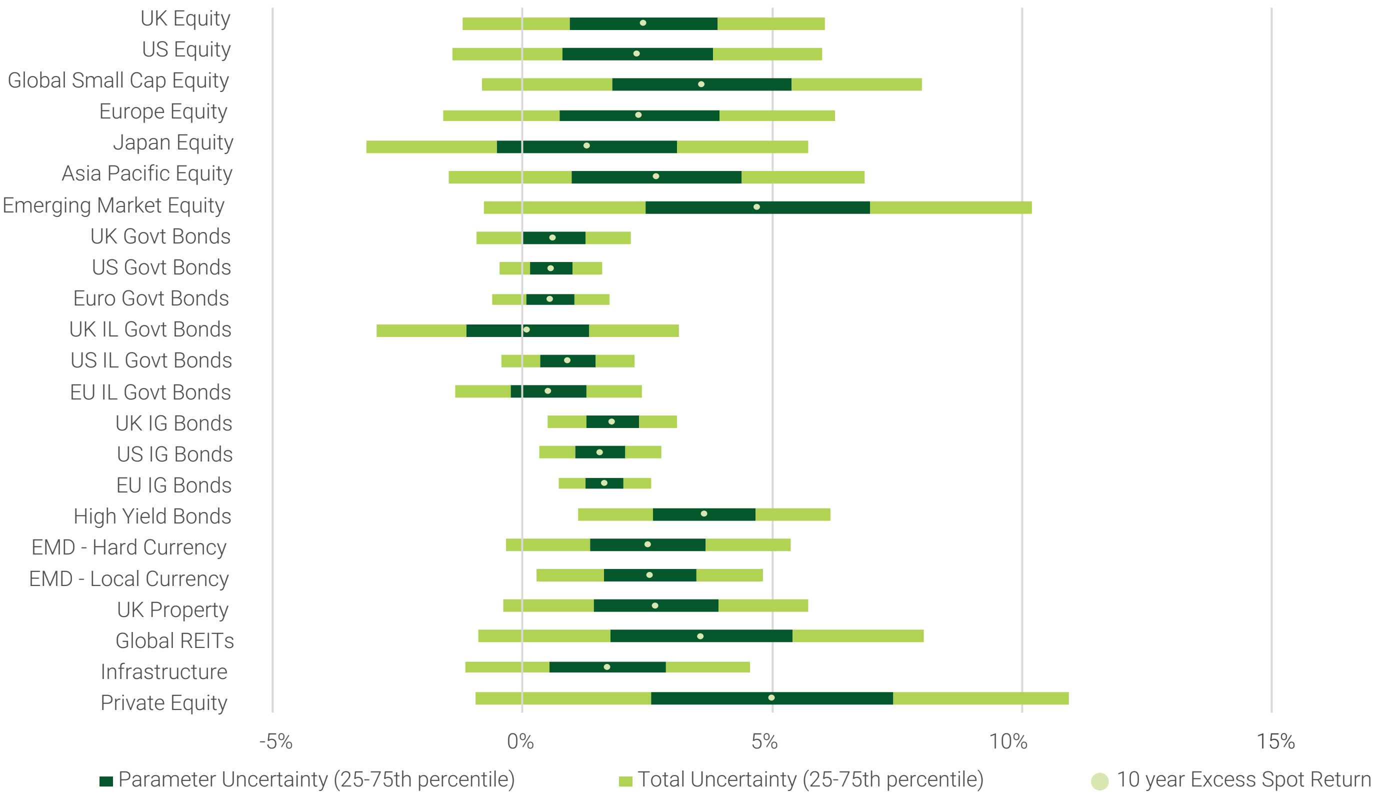
Expected excess return term structure: emerging market equity



Source: LGIM as at 24 September 2024.

Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass.

Ten-year excess return distributions



Source: LGIM as at 24 September 2024.

Of the regional equity markets included in our framework, emerging markets have the highest expected returns over both medium- and long-term horizons. It is perhaps unsurprising that there is also a high degree of uncertainty around those estimates, particularly over shorter horizons. We measure uncertainty both in terms of volatility, meaning fluctuations in asset prices, and parameter uncertainty, meaning the degree to which we can have confidence in the accuracy of our model inputs.

Fixed income asset return assumptions tend to have lower uncertainty associated with them than equity assumptions, both in terms of volatility and parameter uncertainty, and that is also true of emerging market debt (EMD). Interestingly, although there are only small differences between medium- and long-term return estimates for EMD, for local currency EMD we see medium-term expected returns lower than in equilibrium (i.e. an upward sloping CAMERA term structure) whereas for hard currency (US dollar) EMD we see medium-term expected returns slightly higher than in equilibrium. This is consistent with our short to medium-term asset-class views, where we have a positive view for hard currency EMD but a neutral view for local currency EMD.

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	Expected excess returns				**One-year asset class volatility**
	5 Years	10 Years	20 Years	30 Years	
UK Equity	2.2%	2.4%	2.7%	2.8%	15.5%
US Equity	1.7%	2.3%	3.0%	3.3%	15.8%
Global Small Cap Equity	3.0%	3.6%	4.3%	4.5%	18.8%
Europe Equity	1.8%	2.3%	2.9%	3.1%	16.8%
Japan Equity	0.8%	1.3%	1.9%	2.1%	18.9%
Asia Pacific Equity	2.5%	2.7%	2.9%	3.0%	17.8%
Emerging Market Equity	4.5%	4.7%	5.0%	5.1%	23.5%
UK Govt Bonds	0.9%	0.6%	0.3%	0.2%	6.6%
US Govt Bonds	0.7%	0.6%	0.4%	0.4%	4.4%
Euro Govt Bonds	0.7%	0.6%	0.4%	0.4%	5.0%
UK IL Govt Bonds	0.1%	0.1%	0.1%	0.0%	12.9%
US IL Govt Bonds	1.2%	0.9%	0.6%	0.5%	5.7%
EU IL Govt Bonds	0.6%	0.5%	0.4%	0.3%	8.0%
UK IG Bonds	2.1%	1.8%	1.5%	1.4%	5.5%
US IG Bonds	1.7%	1.5%	1.4%	1.4%	5.2%
EU IG Bonds	1.8%	1.6%	1.4%	1.4%	4.0%
High Yield Bonds	3.7%	3.6%	3.6%	3.5%	10.8%
EMD - Hard Currency	2.6%	2.5%	2.4%	2.3%	12.2%
EMD - Local Currency	2.3%	2.5%	2.9%	3.0%	9.7%
UK Property	2.5%	2.7%	2.9%	3.0%	13.1%
Global REITs	3.2%	3.6%	4.0%	4.2%	19.1%
Infrastructure	1.2%	1.7%	2.3%	2.4%	12.2%
Private Equity	4.8%	5.0%	5.2%	5.3%	25.4%

Source: LGIM as at 24 September 2024.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative

Key risks

The value of an investment and any income taken from it is not guaranteed and can go down as well as up, and the investor may get back less than the original amount invested. Assumptions, opinions and estimates are provided for illustrative purposes only. There is no guarantee that any forecasts made will come to pass. Past performance is not a guide to the future.

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