Mason Stevens OCIO Yearly Outlook

February 2024

This document is for dealer groups and wholesale or sophisticated clients only.

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Policy Perfection?

Falling inflation and prospects for easier central bank policy are underpinning the consensus view of a soft landing rather than a recession, hard landing, and bear market. Leading indicators point to slowing growth but not a collapse. There's still risk of recession, albeit comfort exists given significant headroom to cut rates assuming disinflation remains intact.

US exceptionalism in terms of productivity supports the US economy above other developed market regions, with Europe likely to skirt closer to a technical recession. In Australia there is growing evidence that ongoing cost-of-living pressures have begun to impact the consumer, driving higher confidence that inflation is on a sustainable path downwards, whilst China risks a deflation spiral and is staring down a real-estate crisis.

As we face into 2024, we lay out the three macroeconomic scenarios for developed markets that we think investors should anchor to as 2024 unfolds. At this juncture we believe the most relevant macroeconomic scenarios for 2024 are a 'soft landing', a 'no landing' and finally a 'cyclical recession'.

Key Views:

- Neutral Equities – history suggests elections and central bank cutting cycles are supportive of risk assets in the early phases. Whilst equities index upside is muted versus history, in our view, there remain pockets of compelling value.
- Hedging – consider hedging positions in global equities given the Australian dollar may be supported in a soft-landing scenario.
- Infrastructure – provides a compelling risk reward trade off as compared to other asset classes across the scenarios we outline.
- Fixed income – the returns available especially for income investors are compelling at this juncture in our view.
- Portfolio insurance – with a material risk of cyclical recession remaining we recommend investors consider alternative strategies that can provide uncorrelated returns in the event of a meaningful market drawdown.

The world is always uncertain. There is no time in history that replicates the confluence of events that investors are facing. If anything, we expect 2024 will answer whether this cycle is truly different this time or simply that this cycle is the same with the only difference being a longer lag in monetary tightening slowing the economy. Investors are likely to see many twists and turns this year. In some deep sense, the global economy is still normalising from the pandemic. The path being travelled is both unprecedented and unpredictable. As such, investors need to remain nimble and to be prepared for surprises.

Overview

"When the facts change, I change my mind. What do you do, sir?" John Maynard Keynes.

In many ways, markets behave like living organisms which morph based on the direction of data, probability assessment and emotion. By their nature markets can be noisy, with investors often jumping at shadows on data that simply doesn't matter. In the end whether it's a single stock, a sector, or an index there really are only a few things that truly matter at any one time. Investor skill lies in determining what data matters and what is priced in at any particular point.

In conjunction with determining what data will drive markets, is the recognition that new data will shift probabilities of likely scenarios that may or may not ensue. Rarely is it prudent to have a single view of what will happen, but rather we believe that estimates should be based on a range of scenarios, with assigned probabilities of each occurring. This type of thinking is often described as Bayesian, in that it is built upon the use of probability to represent uncertainty. Most importantly as new information comes to the fore, we keep an open mind and adapt in the face of the evolving evidence.

We believe in the wisdom of crowds; we are not the keeper of all good ideas, nor the originator of all key investment tools. The wisdom of crowds is the process of considering the collective opinion of a group of experts rather than any single view to answer a question. Our investment process draws upon research globally and will often source key scenarios or key investment tools from global experts. We believe the value we add is in combining this information, which in turn informs our Dynamic Asset Allocation (DAA) and portfolio implementation.

No economic cycle ever looks the same, however we would argue that the current cycle is particularly peculiar. In 2023 the consensus estimate was for sticky inflation and a mild recession, whereas in early 2024 we would argue the consensus expectation is for 'immaculate disinflation' and a 'soft landing'. As we face into 2024, we lay out the three macroeconomic scenarios for developed markets that we think investors should anchor to as 2024 unfolds:

Macroeconomic scenario		Probability
One	Soft landing/immaculate disinflation	55%
Two	No landing/second wave of inflation	10%
Three	Cyclical recession/deflation	35%

Source: Mason Stevens OCIO

We then overlay the economic scenarios probability assessment with how we expect assets to perform in each scenario, considering current valuations and the risk/reward trade-off within and across asset classes. Additionally, we consider momentum and sentiment indicators in relation to risk assets.

Whilst this lays out the core of our investment process it is important to give thought to structural dynamics and global politics. 2024 has been deemed the "Super Election Year" where half of the world's population goes to the polls, injecting additional uncertainty into the macro environment. Whilst developed market elections rarely change the course of equity markets, they do tend to see fiscal largess with high budget deficits and government intervention in different forms. The drum beat around government debt sustainability, especially within the US, is getting louder. On the one hand this may force the Fed's hand to cut rates more quickly, on the other hand the cost of capital over the longer term may drift higher as markets start to exert a greater price for that spending.

Be prepared to be nimble, 2024 will be anything but predictable. Now is not the time to 'set and forget' portfolios.

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Summary Views

With the soft-landing scenario having a greater than 50% likelihood, we aim to make DAA tilts that will increase our expected portfolio return under the soft-landing scenario, whilst not generating a lower return in the other scenarios. Our analysis based on our 12-month expected return estimates would suggest the following adjustments to SAA:

- 25-30% of the global equities exposure should be hedged.
- Overweight infrastructure at the expense of property.
- Overweight global fixed income at the expense of growth alternatives.

By making these portfolio tilts and comparing to our SAA portfolios, we estimate that the:

- Growth and High Growth Portfolios will perform better in the soft-landing and no landing scenarios, and in line in the cyclical recession scenario.
- Balanced Portfolio will perform better in the soft-landing and cyclical recession scenarios, and in line in the no landing scenario.

	Expansion		Contraction
	No landing – above trend growth Global GDP growth >3.5% Inflation >2%	**Soft-landing** – sub trend growth Global GDP growth 2-3.5% Inflation ~2%	**Cyclical recession** Global GDP growth <2% Deflation
Probability	**10%**	**55%**	**35%**
Drivers	Financial conditions ease, housing cycle turns, China stimulates, and growth reaccelerates.	The cumulative and lagged effects of central bank tightening slow inflation and growth, strong consumer, corporate and municipal balance sheets extend the economic expansion. Ample liquidity and falling inflation forestall a recession.	Consumers deplete savings and increase their revolving credit. Cumulative and lagged effects of monetary tightening challenge both consumers and corporations. Job creation stalls and unemployment rises.
Monetary and fiscal environment	Central banks back away from rate cuts as growth reacceleration risks reversing disinflation progress. Continued fiscal impulse.	Central banks show willingness to be more forward looking and cut rates proactively before inflation reaches target. Continued fiscal impulse.	Weakening growth and falling inflation induce aggressive central bank easing, resulting in lower government bond yield. However, central bank easing is too little too late and the global economy falls into recession.
Market and positioning	Cyclical equities and the value factor should outperform. Short duration floating fixed income exposure would be the preference from a fixed income perspective.	Equities, specifically small caps, and emerging markets equities. Investment grade credit provides compelling carry.	Infrastructure, select alternatives, and US long dated treasuries would likely outperform.

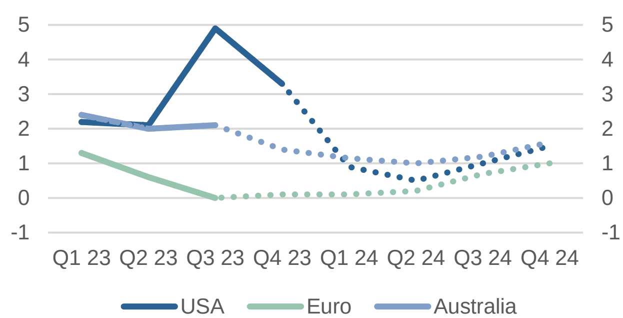
Source: Mason Stevens OCIO

The Global Economy in 2024

Falling inflation and prospects for easier central bank policy are underpinning the consensus view of a soft-landing rather than a recession, hard landing, and bear market. Leading indicators point to slowing growth but not a collapse. There's still risk of recession next year; albeit comfort exists given significant headroom to cut rates assuming disinflation remains intact. US exceptionalism in terms of productivity supports the US economy above other developed market regions, with Europe likely to skirt closer to a technical recession. In Australia there is growing evidence that ongoing cost-of-living pressures have begun to impact the consumer, driving higher confidence that inflation is on a sustainable path downwards, whilst China risks a deflation spiral and is staring down a real-estate crisis.

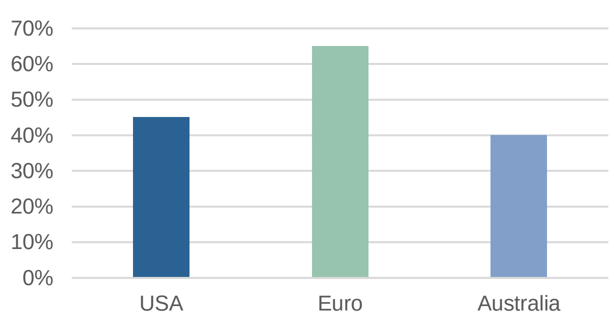
Current consensus estimates for GDP suggest that 2024 will see slowing growth but not a recession, whilst recession risks remain elevated. A cynical investor could argue that the market has a bet in two camps right now and we wouldn't blame them. This economic cycle is like no other and has defied all historical reference to date.

Figure 1 – Consensus Real GDP Estimates



Source: Bloomberg, Mason Stevens OCIO

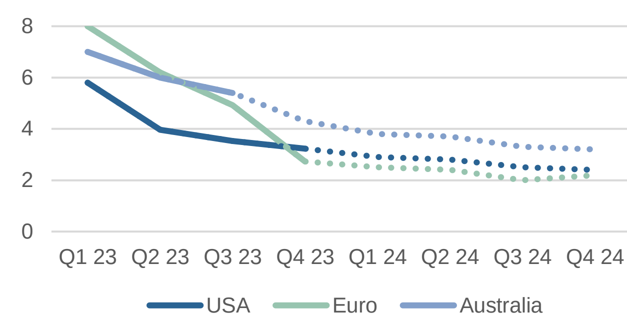
Figure 2 – Consensus Probability of Recession



Source: Goldman Sachs Global Investment Research, Mason Stevens OCIO

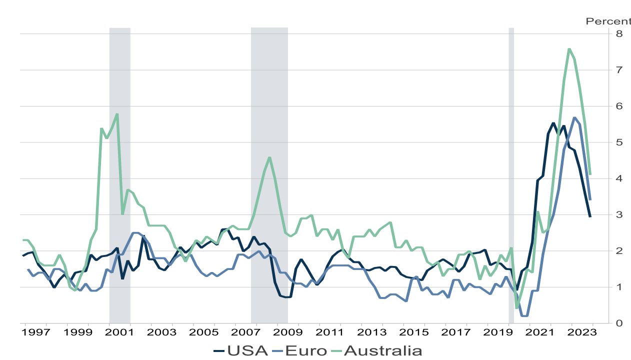
The path of disinflation has defied previous cycles as historically demand destruction has been required to tame inflation. The transitory nature of the pandemic and oil related drivers of inflation have now passed and importantly inflation expectations have remained well anchored providing confidence in consensus estimates.

Figure 3 – Consensus CPI Estimates



Source: Bloomberg, Mason Stevens OCIO

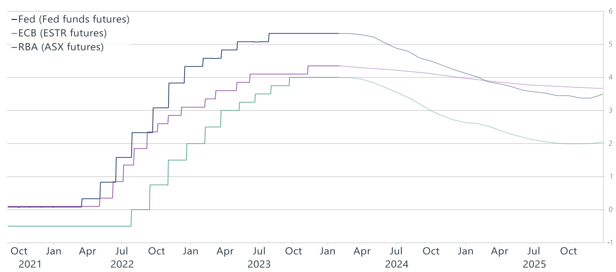
Figure 4 – Core Inflation



Source: Macrobond, Federal Reserve Bank of San Francisco, Australian Bureau of Statistics, ECB (European Central Bank), Mason Stevens OCIO

Monetary policy settings are now considered restrictive globally. As disinflation continues, continued real yields have room to fall. Current consensus estimates in most regions suggest we are on the brink of rate cutting cycles in much of the developed world.

Figure 5 – Central Bank Policy Rates and Market Implied Rate Trajectories



Source: Mason Stevens OCIO, Macrobond, Institute for Supply Management (ISM)

Fiscal policy settings were a dominant driver of persistent upside surprise in US growth in 2023. Whilst the level of stimulus may reduce, we are unlikely to see a fiscal cliff in the US in a general election year, especially with an incumbent president on the ballot.

2024 has been deemed the "Super Election Year" where half of the world's population goes to the polls. Elections rarely change the course of equity markets; they do tend to see fiscal largess with high budget deficits and government intervention in different forms.

Figure 6 - IMF Estimates for Budget Deficits in the 2020s

Source: Mason Stevens OCIO, Macrobond, IMF

Australia appears to be on a similar path to the US. While slightly behind in terms of the disinflation story. The latest Australian CPI data continues a clear trend down that commenced in early 2023, and rate cuts are arguably on the horizon for the first time since the rate hiking cycle began. Growth estimates are generally soft, but not recessionary. High net migration, while beginning to turn, remains well above pre-pandemic levels and continues to support growth. A solid US economic story and modest China stimulus also provide positive impulses into the economy. Conversely, Australia is approximately 75% of the way through its "mortgage cliff" process as households roll-off low fixed rate loans onto higher floating rates. A key risk remains around how this is managed through 2024 as pandemic savings dwindle.

We introduce three key economic scenarios and the key data points that drive the probabilities of each. The case for a soft-landing at this stage is gaining momentum as incremental data continues to be supportive. Alternative endings include the left tail risk of a 'cyclical recession' where the lagged effect of tight monetary policy and an inverted yield curve results in unemployment rising and a far more material downturn than currently expected. On the right tail is the possibility of a 'no landing' scenario supported by an upturn in global manufacturing and housing. We would argue that this scenario whilst right tail in nature for the economy would be volatile for markets given the likely need to raise interest rates to cool the last mile of inflation.

In our view the key from here lies largely in the employment cycle and whether softness already seen gains momentum despite the likely start of a central bank cutting cycle. Additionally, housing cycle strength and a recovery in the manufacturing cycle are key areas to monitor.

Scenario One: Soft landing
Probability: 55%

A soft-landing scenario would involve positive but below trend growth across major economies. Current monetary policy settings are sufficient for immaculate disinflation to continue to within central bank target bands, allowing them to pivot and cut interest rates, easing pressure on indebted households, companies and, for that matter, indebted governments.

Soft-landing proponents point firstly to the strength of consumer and corporate balance sheets, the fixed cost nature of debt and the fact that the duration of debt is somewhat longer dated to past cycles, resulting in less refinancing risk. This combines with labour hoarding, migration and the fiscal thrust of government spending to have allowed the US economy to avoid recession in 2023.

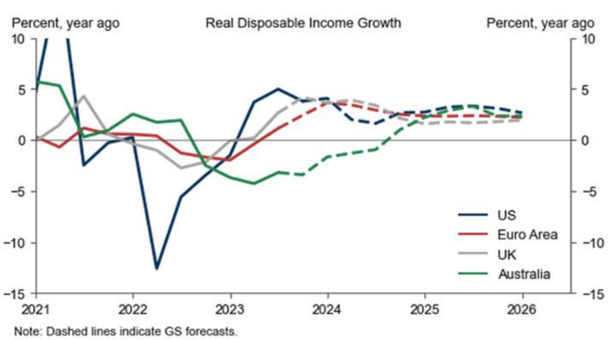
In Australia, excess savings, labour hoarding and migration have also featured however we have not had the same level of fiscal thrust and the nature of our debt structures means that monetary policy has a stronger impact on consumer spending.

Europe's economy has been less resilient given its reliance on manufacturing despite its excess savings, labour hoarding and labour force participation.

Global growth is expected to benefit from several tailwinds in 2024, including:

- strong real household income growth,
- a smaller drag from monetary and fiscal tightening,
- a recovery in manufacturing activity, and;
- an increased willingness of central banks to deliver insurance cuts if growth slows.

Figure 7 – Real Disposable Income Growth

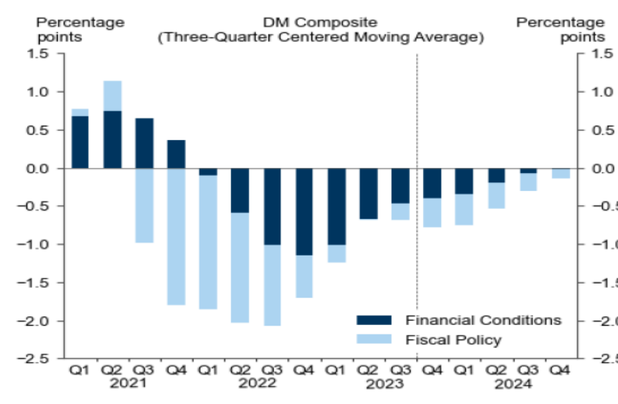


Source: Goldman Sachs Global Investment Research

Assuming unemployment remains steady, with headline inflation falling, then real disposable income will rise. This should be sufficient to support consumption and GDP growth. Europe should see a more significant rate of growth given gas price reductions. Given Australia lags the rest of the world in terms of inflation and the impact of interest rates, we would argue that through the course of the year Australia will be a beneficiary of this trend as well.

Financial conditions have eased and hence the worst is over in terms of the impact on GDP growth of tighter monetary policy. Whilst fiscal policy is quite different across most developed economies, as inflation becomes more contained the ability of governments to support the economy improves. Additionally, as discussed earlier, with significant election activity around the globe, incumbent governments are incentivised to open the purse strings.

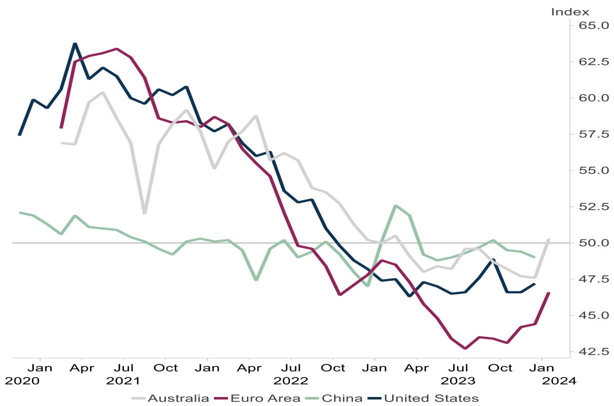
Figure 8 – Estimated Impact of Financial Conditions and Fiscal Policy on GDP



Source: Goldman Sachs Global Investment Research

The manufacturing cycle driven by Covid has been more volatile than history and has the potential to recover in 2024. Weak industrial activity this year reflected a combination of unusual headwinds, including a rebalancing of spending back towards services from goods, the European energy crisis, an inventory destocking cycle that corrected for an overbuild in 2022, and a weaker-than-expected rebound in Chinese manufacturing. Most of these headwinds are set to fade this year, as spending patterns normalise, gas-intensive European production finds a trough, and inventories-to-GDP ratios stabilise, prompting a gradual manufacturing recovery as the lagged impact of easing financial conditions globally supports global goods production and consumption.

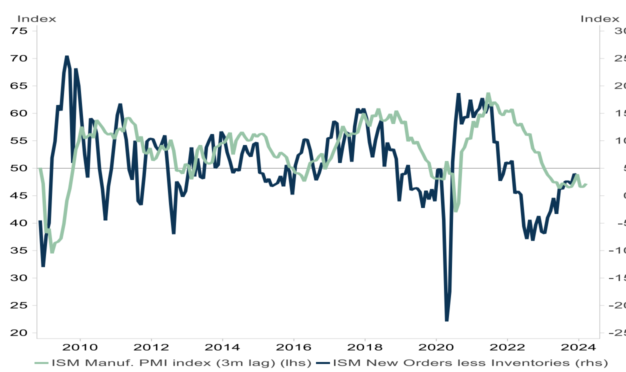
Figure 9 – Manufacturing PMIs



Source: Mason Stevens OCIO, Macrobond, Institute for Supply Management (ISM), S&P Global, China Federation of Logistics & Purchasing

The leading New Orders-Inventories Spread has been trending higher since 1Q23 and suggests we are likely to see the headline ISM Manufacturing PMI trend higher over the medium term, escorting residual "hard landing" holdouts into the "soft landing" or "no landing" communities in the process.

Figure 10 - US New Orders Less Inventories

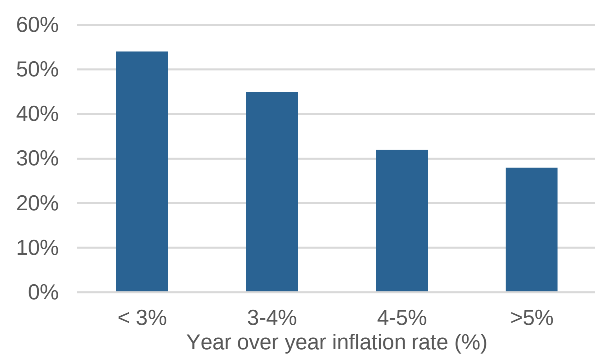


Source: Mason Stevens OCIO, Macrobond, Institute for Supply Management (ISM)

Finally, assuming disinflation trends remain intact there is considerable scope for central banks to cut rates. That is to say that the recent Fed's dovish pivot has tipped the odds in favor of a soft landing. We expect that the Fed will shift from fighting inflation to managing the business cycle this year. Additionally, we expect that there is an inordinate level of pressure for cuts to begin sooner rather than later given levels of government debt and the associated interest rate burden. We expect other central banks will follow suit once their respective disinflation paths reach appropriate levels. Importantly, however, we expect that this process will start without material softening in the economy.

Several of the EM early hikers—including Brazil and Poland—have already begun to cut policy rates from highly restrictive levels and are likely to deliver ongoing steady cuts. Indeed, Goldman Sachs analysis of past hiking cycles confirms that major central banks are twice as likely to cut rates in response to downside growth risks once inflation has normalised to sub-3% rates relative to when inflation is above 5%. This is an important insurance policy against a recession.

Figure 11 - Effect of 1pp Unemployment Rate Increase on Probability of Rate Cut in Following Quarter, By Rate of Inflation



Source: Goldman Sachs Global Investment Research

Soft landings are not common, and there are no modern examples of a sustained growth phase following synchronised global monetary tightening. The US has, however, had three soft-landing episodes since 1960. The Fed raised policy rates by more than 250bp during 1964-66, 1983-84, and 1994-95. The 1960s expansion lasted three years beyond Fed tightening, while the 1980s and 1990s episodes saw expansions extend for more than five years.

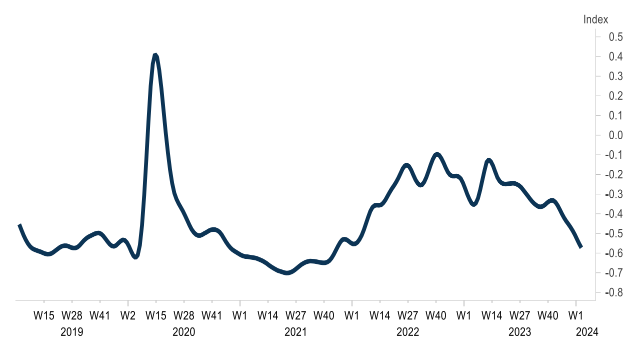
Two important features of these soft-landing episodes are worth highlighting. First, none of these episodes generated labour market slack or reduced wage pressures. Rather than cutting costs on labour, firms initially absorbed some of the impact of monetary tightening by accepting a margin compression. Second, in each of these soft-landing episodes, the Fed quickly reversed course, easing within six months of its final hike. This calibration away from restrictive stances, combined with other positive growth impulses, boosted demand and bolstered business confidence in a manner that extended the economic expansion.

Scenario Two: No landing
Probability: 10%

In a no landing scenario, recent loosening of financial conditions would result in US economic growth continuing to be at, or above, trend. Europe’s current slowdown would reverse, and the Chinese economy would be supported by global demand, and potentially local stimulus. In this scenario, core inflation could prove stickier and settle one or two percentage points above central bank targets, resulting in monetary policy settings tightening (or not being cut in line with market expectations) to force inflation to target. Australia would likely follow the US economy’s lead, however, given the lack of labour productivity and higher inflation the RBA may have more work to do than global central bank peers.

With the U.S. economy currently operating at full employment, a recovery in manufacturing when combined with any pickup in China, and the tailwind of lower policy rates, could lead to a meaningful reacceleration to above trend growth. Financial conditions over recent months have loosened, which some argue will re-ignite the global economy as opposed to simply supporting a soft landing.

Figure 12 – US Financial Conditions Index

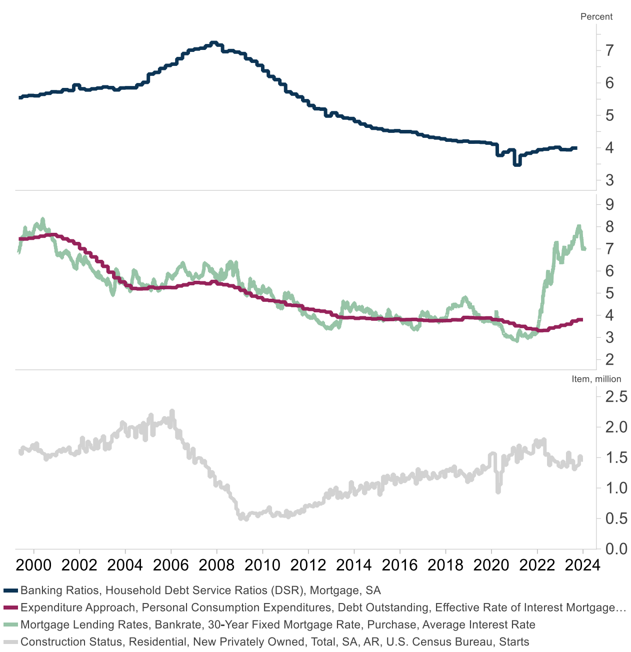


Source: Mason Stevens OCIO, Macrobond, Federal Reserve Bank of Chicago

The latest key economic data reduces the probability of a recession in the US economy. If anything, the data is much stronger than consensus expectations. As already discussed, the global manufacturing downturn is showing signs of bottoming. January PMI data from the major economies signaled green shoots in the global economy, which represent upside risk for risk assets over the medium term. With that said, we need to be mindful that the robust US flash PMI releases are at odds with the results of other recent business surveys. In particular, regional Fed business surveys are downbeat with the manufacturing indices of both the Empire and Richmond Fed releases as well as the Philly Fed non-manufacturing index deteriorating meaningfully in January.

Secondly the housing market is also providing green shoots. Given the healthy spread between effective and marginal mortgage rates, as well as a favourable household leverage profile, demand for new housing and therefore construction labour continues to support either the soft or no landing scenario.

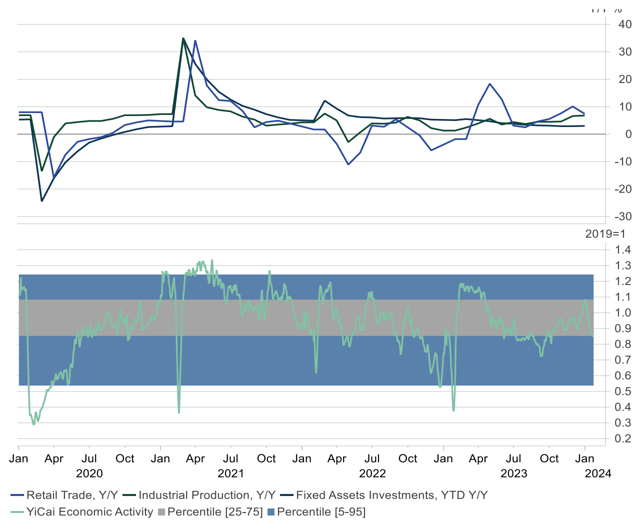
Figure 13 - US Mortgages and Construction Status



Source: Mason Stevens OCIO, Macrobond, Bankrate, Federal Reserve, U.S. Bureau of Economic Analysis (BEA), U.S. Census Bureau

The other key swing factor for this scenario is the economic path for China, a fundamentally imbalanced economy. To date the PBOC has undertaken a series of stimulus activities which have yet to take hold. However, a pick-up in global growth may be sufficient to support China's recovery. The chart below utilises a series of high frequency data to determine whether there are in fact green shoots in the Chinese economy. At this stage there is no evidence of a cyclical turn.

Figure 14 – China's High Frequency Daily Data



Source: Mason Stevens OCIO, Macrobond, NBS, YICAIRI

The weakness in China owes to a range of factors. Foremost is the real estate sector, where the legacy of years of borrowing is causing severe financial challenges. However, the impact is also felt in real activity, as private housing starts have plunged over the past two years and continue to move lower. More concerning, however, is the lack of private investment in fixed assets, which has moved sideways for two years with no sign of re-engaging. At the same time, household consumer goods spending is picking up after being severely depressed through the lockdowns, but the recovery has been far more lacklustre than expected.

Our long-term view on China is not positive given the lack of serious reforms to improve these productivity issues along with poor demographics which have seen their population decline for the second year in a row.

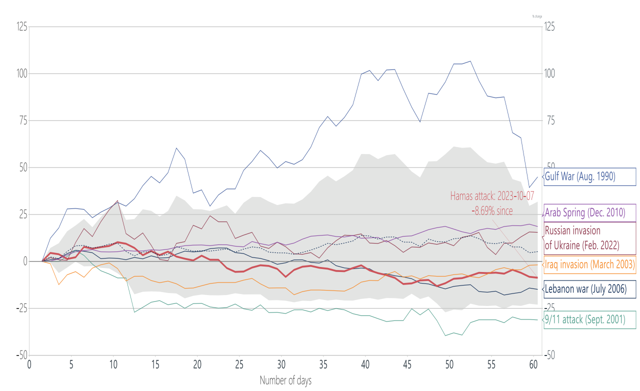
That said in the shorter-term authorities in China have just announced additional stimulus measures commencing on February the 5th, with a reduction in bank reserve requirements. In an environment where global growth is better than expected this may see local Chinese stimulus finally gain more purchase in the economy.

Most proponents of this overall 'No Landing' scenario argue that the 'last mile' of inflation would be difficult to achieve without central banks either keeping rates higher for longer or even raising rates from here. Such a positive growth outlook implies that employment in developed markets remains somewhere near current historic lows, which in turn would keep a degree of pressure on inflation numbers given strong wage growth and consumer spending.

This then brings into view the concerns of central bankers of ongoing waves of higher inflation as was seen in the 1970s. Strong growth may see inflation settle slightly higher than target, but in isolation may not be sufficient for another meaningful inflation spike. We do, however, currently have some obvious geopolitical catalysts that could change this. The current disruption of shipping in the Red Sea by Houthi rebels operating out of Yemen has caused significant disruption and delays in global trade as container ships take longer routes around Africa to avoid the area. The cost of shipping a standard 40-foot container from Asia to northern Europe has surged from less than $1,500 USD in mid-December to nearly $5,500 USD currently[1]. This is not as severe as during the COVID pandemic when these costs got to $15,000 a container, but current pricing is nevertheless clearly inflationary to the cost of goods. If these shipping disruptions are sustained through the first half of this year, we could see this flow into higher prices and therefore inflation numbers.

There is also a risk of further escalation in the Middle East. US troops have recently been killed in a rocket attack at a base in Jordan, seemingly by Iranian backed militants, and the US has stated it will retaliate. This will be something to watch closely in the first quarter of this year. This may well remain a conflict largely contained to Israel and Gaza, but there is an increased risk of direct conflict between the US and Iran. This scenario may lead to a short-term impact on Brent prices, which if sustained could flow through to inflation more broadly.

Figure 15 – Short-term Impact of Various Geopolitical Events on Brent Prices



Source: Mason Stevens OCIO, Macrobond, ICE

Finally, if these waves of inflation do eventuate, it does bring into prospect a genuine hard landing, as central banks increase rates to bring down inflation. This is likely a risk late in 2024 and then into 2025.

[1] AP News, 28 January 2024

Scenario Three: Cyclical Recession
Probability: 35%

A mild to moderate recession driven by the lagged effect of tight monetary policy and a lack of credit availability would result in an economic downturn across developed and emerging economies. Central banks would respond by cutting interest rates aggressively, while inflation would also fall sharply as demand destruction delivers the last mile of disinflation.

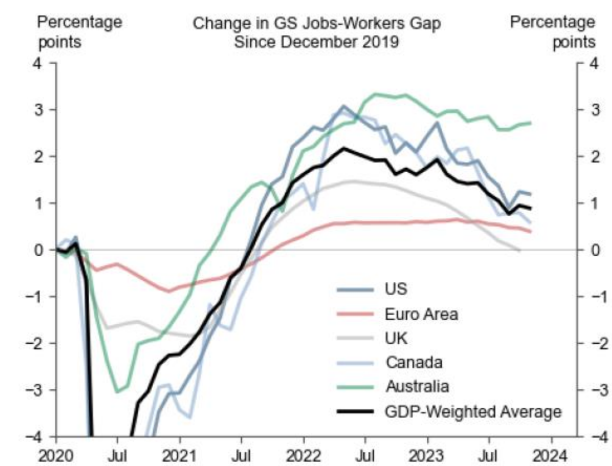
The thesis around a cyclical recession revolves largely around time. Over time, labour demand will continue to slow given the lagged effect of tight monetary policy settings. The Fed's tightening cycle was remarkable in both size and speed and as such the full lagged effects of the tightening have yet to hit the economy. The Chicago Fed[2] estimated in September 2023 that about one-third of the impact from past rate hikes had flown through to real GDP, and over half of the impact on aggregate hours worked still lie ahead.

With enough time, the labour demand curve will reach the kink in the supply curve. When that happens, any further decline in labour demand will push down employment. That is to say, the economy will slow once all the job openings that have insulated it from recession are depleted. The economy through this phase will shift from boom to bust.

Proponents of this thesis argue that this phase of transition will occur when investors least expect it. At the kink in the labour supply curve, everything looks wonderful: inflation is near target while employment is still high – the exact description of a soft landing.

Not surprisingly, the key data points with regard to this scenario relate primarily to the state of labour markets. Figure 16 shows the jobs-workers gap across the key economies. At present, the jobs-workers gap remains above pre-pandemic levels, however as job openings continue to fall this metric is coming back into balance. At that point, workers who lose their jobs will struggle to find new ones. Workers who are still employed will become increasingly concerned, causing them to raise precautionary savings. With most of the excess pandemic savings exhausted by then, the economy will start to suffer from a shortfall of spending. And since one person's income is another's spending, falling employment will feed on itself, culminating in a recession.

Figure 16 – Jobs-workers Gap Falls



Source: Haver Analytics, Goldman Sachs Global Investment Research

Other key planks of the cyclical recession scenario revolve around the inverted yield curve and the implications of this on credit availability and growth. The nominal 3 month – 10-year US treasury yield curve inversion is the most reliable leading indicator of recession. An inverted yield curve typically puts pressure on bank profitability therefore impacting the availability of credit for the economy to grow.

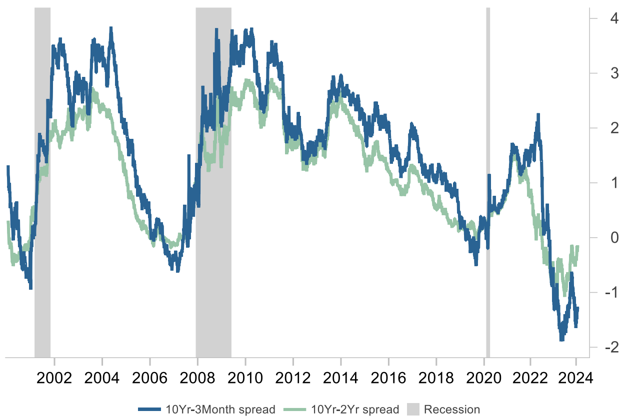
Bank lending standards for business loans have been tightening for a year and a half and interest rates have been rising. There are headwinds to consumer and business spending that we expect to strengthen in 2024, reflecting the lags from tightening in policy to slowing in activity.

There have been signs that business fixed investment is being affected by policy tightening. In the Fed's Senior Loan Officer Opinion Survey (SLOOS), banks have reported falling demand for commercial and industrial loans (C&I) and for commercial real estate loans (CRE) since mid-to late 2022. In each quarter of 2023, about 60% of banks reported falling demand for CRE loans – a similar share to 2009. About

[2] Source: Stefania D'Ámico and Thomas King, September 2023
https://www.chicagofed.org/publications/chicago-fed-letter/2023/483

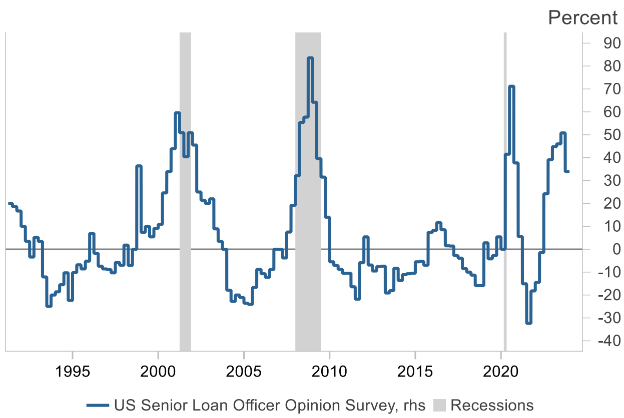
40%-50% of banks saw weaker demand for large and small business C&I loans in each quarter. Typically, declines in loan demand are only that broad or long-lasting during recessions.

Figure 17 –US Yield Curve Inversion



Source: Mason Stevens OCIO, Macrobond, US Department of Treasury, NBER (National Bureau of Economic Research)

Figure 18 – US Senior Loan Officer Survey



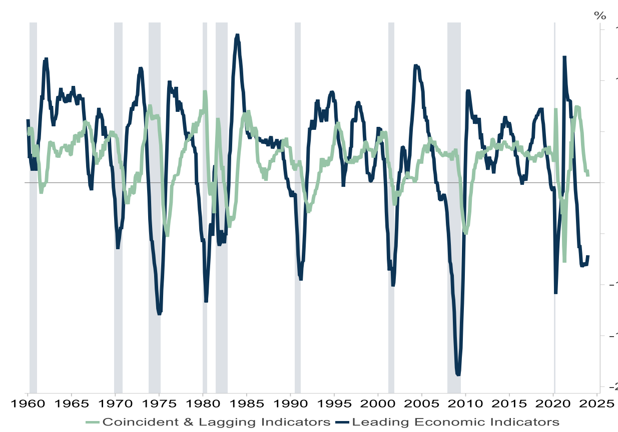
Source: Mason Stevens OCIO, Macrobond, Federal Reserve, Federal Reserve Bank of St Louis

Finally, the US Conference Board's Leading Economic Indicator (LEI) continues to provide a strong signal for a softening economic outlook. The index first started falling nearly two years ago. Whilst some solace can be found in recent data suggesting the rate of decline is slowing and in addition, six of the ten components of the indicator made positive contributions to the LEI in December.

Additionally, the Coincident Economic Index (CEI) is sending a sanguine signal about current economic conditions, rising 0.2% m/m in December. This is consistent with the message from the Atlanta Fed's GDPNow model which has real GDP growth tracking 2.4% in Q4.

To the extent that the LEI is heavily weighted towards goods-producing sectors, whose cycle was amplified during the pandemic, there remains an argument that the LEI's are less compelling as an indicator in this cycle and is therefore potentially overstating the weakness of the aggregate economy.

Figure 19 – US Economic Indicators



Source: Mason Stevens OCIO, Macrobond, Conference Board

That said, restrictive monetary policy remains a headwind for the economy. Labour demand is already softening which may, according to this argument, foreshadow an increase in unemployment later this year. Meanwhile, the tailwind to consumption from excess pandemic savings is fading.

Sentiment Indicators

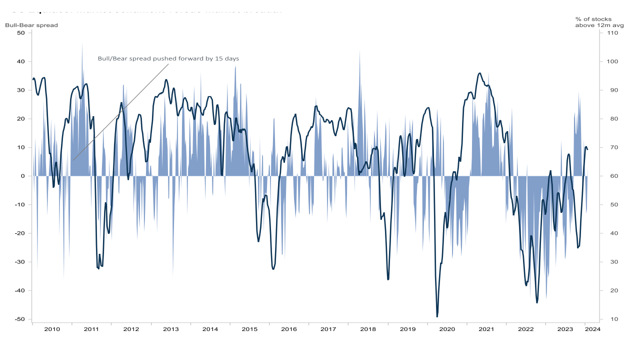
Sentiment indicators suggest that whilst investors have transitioned in recent months to a more optimistic outlook that it is not yet at extreme measures to warrant a significant risk-off posture in portfolios.

The basis for incorporating sentiment analysis into multi-asset strategies lies in recognising that different asset classes often respond differently to investor sentiment.

We assess sentiment through a number of different tools; specifically, the AAII (American Association of Individual Investors) sentiment surveys and Citi's Levkovich Index which both have proven alpha generating signals. These surveys gauge the sentiments of individual investors towards various asset classes, providing valuable insights for portfolio decision-making.

Investors have transitioned toward a more optimistic outlook as of mid-November. That aligns with the analysis on the following pages that suggests that the market has broadly priced in a soft-landing scenario. Importantly, however, sentiment has not moved to an unsustainable extreme that would warrant a significant risk-off posture in portfolios.

Figure 20 – US Equities: Market Sentiment Versus Market Breadth

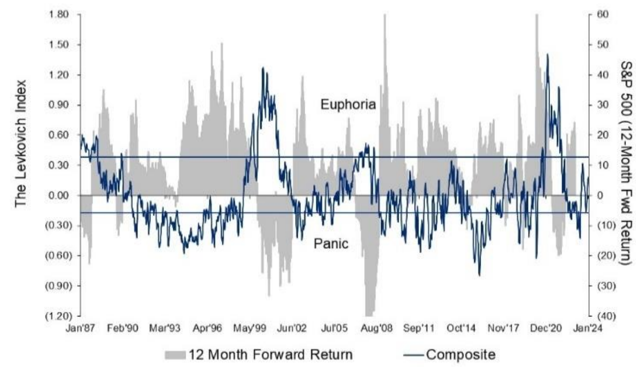


Source: Mason Stevens OCIO, Macrobond, American Association of Individual Investors (AAII)

The figure above shows that as sentiment turned at the back end of 2023, the market also began to broaden out. The proportion of stocks at or above 12-month highs is currently sitting at around 70%. That is to say90, whilst sentiment has improved, it is not yet euphoric.

The Citi Levkovich index is a combination of a number of factors including NYSE short interest % of float, margin debt, TRF volume % of total, Market Vane and AAII bullishness, NCF Nonfinancial Leverage, put/call ratio, CRB futures, gasoline prices, and 25 delta put/call skew. Importantly, this index suggests that again the market is somewhat neutral in its positioning.

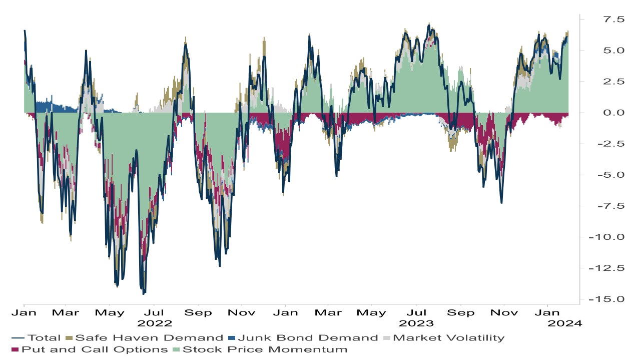
Figure 21 – Citi Levkovich Index (Fear & Greed)



Source: Mason Stevens OCIO, Haver Analytics, FactSet, Bloomberg and Citi Research

The final survey that we consider is the Fear & Greed Index. It captures a different set of inputs and includes some momentum-based indicators. This chart below offers a historical perspective on five out of the seven Fear & Greed indicators: stock price momentum (as defined by the S&P 500 versus its 125-day moving average), the five-day ratio of put to call options, market volatility (the VIX), junk bond demand (the spread over investment grade), and safe haven demand (as measured by short-term bond outperformance versus stocks).The chart utilises Z-scores (divergence from the norm, as measured by standard deviations) for each indicator in this chart. Where the AAII survey and Levkovich tools suggest neutral sentiment, the CNN Fear and Greed Index suggests the market is 'greedy'.

Figure 22 – CNN Fear & Greed Index



Source: Mason Stevens OCIO, Macrobond, S&P Global, Chicago Board Options Exchange (CBOE), Federal Reserve, U.S. Dept. of Treasury

Modelled asset class performance per scenario

The tables on the following pages detail our view of the available returns in each asset class. The methodology of these return expectations is articulated in detail. We encourage investors to consider these expectations as a framework for assessing risk and reward in the context of portfolio construction, rather than specific targets.

	Soft landing (%)	No landing (%)	Cyclical recession (%)
Australian Equities	7.5	-7.3	-23.8
Global Equities (unhedged)	0.7	-10.6	-14.9
Global Equities (hedged)	6.3	-2.3	-22.8
Australian Fixed Income	6.6	-1.5	11.1
Global Fixed Income (hedged)	6.6	-3.4	9.3
Global REITs (hedged)	2.2	-6.5	-8.2
Global Infrastructure (hedged)	5.4	-4.7	-2.6

Source: Mason Stevens OCIO

Methodology

For equities we calculate the equity risk premium (ERP) as the current consensus estimated 1-year forward earnings yield (inverted Price-to-Earnings ratio) less the current 10-year bond yield and estimate where the risk premium is headed under each scenario to calculate an expected return from capital growth. We also adjust consensus 1-year forward earnings depending on the scenario. The total return expectation incorporates an estimate of total yield for the market, which includes share buybacks for the US market.

We apply a similar process to listed property and infrastructure, however we replace earnings yield with capitalisation rate (net operating income / market value) for property and an earnings yield before interest, tax, depreciation & amortisation over enterprise value (inverted EV/EBITDA ratio) for infrastructure.

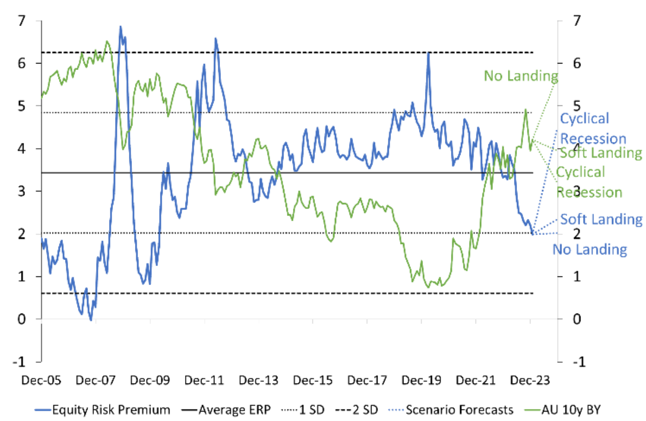
For fixed income we consider the level of inflation and growth under each scenario and utilising the wisdom of crowds approach we estimate the 10-year bond yield, the term premium and credit spreads, considering historical outcomes under different regimes.

Under our DAA approach, we do not estimate returns for alternatives in aggregate. We assume the long-term capital market assumptions from our SAA are valid through the cycle given the nature of this asset class, where the majority of returns are uncorrelated to market beta. See our sleeve strategy for alternatives on page 20 for how we expect certain categories of alternatives to perform under each macroeconomic scenario.

Australian Equities

The ERP is currently below the long run average for the Australian market, signaling that investors are willing to pay up for risk, and a reflection of anticipated lower future bond yields and cash rates.

Figure 23 – S&P/ASX200 Equity Risk Premium



Source: Bloomberg, Mason Stevens OCIO

	Index Target	Capital Return (%)	Dividend Return (%)	Total Return (%)
Soft landing	7831	3.3	4.2	7.5
No landing	6693	-11.7	4.4	-7.3
Cyclical recession	5499	-27.4	3.6	-23.8

Source: Mason Stevens OCIO Current index 7578 as at 29/1/2024

Soft Landing

In this scenario, we estimate the ERP to revert from current low levels and progress back up to long term averages, without quite getting there. The increase is a function of the anticipated lower yields eventuating, while the still below average premium reflects the expected investor optimism at having avoided a cyclical recession, yet still benefiting from lower real rates.

The increase in ERPs more than offsets the lower expected bond yield (from the current 4.2% to 3.95%). Whilst we believe the market is broadly pricing in a soft-landing scenario, as central banks begin to cut, momentum may push indices into expensive territory. The implied 1-year forward P/E ratio under these assumptions is 15.9x, implying a de-rating of 0.3 points (-1.6%).

We do, however, expect forward consensus earnings to increase circa 5% as the year rolls on with growth, albeit below trend, still positive. Lower inflation should also bode well for corporate margins and continued consumer and business spending. Our 5% increase to consensus earnings implies an earnings per share (EPS) growth estimate of 4.1% versus the current consensus 1-year forward EPS growth of -0.9%. Interestingly, the consensus growth rate this time next year sits at +3.8%.

Together with an estimated 4.2% dividend yield, the **expected total return for the S&P/ASX 200 under the soft-landing scenario is 7.5%.**

No Landing

We estimate the ERP to remain at one standard deviation below average and forward consensus earnings to increase circa 10% as the year rolls on with higher-than-expected economic growth driving continued sales growth. The implied 1-year EPS growth in our model is 9.0%.

The **expected total return under this scenario is -7.3%,** assuming a dividend yield of 4.4%. The circa 12% decline in capital value is driven by the significant increase in the estimated 10-year bond yield from 4.2% to 5.7%.

The implied 1-year forward P/E ratio under these assumptions is 13.0x, implying a de-rating of 3.2 points (-19.7%).

Cyclical Recession

Under this scenario we expect bond yields to fall, the equity risk premium to significantly increase, consensus earnings expectations to decline 10%, and a dividend yield of 3.6% leading to **an expected total return of -23.8%.**

The implied 1-year EPS growth is -10.8% and the 1-year forward P/E ratio under these assumptions is 13.0x, implying a de-rating of 3.1 points (-19.4%).

Global Equities

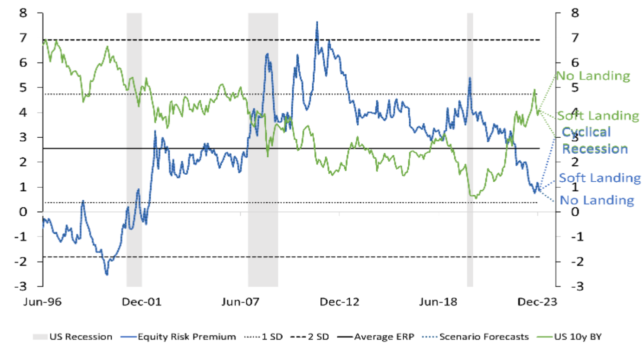
For global equities we model the US and the European markets which between them represent circa 90% of the MSCI World index, with the US dominating the exposure at over 70%.

As with Australian equities, the ERP is currently below long run averages for the US and European markets although not quite the -1-standard deviation as is the case for the S&P/ASX 200.

	S&P500 Index Target	Capital Return (%)	Dividend Return (%)	Total Return (%)
Soft landing	5093	3.4	2.7	6.5
No landing	4569	-7.3	3.3	-4.0
Cyclical recession	3598	-27.0	3.2	-24.3

Source: Mason Stevens OCIO Current index 4928 as at 29/1/2024

Figure 24 – S&P500 Equity Risk Premium

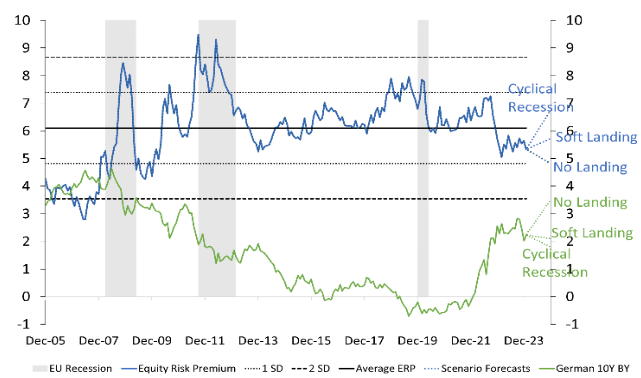


Source: Bloomberg, The National Bureau of Economic Research (NBER), Mason Stevens OCIO

	STOXX600 Index Target	Capital Return (%)	Dividend Return (%)	Total Return (%)
Soft landing	493	1.6	3.7	5.3
No landing	485	0.0	3.9	3.9
Cyclical recession	387	-20.3	3.2	-17.1

Source: Mason Stevens OCIO Current Index 485 as at 29/1/2024

Figure 25 – STOXX 600 Equity Risk Premium



Source: Bloomberg, The Centre for Economic Policy Research (CEPR), Mason Stevens OCIO

Soft Landing

Our expectation under this scenario is for the ERP to drift higher as the consensus lower bond yields eventuate, but at a lower rate than both Australia and Europe given the higher relative exposure to generative artificial intelligence that should deliver higher earnings growth over multiple years.

However, the increase in ERPs do more than offset the lower expected bond yields. The implied 1-year forward P/E ratio for the S&P500 under these assumptions is 19.9x, implying a de-rating of 0.3 points (-1.6%), while for the European market the implied 1-year forward P/E ratio is 12.8x, implying a de-rating of 0.4 points (-3.2%).

As with Australia, we expect forward consensus earnings in the US and Europe to increase circa 5% which implies an EPS growth estimate of 15.5% for the US (versus current consensus of 10.0%) and 6.2% for Europe (versus the current consensus of +1.2%).

We estimate the total yield for the US under this scenario to be 3.2% and 3.7% for Europe and calculate **the expected total return for the MSCI World ex Aus to be 6.3%.**

No Landing

We expect the ERPs to fall to one standard deviation below averages and forward consensus earnings to increase 10%. The implied 1-year EPS growth in our model for the US is 21.0%, and 11.3% for Europe.

The **expected total return under this scenario is -2.3%,** with a negative 4.0% return for the US more than offsetting the positive 3.9% for Europe.

Under these assumptions, the implied 1-year forward P/E ratio is 17.0x for the US and 12.0x for Europe.

Cyclical Recession

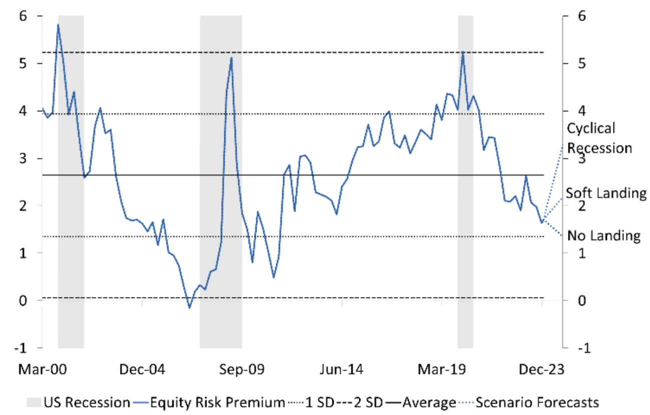
We expect bond yields to fall, the ERP to significantly increase, consensus earnings estimates to decline 10% and a total yield of 2.8% leading to an **expected return of -22.8%.**

The implied 1-year forward P/E ratio under these assumptions is 17.0x for the S&P 500 and 11.4x for the STOXX 600.

Listed Property and Infrastructure

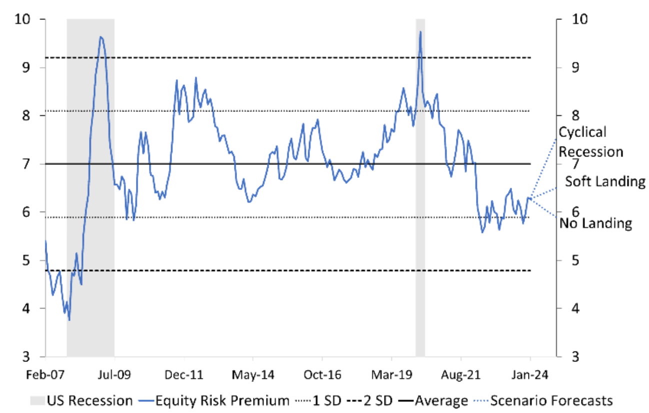
Again, we find the ERPs for property and infrastructure to be below long run averages.

Figure 26 – Global Listed Property ERP



Source: Bloomberg, NBER, Mason Stevens OCIO

Figure 27 – Global Listed Infrastructure ERP



Source: Bloomberg, NBER, Mason Stevens OCIO

Soft Landing

We expect the ERP to revert from current low levels and progress back up to long term averages, consistent with the approach for broader equities.

The increase in ERPs offsets the lower expected bond yield, leading to a 1-year forward cap rate for the global listed property sector of 5.9%, up slightly from the current 5.8%. With respect to global listed infrastructure, the implied 1-year forward EV/EBITDA ratio is 9.8x, which is slightly above the current 9.6x. Again, this is consistent with our belief the market is pricing in a soft-landing scenario.

In this scenario we do not adjust consensus net operating income for Property or EBITDA for infrastructure. We estimate a total yield of 4.25% for each of the sectors. Under these assumptions we calculate the **expected total returns to be +2.2% and +5.4% for property and infrastructure respectively.**

No Landing

Consistent with equities, we expect the ERPs to fall to one standard deviation below averages, but in contrast to broader equities, we assume consensus net operating income for property stocks to increase by a more mooted 5%, and consensus infrastructure EBITDA to remain unchanged.

The implied 1-year forward cap rate for the global listed property sector under these assumptions is 6.9%, up 1.1 percentage points from 5.8%.

With respect to global listed infrastructure, the implied 1-year forward EV/EBITDA ratio is 8.8x, implying a de-rating of 0.9 points (-9.0%).

Taking into account estimated total yield (4.5% for property and 4.25% for infrastructure) the **expected total returns are -6.5% and -4.7% for property and infrastructure respectively.**

Cyclical Recession

We expect bond yields to fall, the ERP to significantly increase, consensus net operating income for property stocks and EBITDA for infrastructure stocks to decline 5%, and a total yield of 4.0% leading to **expected returns of -8.2% and -2.6% for property and infrastructure respectively.**

The implied 1-year forward cap rate for the global listed property sector under these assumptions is 6.3%, up 0.5 percentage points while the implied 1-year forward EV/EBITDA ratio for global listed infrastructure is 9.5x, implying a de-rating of 0.2 points (-1.7%).

Global Fixed Income

	Soft landing (%)	No landing (%)	Cyclical recession (%)
US 10-year	3.75	5.50	3.00
US IG Spreads	0.95	1.10	2.10
US Gov. ER	6.7	-3.7	14.6
US IG Credit ER	7.8	-3.5	9.2
US Global Agg. ER	**7.3**	**-3.6**	**11.5**
Euro 10-year	2.10	3.50	1.80
Euro IG Spreads	1.15	1.35	2.15
Euro Gov. ER	3.6	-4.1	7.1
Euro IG Credit ER	6.5	-2.4	4.0
Euro Agg. ER	**5.2**	**-3.1**	**5.3**
Global Agg. ER	**6.6**	**-3.4**	**9.3**

Source: Mason Stevens OCIO

Figure 28 – US 10-Year Bond Yield

Source: Bloomberg, NBER, Mason Stevens OCIO

Figure 29 – German 10-Year Bond Yield

Source: Bloomberg, CPER, Mason Stevens OCIO

Soft Landing

In this scenario we expect inflation to fall back within central bank targets coupled with positive but below trend growth. This is the majority of researchers' base case / central scenario.

Given these assumptions, and utilising our wisdom of crowds approach, we expect the US 10-year bond yield to fall from the current 4.1% to 3.75% by the end of 2024, and the German 10-year yield to fall from 2.3% to 2.1%.

We expect investment grade credit spreads to be broadly flat for the US and to fall slightly more in Europe.

We also assume a continued bull-steepening of the yield curve and calculate a total **expected return for global bonds under these assumptions to be 6.6%**, with the US outperforming Europe, and investment grade credit outperforming treasuries.

No Landing

Our expectations under the scenario in which both economic growth and inflation remain elevated is for the US 10-year to go back to 5% (recent high) and eventually go higher to 5.5% and for the German 10-year in increase to 3.5%.

We expect credit spreads in the US to widen marginally by low double digits and broadly flat in Europe.

The total **expected return for global bonds under these assumptions is -3.4%,** with Europe outperforming the US, and investment grade credit outperforming treasuries.

Cyclical Recession

Our expectations under the scenario in which economic growth enters a cyclical recession and inflation falls is for the US 10-year to fall to 3.0% and for the German 10-year to decrease to 3.5% as central banks cut rates to stem slower growth and deflation.

Under this scenario we expect credit spreads in the US to significantly widen by greater than 100bps in the US and by approximately slightly less than that in Europe.

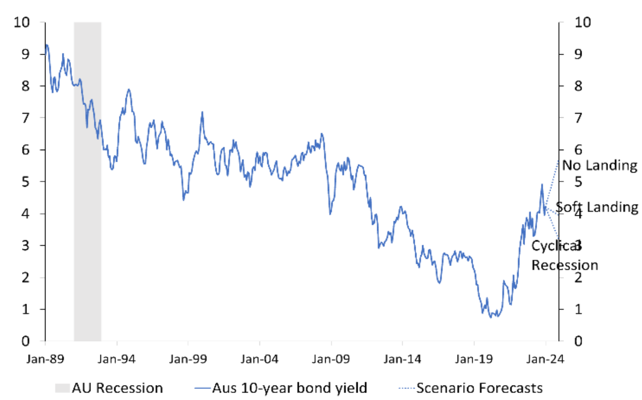
The **total expected return for global bonds under these assumptions is 9.3%,** with US outperforming Europe, and treasuries significantly outperforming credit in both regions.

Australian Fixed Income

	Soft landing (%)	No landing (%)	Cyclical recession (%)
Aus 10-year	3.95	5.70	3.20
Aus IG Spreads	1.15	1.26	2.26
Aus Gov. ER	6.1	-1.7	12.9
Aus IG Credit ER	7.1	-1.2	9.0
B'berg Comp 0+	**6.6**	**-1.5**	**11.1**

Source: Mason Stevens OCIO

Figure 30 – Australian 10-Year Bond Yield



Source: Bloomberg, Reserve Bank of Australia, Mason Stevens OCIO

Soft Landing

We base our Australian 10-year bond yield on the US estimates, applying a ~20bps premium, which implies that under this scenario the Australian 10-year bond yield falls from the current 4.2% to 3.95%.

The decline in bond yields and assuming a bull-steepening of the yield curve implies an expected return from the government component of the index to be 6.1%.

Given the better carry and stable spreads, investment grade credit would outperform base rates with 7.1% expected return and implies a **total return for the Bloomberg Composite 0+ index of 6.6%.**

No Landing

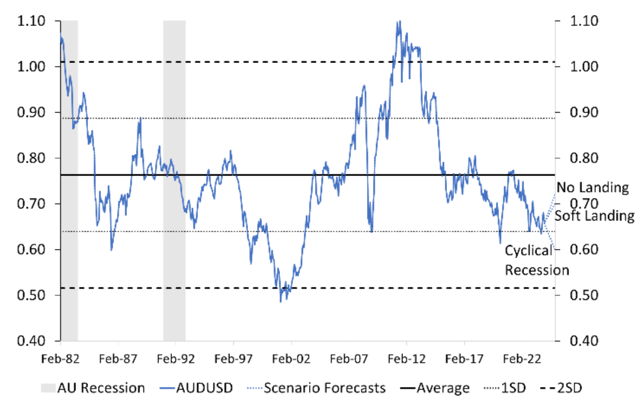
We would expect the 10-year to bear-steepen and increase to 5.7% (consistent with a premium to US) and credit spreads to widen low double digits delivering a negative **expected return of -1.5%,** with the government component underperforming.

Cyclical Recession

We would expect the 10-year to fall to ~3.2% and credit spreads to widen greater than 100bps delivering **expected return of 11.1%** with base rates movements providing the outperformance against losses in credit.

Australian Dollar

Figure 31 – Australian Dollar / US Dollar



Source: Bloomberg, Reserve Bank of Australia, Mason Stevens OCIO

Soft Landing

The Australian dollar (AUD) should appreciate relative to the US dollar (USD) and the Euro (EUR) given this scenario will trigger more 'risk-on' trades and the USD unwinds some more of the 'safe-haven' flows it received in 2023.

We expect the AUD to be at USD0.70 and EUR0.63 under this scenario which leads to higher expected returns for hedged international assets.

No Landing

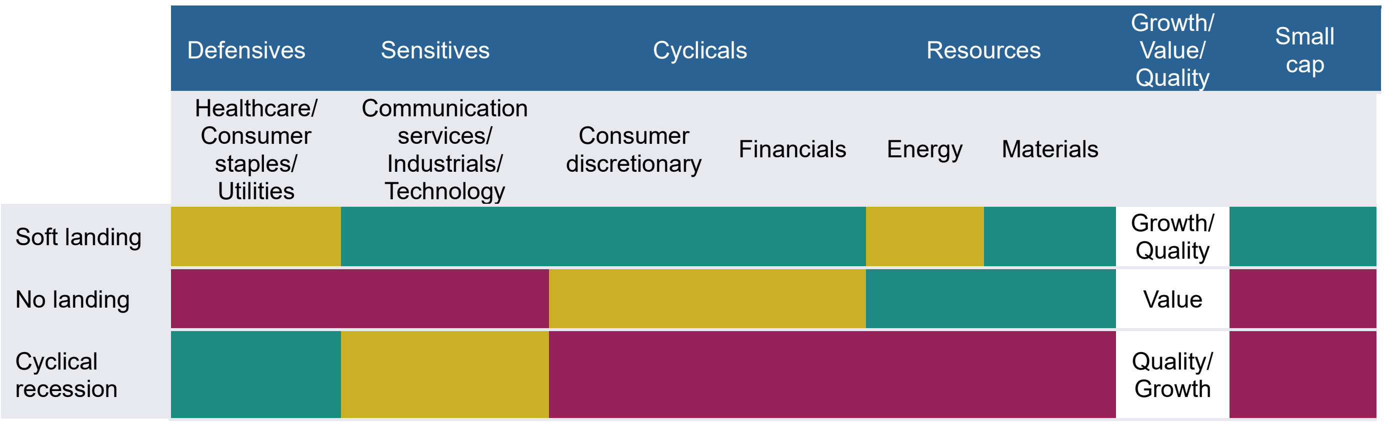
As with the soft-landing scenario, the AUD should appreciate, however we believe it will appreciate a more meaningful ~10% given its correlation with global growth.

The estimates for the AUD under this scenario are: USD0.72 and EUR0.67, which will lead to substantially higher returns for hedged international assets.

Cyclical Recession

We expect the AUD to depreciate circa 9-10% under a cyclical recession scenario in which global growth falls into recession. **We estimate the AUD to buy USD0.60 and EUR0.55**, which leads to higher expected returns for unhedged international assets.

Equity sleeve strategy



Source: Mason Stevens OCIO

Soft Landing

With inflation returning to target levels and bond yields falling we would expect Growth to outperform.

The soft-landing scenario should initially trigger risk appetites to increase, leading to 'high beta' stocks to outperform, such as cyclicals and small-to-mid caps.

Higher beta emerging markets, such as Brazil, and those exposed to more growth industries, such as Taiwan and Korea, should also benefit.

As the initial euphoria wears off, investors will begin to punish those companies that don't deliver on earnings growth being priced in or suffer from excessive margin erosion. For this reason, we believe Quality should also outperform over the course of the soft-landing scenario.

No Landing

Elevated inflation and rising bond yields would be negative for interest-rate sensitive sectors, and longer 'duration' growth, therefore driving Value stocks to outperform Growth.

An acceleration in emerging markets growth, presumably driven in some part by China, should be positive for select Industrial stocks exporting to these markets, the Energy sector and commodities more broadly.

Caution is warranted from the effects of continued high interest rates, such as highly leveraged companies needing to refinance debt, and 'price takers' who have limited scope to pass on higher costs arising from high inflation. Small caps tend to be more at risk than their larger counterparts. Additionally global small caps tend to have higher leverage ratios than their larger counterparts such that additional caution is warranted in this scenario.

Cyclical Recession

In a 'risk-off' scenario, defensive sectors such as Consumer Staples and Healthcare should outperform. Falling bond yields would lead to interest rate sensitive sectors that are relatively better positioned to weather the downturn in economic growth, such as Utilities, to outperform.

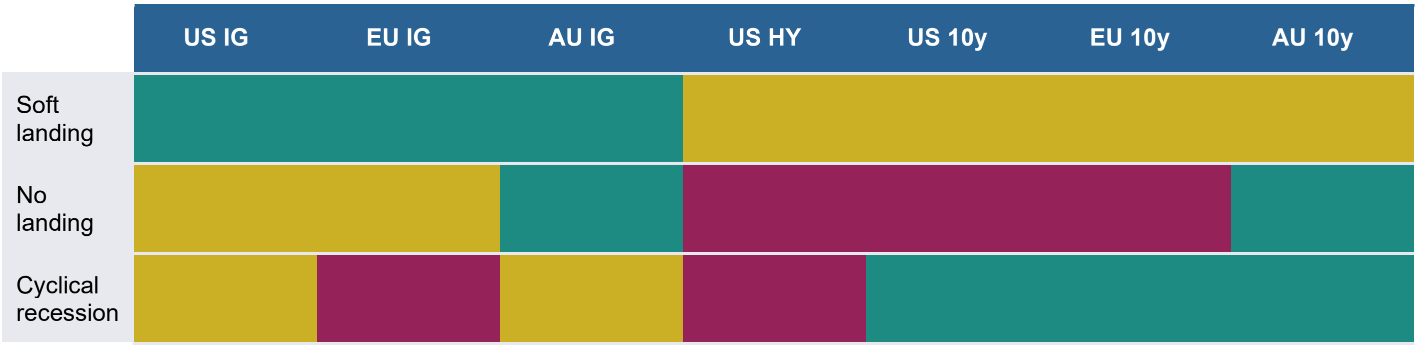
The most at-risk sectors are those most leveraged to global growth such as Materials, Energy, Financials and Consumer Discretionary.

We would expect Quality to outperform during the market drawdown as investors flock to relative 'safe havens', valuing stability and financial strength more highly during times of rising risk aversion.

Post the initial decline, we would expect Growth stocks to come back in favour as central banks pivot to aggressively cut interest rates to save the economy.

Small caps ordinarily struggle in an environment such as this, however again it may prove to be an opportune time to accumulate this sector after the initial drawdown as investors start to see light at the end of the tunnel.

Fixed Income sleeve strategy



Note: the table above represents relative outperformance/underperformance versus sectors within fixed income only.
Source: Mason Stevens OCIO

Soft Landing

A soft-landing across most developed countries is largely priced in however it is hard to imagine central banks beginning to cut, without yields reacting to the downside. Hence there is most likely some yield contraction yet to occur. This does, however, provide a basis for a relatively attractive environment for fixed income. Arguably getting the best of both worlds with spreads providing additional carry and the benefit from duration as yields come down. Within fixed income we prefer US credit (estimate 7.8% return) with a potentially bigger move in rates to occur and slightly longer duration than the Australian index. The RBA remains behind the curve in terms of tackling inflation however would still generate relatively better performance than the EU. EU rates are simply not as attractive in absolute terms, versus the US or even Australia, mainly as a result of the very low starting point given, they had negative rates.

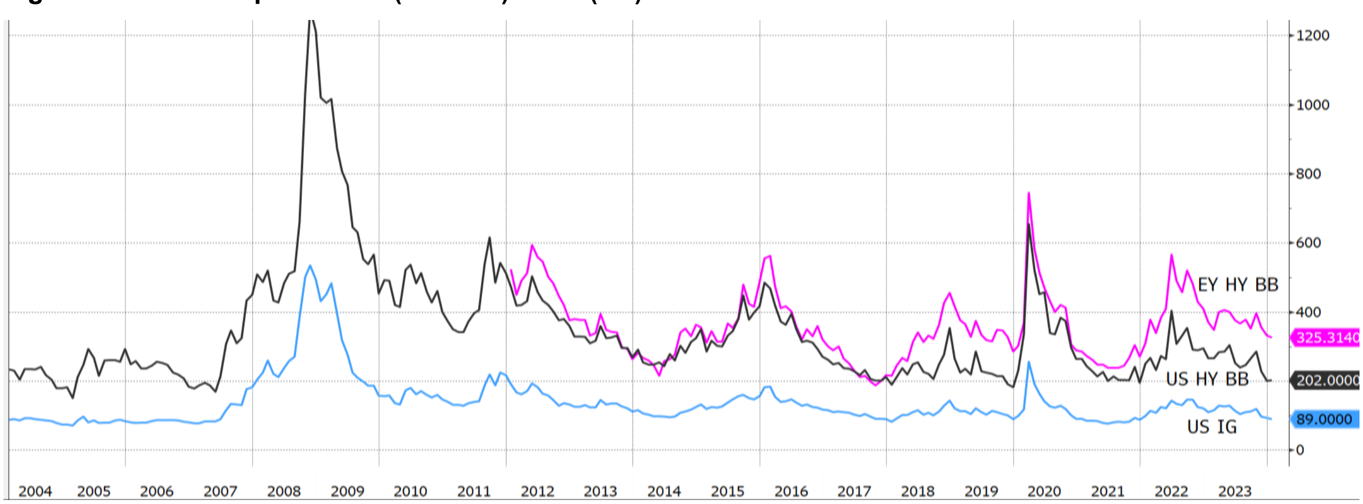
No Landing

A no landing scenario would be the most negative outcome for fixed income with rates going higher to tackle a 'failed regime of killing off inflation' and potentially in a short course manner to 5% in the US and 5.5% or higher in the medium term. The duration alone would represent a similar experience to the 2022 year and the worst parts of 2023. Carry would provide some buffer but not enough to forgive the losses caused by duration. The Australian index performs the best in this scenario largely as a result of the relatively shorter duration, but also US yields would likely move in a more aggressive fashion to the upside.

Cyclical Recession

Within fixed income, we would favour US Treasuries given the longer duration and likely bigger move in rates as the Fed back peddles the aggressive policy actions, they have taken over the past two years. Given the impacts on growth, credit spreads would move at least 100bp wider in investment grade and 200bp higher in high yield. Further, the risk off sentiment would be cause for investors to seek safety and capital preservation. Along those lines cash and gold would also benefit from the negative sentiment, as would 'safe haven' currencies such as the US dollar.

Figure 32 – Credit Spreads US (IG & HY) & EU (HY)



Source: Bloomberg, Mason Stevens OCIO

Alternatives sleeve strategy

We classify strategies with equity like objectives but low correlations and market beta to equities as growth alternatives. Similarly, strategies with bond like objectives but with low correlations and market beta to bond markets are classified as defensive alternatives. Within the context of a multi-asset portfolio, an allocation to a strongly performing alternatives sleeve will typically significantly enhance the risk adjusted return of the portfolio over time.

Given these characteristics and depending on your approach to portfolio construction, the alternatives allocations may well be the most stable component of your Strategic Asset Allocation, particularly given illiquidity considerations.

With that said there are some considerations and opportunities within your alternatives allocation depending on the economic scenario.

Soft Landing

In this scenario traditional market beta across bonds and equities performs well and may outperform your alternatives allocations depending on the extent of the rally. To the extent there is scope to underweight your alternatives allocation this may be considered.

In terms of where an underweight might be considered, in a soft-landing scenario volatility and trends likely remain relatively muted, and so strategies that derive their returns from these sources can be reviewed e.g. a trend following strategy. Further to this, lower cash rates may also impact the total return a given alternatives strategy may deliver, depending on how much cash rates are a component of their return. Any changes of this kind would need to consider how much tail risk hedging is being removed from the portfolio.

No Landing

In this scenario both equities and bonds underperform, with higher inflation and tighter than expected monetary policy more than offsetting the improvement in the growth outlook. An overweight to alternatives may be considered in this environment, with a genuinely diversified alternatives sleeve being able to deliver somewhere near long-term market beta returns, while other assets sell-off.

Absolute Return Bond strategies should outperform traditional bonds given the sell-off expected in rates. Private credit strategies should also perform well in this environment, given their running yield would remain at current high levels, while solid economic growth would support company profitability. Given there is an expectation that irrespective of the scenario defaults and distress will rise among SMEs from current historic lows, ensuring any private credit exposure is highly diversified remains important.

Cyclical Recession

Growth alternatives will often provide their strongest periods of relative outperformance during the large market drawdowns brought on by a recession. The uncorrelated nature of the returns means a genuine alternative won't necessarily drawdown despite large equity corrections, and indeed in some cases may actually provide strong positive returns.

Trend following strategies typically perform very well in this environment. During a recession there are sustained, clear trends in markets for multiple months, if not quarters – equities down, commodities down, bonds rally, USD rallies etc. In such an environment a trend following strategy should be able to generate profits across most asset classes and provide a significant buffer to overall portfolio returns.

Long/short strategies may vary from market neutral through to variable beta approaches, but in either case should provide relative outperformance during a cyclical recession. The lower and/or zero market beta and ability to short stocks or sectors most affected during a recession should deliver meaningful relative outperformance.

In terms of exposures to consider reducing in such a scenario, alternative strategies with an obvious connection to the real economy should be reviewed including private credit (PC), private equity (PE) and direct property. For PE and PC there is an underlying exposure to SMEs, which in aggregate will be challenged during a recession, and lower returns would be likely from both sets of strategies. For any PE funds the further a portfolio extends to Growth and VC holdings, the more exposures may need to be reduced where liquidity permits. On the private credit side, the fall in interest rates will see the running yields from portfolios fall with at least some degree of increased default rates as well. For direct property, while a fall in interest rates will likely present a buying opportunity at some point, the initial hit to income and rents in a recession will likely be the driver of returns in the first instance. Finally Absolute return bond strategies may see some relative underperformance as traditional bonds rally during a recession.

DAA and Portfolio Positions

Source: Mason Stevens OCIO

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