# What if everything goes right?

While equities have headroom in a benign environment, we now see credit as unfavourably asymmetrical given limited risk compensation and capped upside.


**Emiel van den Heiligenberg**
Head of Asset Allocation

**Tim Drayson**
Head of Economics


In January we shifted our base-case thesis from a mid-year recession to an uneasy status quo vulnerable to any deviation from the soft-landing narrative.

This evolution of our thinking has continued throughout the year, reflecting what we're seeing in markets and our beliefs about the best ways of finding value in the various possible scenarios.

## The macro backdrop: staying on that narrow path

Consensus growth forecasts for the US were revised higher earlier in the year, mainly reflecting an abandoning of recession calls by the pessimists rather than an upgrade from the optimists. This left consensus strongly clustered around a US soft landing.

In recent weeks the upside surprises have given way to more mixed reports. This has helped reduce concerns around a possible 'no landing' and inflation, but has not been sufficiently weak to create renewed worries about a hard landing. The Federal Reserve has signaled only one cut this year in its June dot plot, but it's worth remembering that there are still three more inflation readings to come before the September meeting.

Across Europe, consensus forecasts have been relatively stable over the past few months as the gradual recovery from stagnation last year has proceeded largely as expected. The data have been supportive of a benign rebalancing, but we still see limited slack across developed markets and overconfidence among economists and markets that the path forward will remain smooth. Geopolitics could still surprise, especially when combined with fragile fiscal positions in many countries, as we have seen recently in France.

In terms of central banks, the mean outcomes embodied in market pricing seem appropriate at present. If growth does not slow in the US or picks up further in Europe, inflation risks are skewed to the upside. But if unemployment rises, central banks would likely be quick to cut. So, a once-a-quarter path for rate cuts seems reasonable, even if we have low conviction around this being the ultimate path. We also think it will be difficult for central banks to meaningfully diverge from one another.

## How we're positioned: short credit

We believe markets remain vulnerable, but this idea has not worked so far, and it's hard to see a catalyst for a shock to the narrative (famous last words). Consider the evidence:

- Sentiment and positioning indicators remain far from extreme, which is at odds with our 'vulnerable market' thesis
- Aggregate earnings projections, once we adjust for tech megacaps, don't look unduly challenging. Nvidia* earnings, a bellwether for the AI theme, once again came in better than expected
- Wage growth keeps moderating despite our earlier assertions that this was unlikely without a rise in unemployment

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- We believe profit margins will be squeezed as nominal growth slows, but we've been waiting a long time given that nominal growth has been slowing since late 2021
- Inflation stickiness has been apparent in recent months, but the bigger picture is that inflation has fallen back to fairly comfortable levels without much economic pain

So, we've adapted our short risk position, closing the equity short while increasing the credit short. We want to remain short risk but predominantly in credits now as credits have less upside risk than equities.

We've been waiting for spreads to stabilise around current levels before going further underweight. We know that selling too early can be costly in terms of carry accrual. But we think we are getting very close to that point as the pace of credit outperformance has slowed dramatically. Looking just at USD investment grade, spreads tightened 20 basis points (bps) in Q423, 10bps in Q1 this year and just 3bps in the first couple of months of Q2.[1]

We also worry that credit excess returns will start to lag behind equities on a risk-adjusted basis from here, consistent with the historical precedent. The potential for speculative excess in an asset class offering capped upside is limited.

## This quarter's articles: from the mainstream to the unfamiliar

This quarter's outlook features a wide range of our thinking, from widely discussed topics that just won't go away to more esoteric parts of the investment world that we feel deserve attention.

In the former camp is Andrzej and Robert's piece on the seemingly unstoppable rise of US tech stocks, and how to guard against a momentum reversal. Camilla and Patrick, meanwhile, question whether London has lost its appeal as a listing location, and what it would take for valuations to rebound.

Willem heads into less familiar territory in his article, examining the role of alternative risk premia (ARP) strategies and what we've learnt about them in the near-decade we've been integrating them into some of our multi-asset portfolios. Tim rounds out this quarter's update with his regular CAMERA feature showing our long-term return expectations across a range of assets, this time with a focus on the UK.

**Corporate credit spreads, particularly in the US, offer little compensation for risks**

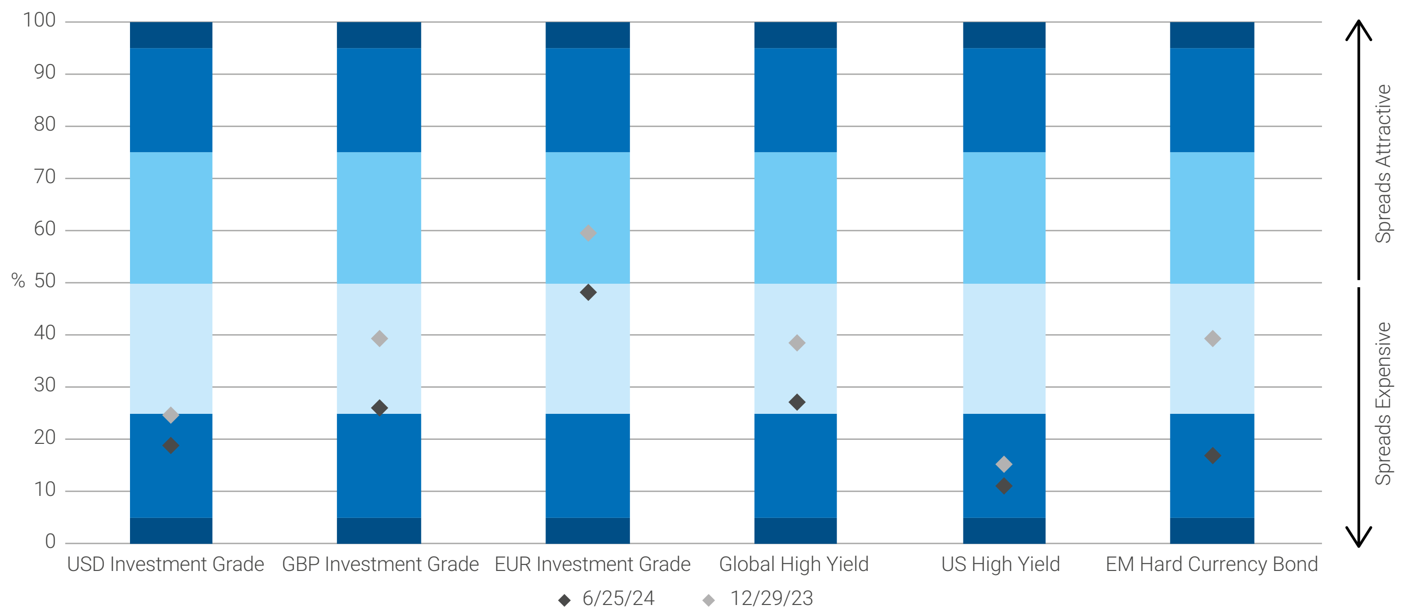
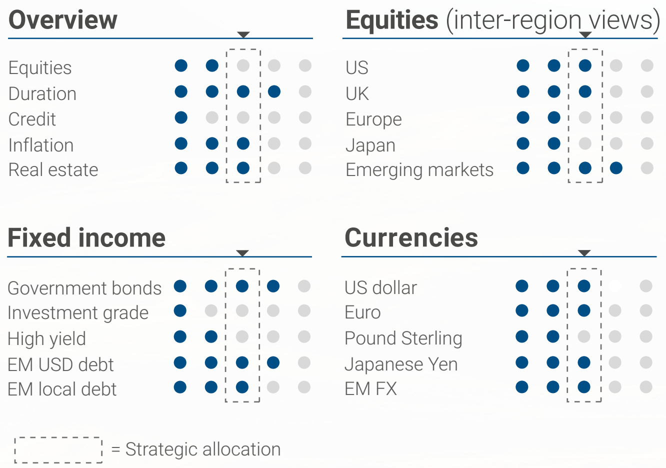


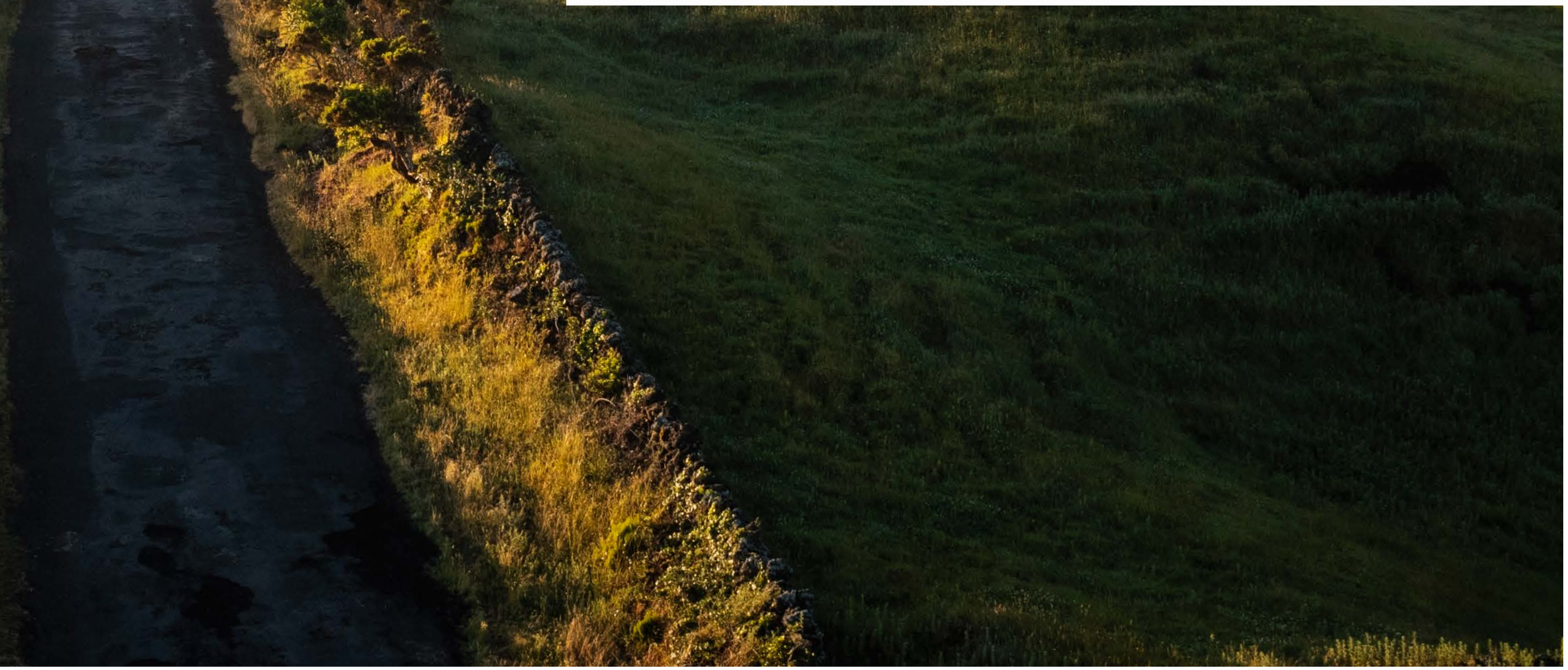

Chart above: Source: LGIM as at 24 June 2024.
1. Source: Bloomberg data as at 20 June 2024.

## Our key asset class views




This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 24 June 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.

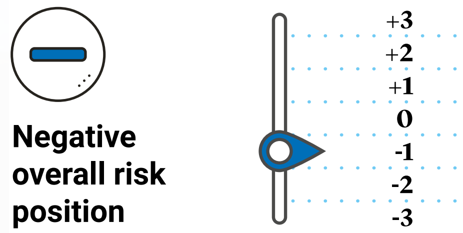
**The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

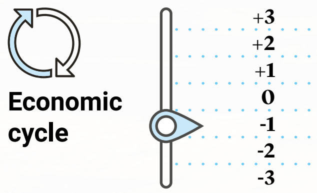




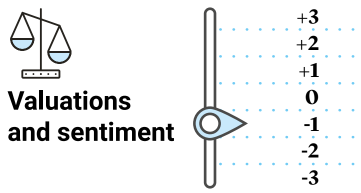


## Our core asset allocation view

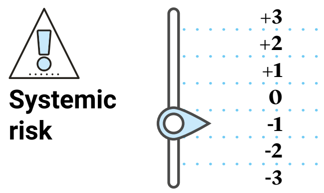



Growth outlook turning more positive, but vulnerable to shocks and sticky inflation




Valuations verging on expensive while sentiment has a bullish tilt




Financial crisis risks have subsided, but geopolitical backdrop remains tense

Source: LGIM. Views current as at 24 June 2024. **There is no guarantee that any forecasts made will come to pass.**

| |
|---|
| **Economic cycle** |
| Overall risks to growth look balanced |
| Inflation risks remain skewed to the upside given the lack of slack |
| Late cycle dynamics make world economy vulnerable to shocks |
| **Valuations and sentiment** |
| Sentiment indicators show optimism, but this position can persist |
| Relative valuations don't offer the natural bullish support for equities |
| Absolute valuations verging on expensive, especially in some sectors |
| **Systemic risk** |
| Banking lending has returned but credit and real estate risks remain |
| Multiple potential flashpoints for potential geopolitical escalation |
| Indicators show no signs of private sector debt distress |

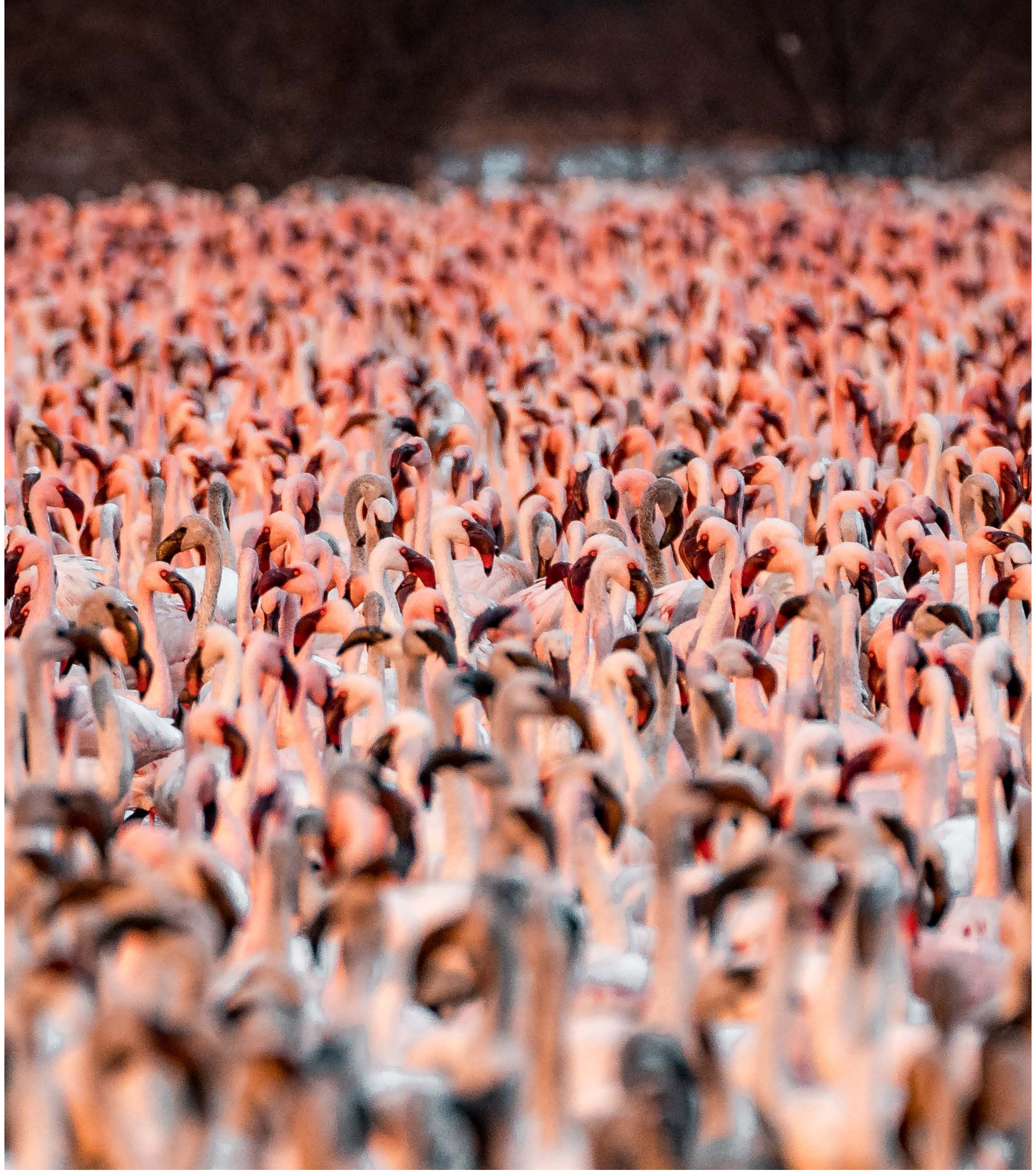
# Is US tech the only game in town?

So far, it seems impervious to monetary tightening, political dramas in Europe and fears of over-ownership. But it's a very crowded market, and a momentum reversal could prove painful.

**Robert Griffiths**
Global Equity Strategist

**Andrzej Pioch**
Fund Manager

In 2023, the 'Magnificent Seven' stocks – Apple*, Alphabet*, Amazon*, Meta*, Microsoft*, Nvidia* and Tesla* – collectively rose 106%, accounting for more than half of the 22% rise in the S&P 500. [2]



Remarkably, the same group seem to be repeating that feat in 2024, up another 35% on a market-cap-weighted basis, which would annualise for the full year at just short of another doubling in value.[3]

However, that headline hides growing dispersion in performance: of the seven names, only four have strongly outperformed the S&P 500 this year, with two underperforming and one outperforming only by a couple of percentage points. One, Nvidia, is seeing its advantage and importance to US and global equities stretch to what could be considered uncomfortable proportions. It's up 166% year-to-date and has accounted for just over a third of the gain in the S&P in that time.

### Will the rally broaden out?

This raises the question: can performance broaden out to the laggards that include, well, everything else? Europe is up just 6% year-to-date in USD terms, Japan 6%, the Russell 2000 is up just 1% and even the S&P 500 itself on an equal-weighted basis is up only 3%.[4]

For broadening out to occur, some combination of two things need to happen: US tech needs to underperform and/or the rest of the world needs to discover some independent upward impetus.

On the former, it should be noted that tech has, thus far, proven nearly infallible to monetary tightening, political dramas in Europe or fears of over-ownership. Neither are we yet at valuations that have historically represented bubble peaks. Nvidia* trades on a forward price-to-earnings (P/E) ratio of 45x earnings; in 2000, Cisco Systems*, the Nvidia of its day responsible for the physical architecture of the burgeoning internet, traded up to 110x earnings.

### It's getting very crowded in here

However, the extent of the crowding into winners is becoming notable: the momentum index – the strategy of buying winners and selling losers – is close to an all-time high relative to the

2. Source: Bloomberg, as at end-2023.
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3. Source: Bloomberg, as at 14 June 2024.
4. Source: Bloomberg, as at 9 July 2024.
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S&P. And inevitably, when momentum reversals occur, they tend to be painful and self-fuelling processes.

Nvidia's quarterly results have become critical market events, superseding some of the major economic data releases (if we look at the size of implied market moves in the derivatives market).

To add fresh capital to US tech, one has to have a high level of confidence in one company's ability to execute and dominate not just in the short term, but over the medium term too.

### Comeback kids

And what of the rest of the world's ability to help itself? A fresh bout of political noise in Europe is perhaps the last thing that was needed. But if US and tech is a crowded position where expectations represent a high hurdle, the rest of the world is the opposite.

So, some combination of possible stimulus from China, a new and stable government in the UK and a polarising but perhaps hamstrung new government in France (which could be limited in its ability to pass any legislation, good or bad) could lead to outcomes in the rest of the world that are better than is captured in prices.

If non-US sentiment ticks higher, or if the AI revolution hits a bump in the road, a subsequent momentum reversal could be disruptive, something which continues to make a degree of diversification (i.e. spreading the equity risk across regions in a more balanced way rather than holding concentrated position in US equities alone) more than prudent.

As our colleague John Roe has described, diversification is not without psychological cost: the benefit of reduced exposure to price fallers has the flipside of a lack of concentrated exposure to the gainers.

But as part of a clear investment framework, we believe this is a price worth paying.



### Momentum index nears all-time highs


Source: Bloomberg as at 14 June 2024. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

# Is London losing its lustre as a listing location?

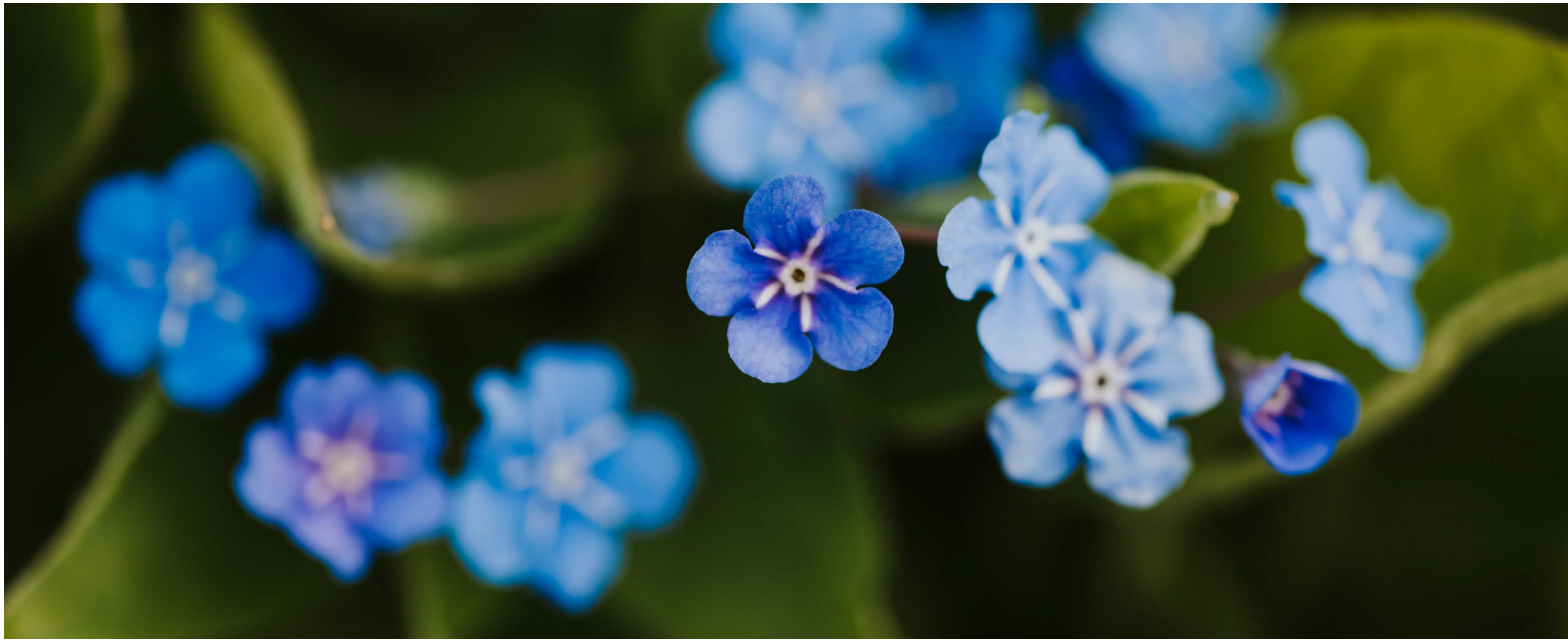
UK assets have increasingly fallen out of favour with global investors and corporates alike. However, there are measures underway to change this, and attractive valuations on a relative basis have seen the UK gaining investor attention.

**Camilla Ayling**
Fund Manager

**Patrick Greene**
Strategist



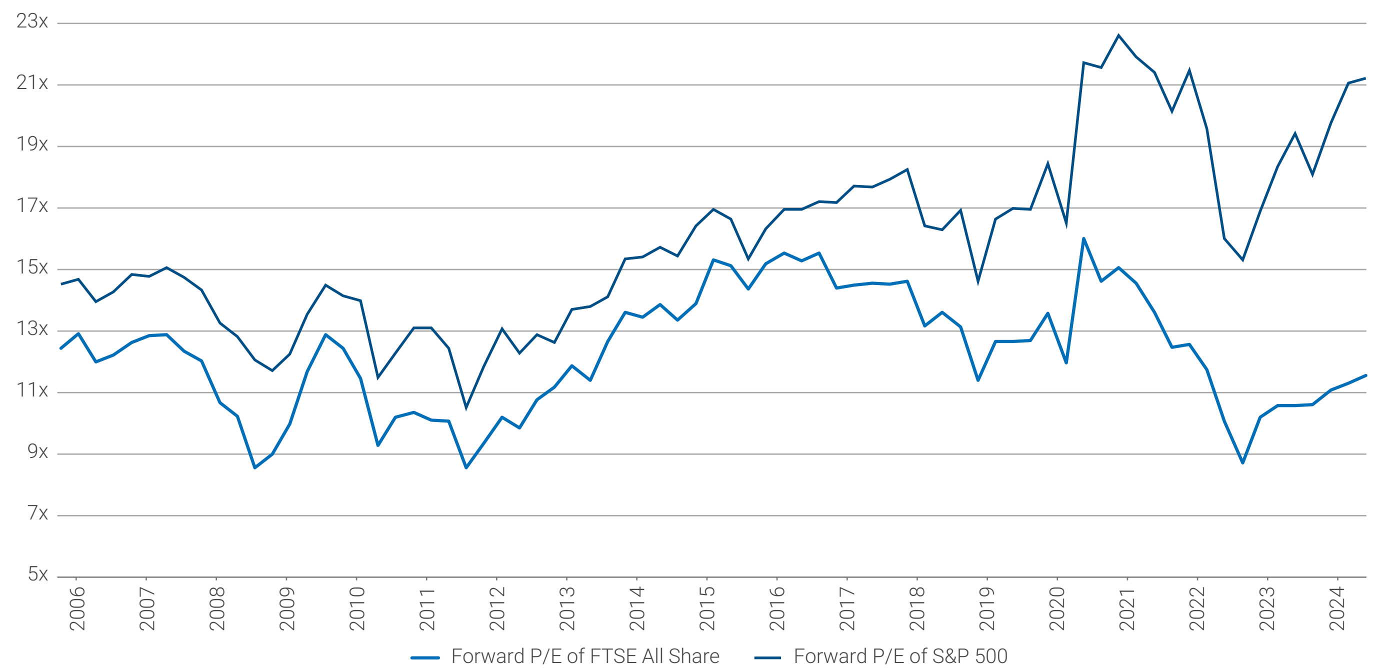




In our blog '[They say good things come in small packages…](#)', we highlighted the widening valuation gap between UK large and small caps. Yet even though small caps have become cheaper relative to their large-cap counterparts, the valuation of the UK equity market in general has also reduced.

The valuation discount versus the US is now wider than it has been at any point over the last 19 years:

**Valuation discount of UK equities to US equities wider than historical levels**




Source: Bloomberg data, as at 14 June 2024.

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## Relocation, relocation, relocation…

It's therefore unsurprising that we've seen a flurry of listings leave the UK. Last year, the decision to list UK chip designer ARM Holdings* solely on the NASDAQ caught attention because prior to being taken private, ARM Holdings* held dual UK and US listings.

This year, UK gambling company Flutter Entertainment* opted for an additional US listing, before transferring its primary listing destination there. Management highlighted the US listing gives "access to the world's deepest and most liquid capital markets".[5]

Multiple reasons are behind this declining preference for the UK. First, the quote from Flutter cites a crucial one. The relatively lower liquidity of UK-listed stocks has limited institutional demand. This graph shows how liquidity has worsened over the past two decades:

Secondly, executive pay is another factor, with LSE's CEO Julia Hoggett warning that the UK's restrictions on pay are hindering companies' efforts to compete for top talent and retain listings[6].

Thirdly, despite the UK pensions sector being one of the largest in the world, UK pension funds have a lower allocation to equities than other countries, and their allocation to domestic stocks is lower too[7]. The profile of these funds explains to some extent the lack of ownership of UK equities; however, any increased allocation will lead to more equity capital in the market.

## Make it stop

Policymakers are acutely aware of the UK's standing, and a range of pensions agreements and capital market reforms are underway that aim to improve the attractiveness of our market.

A rise in corporate activity (including M&A) in recent months has helped draw attention to the valuation opportunities available, and we've noted across the market equity strategists turning more bullish towards the region.

Likewise, if initiatives such as the Capital Markets Industry Taskforce[8] succeed in increasing domestic capital availability in the UK and addressing some of the other factors we've discussed in this article, then both investor positioning and corporate sentiment towards the UK should become more favourable.

## Looking for a spark

Earlier this year many of our multi-asset portfolios took a tactical position in UK midcaps, aiming to capitalise on the emerging trends described above. We had hoped for a longer window before the elections to draw attention to new policies. But with future catalysts we could re-engage as we believe many of the right ingredients are in place for a turnaround.

5. Flutter*, 2024: https://www.flutter.com/investors/additional-us-listing/#:~:text=Flutter%20is%20listing%20on%20the%20New%20York%20Stock%20Exchange&text=Subject%20to%20the%20effectiveness%20of,Exchange%20(%22NYSE%22).
6. Bloomberg UK, 2023: https://www.bloomberg.com/news/articles/2023-10-05/top-city-boss-warns-pay-is-causing-london-to-lose-war-for-talent
7. Pensions and Lifetime Savings Association, 2023: https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2023/Pensions-and-Growth-Jun-2023.pdf
8. https://capitalmarketsindustrytaskforce.com/

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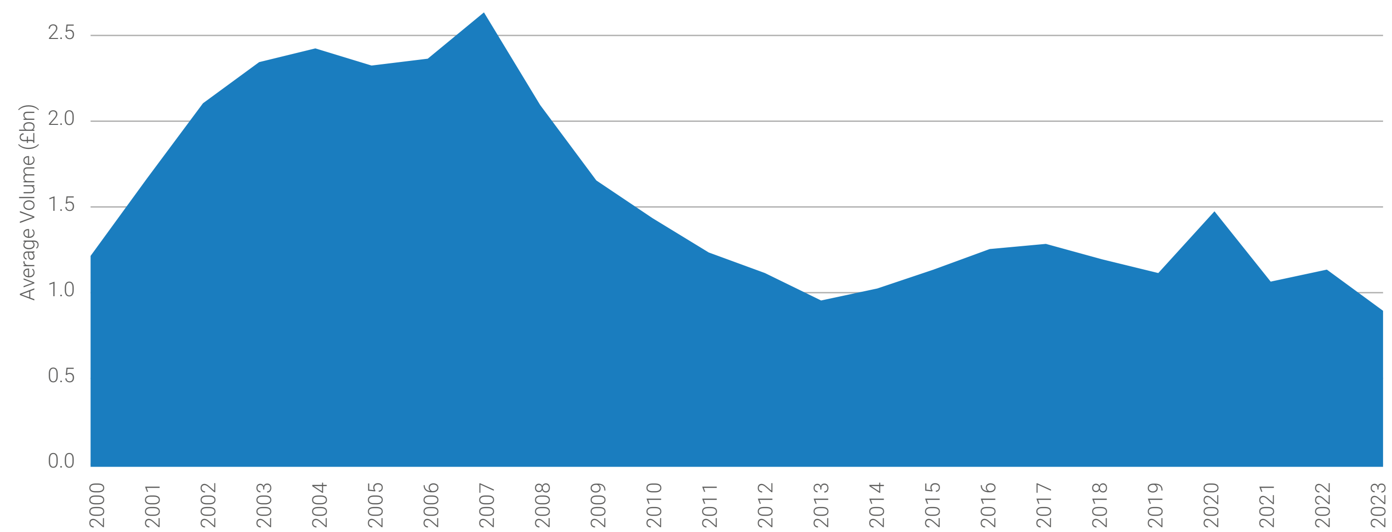
### Yearly average volume traded on FTSE All Share




Source: Bloomberg data, as at 2 January 2024.

# A long-term perspective on ARP


**Willem Klijnstra**
Strategist

**Chris Teschmacher**
Fund Manager


We're now within touching distance of a decade of integrating alternative risk premium (ARP) strategies into some of our multi-asset portfolios. So, it feels like a good time to reflect on what we've learnt about the role of these strategies, how we've implemented them and – of course – how they've performed in a variety of market environments.

As the name suggests, ARPs are an alternative way of seeking returns over the risk-free rate in exchange for taking on various risks. They aim to capture risks that are persistent due to structural or behavioural reasons, and to do so in a systematic and repeatable way. While equity risk premium is earned by taking company-specific risks, ARPs typically target factors. There are hundreds of them out there, but the four shown below are the most common and understandable:





**Value**
Assets or currencies that are 'cheap'.
i.e. that trade at discount to fair value

**Flow**
Providing liquidity amid a structural imbalance between supply and demand

**Carry**
Higher yielding assets or currencies that earn an insurance premium

**Momentum**
Rule-based approach to avoid behavioural biases causing the persistency in returns

Our overarching philosophy on using ARPs in a multi-asset context is simple: you're only harvesting a reward for taking a certain risk, so make sure you understand the risk, target risks that are different from what you already own, and harvest them without undue costs.

This means we look for simplicity, liquidity, transparency and diversification relative to other return streams in a multi-asset portfolio.

1. **Simplicity:** we try to capture 80% of the risk premium and leave the last hard-to-get 20% to others – this allows us to use cheaper-to-trade derivatives
2. **Liquidity:** turnover tends to be higher than for most traditional long-only strategies, so trading in liquid derivatives and keeping trading costs low are important, in our view
3. **Transparency:** we want to know which risk we are insuring against, which structural flow are we hedging, or which behavioural bias is causing the inefficiency
4. **Diversification:** we're wary of ARP strategies that may look different, but basically provide more of what we already own

### How have they done?

When considering the performance of ARP strategies, it's important to remember their quantitative nature. Not only does this mean the models can be easily back-tested, but they can be created specifically to produce a favourable back-test. 'Data mining' can lead to models with apparently remarkable risk and return characteristics, but academic research finds this advantage can all too easily slip away in the real world. As such we apply a 75-100% haircut to any historical Sharpe ratio to arrive at a more realistic expectation.

Even with significantly lowered expectations, the industry-wide performance of ARP has struggled for much of the period in question. However, our sophisticated statistical testing of the realised track records of ARP suggests the returns we have experienced are within the normal range of expectations, albeit at the low end.

One of the ways we've evolved our use of ARP is to be mindful of structural breaks in markets that may limit the effectiveness of particular strategies.

For example, we stopped following currency momentum signals during the period of historically low interest rates and increased central bank intervention in FX markets – this was vindicated as those strategies went on to deliver negative returns. Similarly, during the pandemic we moved away from slow-moving momentum strategies as we were wary of their ability to keep pace with the rapidly shifting market of that time.

### Diversify and thrive

While headline performance of ARP strategies has struggled, their diversification benefits* have led to improved client outcomes, in our view. Over the near-decade in question they've showed close to zero average correlation to other return streams in multi-asset portfolios – namely, market risk and tactical asset allocation.

As ardent believers in diversification we note that ARP strategies aren't just different from traditional market risk premia; because they are systematic, they are fundamentally different from the people-led discretionary macro investment process we use elsewhere. This is demonstrated by their low correlation of -0.2 with our tactical trades.

The diversification properties have been especially important in periods of market downturns, when our ARPs have generally been positive or at least remained flat. This return profile is arguably the key reason for us to keep using them.

Overall, we believe ARPs justify their place in a multi-asset portfolio, but with the caveat that they need to be considered holistically. In our view, this is best done by integrating ARP research into a team with the experience to read the macroeconomic environment and spot structural breaks that could cause certain risk premia to underperform.

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

# CAMERA: our capital market assumptions update

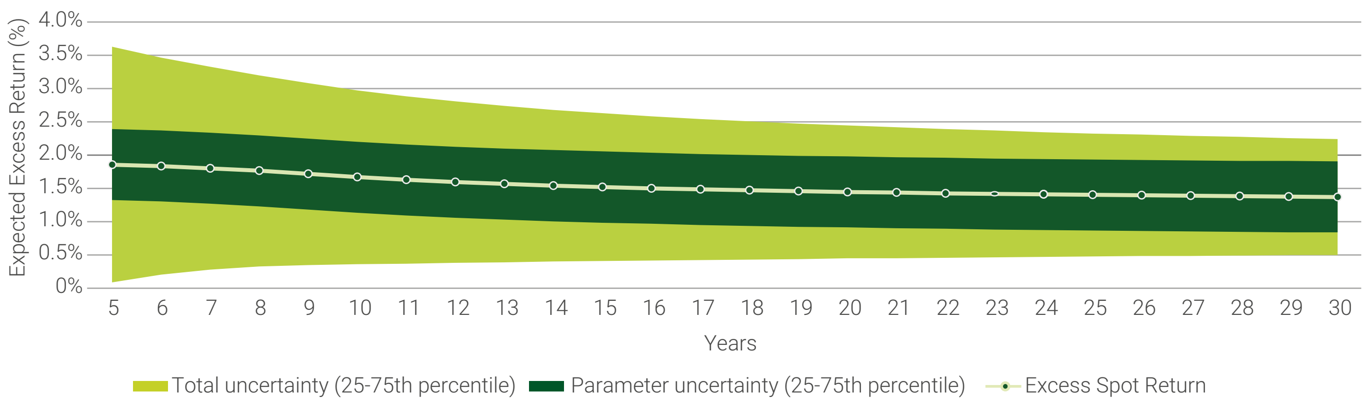
**Tim Armitage**
Multi Asset Fund Manager

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.

With the UK general election now behind us, and with the Bank of England taking a 'finely balanced' decision not to cut in June, it is perhaps interesting to zoom out from recent noise and view our longer-term expectations for UK assets.

While we don't expect significant changes in long-term asset class return expectations from quarter to quarter, since the last update, valuation-based return estimates for UK equities have fallen the most out of the major equity regions, with the exception of emerging markets. Conversely, valuation-based return estimates for UK corporate bonds have increased while those for other major developed markets have fallen, reflecting the widening of UK credit spreads relative to other markets, while return estimates for gilts have risen in line with those for other major government bonds.

### Expected excess return term structure: UK Investment Grade bonds




Source: LGIM as at 24 June 2024.

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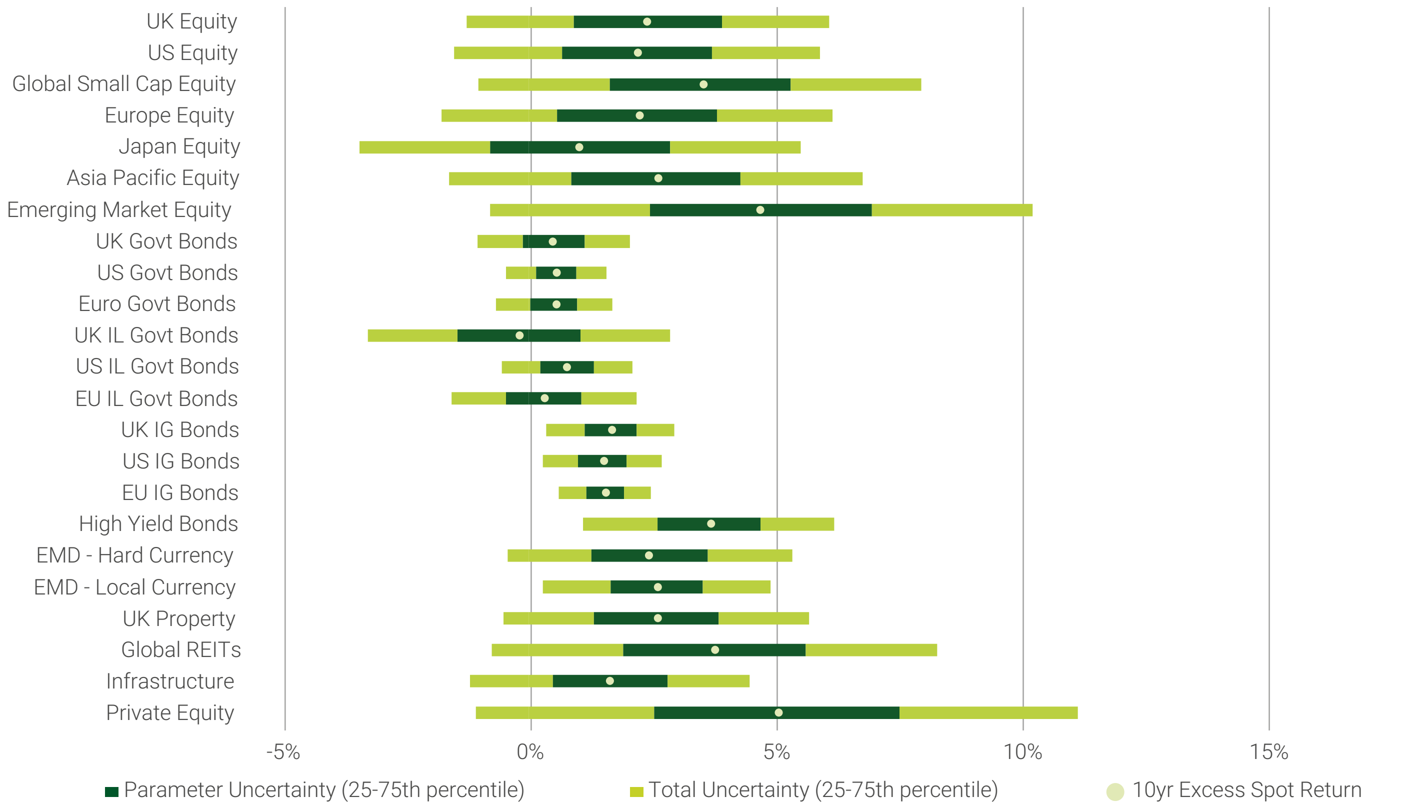
### Ten-year excess return distributions




Source: LGIM as at 24 June 2024.

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| | Expected excess returns | | | | One-year asset class volatility |
|---|---|---|---|---|---|
| | 5 Years | 10 Years | 20 Years | 30 Years | |
| UK Equity | 2.1% | 2.4% | 2.7% | 2.9% | 15.7% |
| US Equity | 1.5% | 2.2% | 3.0% | 3.3% | 15.9% |
| Global Small Cap Equity | 2.8% | 3.5% | 4.2% | 4.4% | 19.2% |
| Europe Equity | 1.6% | 2.2% | 2.9% | 3.1% | 16.9% |
| Japan Equity | 0.4% | 1.0% | 1.8% | 2.0% | 19.1% |
| Asia Pacific Equity | 2.3% | 2.6% | 2.9% | 3.0% | 17.9% |
| Emerging Market Equity | 4.4% | 4.7% | 5.0% | 5.1% | 23.5% |
| UK Govt Bonds | 0.7% | 0.5% | 0.2% | 0.2% | 6.6% |
| US Govt Bonds | 0.7% | 0.6% | 0.4% | 0.4% | 4.3% |
| Euro Govt Bonds | 0.6% | 0.5% | 0.4% | 0.3% | 5.0% |
| UK IL Govt Bonds | -0.3% | -0.2% | -0.1% | -0.1% | 13.1% |
| US IL Govt Bonds | 1.0% | 0.8% | 0.5% | 0.4% | 5.6% |
| EU IL Govt Bonds | 0.3% | 0.3% | 0.3% | 0.3% | 8.0% |
| UK IG Bonds | 1.8% | 1.7% | 1.4% | 1.4% | 5.5% |
| US IG Bonds | 1.6% | 1.5% | 1.4% | 1.3% | 5.2% |
| EU IG Bonds | 1.7% | 1.5% | 1.4% | 1.3% | 4.0% |
| High Yield Bonds | 3.7% | 3.6% | 3.6% | 3.5% | 10.9% |
| EMD - Hard Currency | 2.5% | 2.4% | 2.3% | 2.3% | 12.3% |
| EMD - Local Currency | 2.3% | 2.6% | 2.9% | 3.0% | 9.8% |
| UK Property | 2.3% | 2.6% | 2.9% | 3.0% | 13.2% |
| Global REITs | 3.4% | 3.8% | 4.1% | 4.3% | 19.3% |
| Infrastructure | 1.1% | 1.6% | 2.2% | 2.4% | 12.1% |
| Private Equity | 4.8% | 5.0% | 5.2% | 5.3% | 26.1% |

Source: LGIM as at 24 June 2024.

# Contact us

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

### Key risks

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