Balancing act

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CIO Global Wealth Management provides objective investment research and guidance to help you pursue your investment goals. Here is a brief overview of an important new report. Take a look and if you have any questions, please call.

Financial markets inflected over the past month, breaking out to the upside of what had been very narrow ranges for the S&P 500 and Treasury yields. These moves stemmed from the markets pricing in a more optimistic outlook for the US economy. There is fundamental justification for this performance, based on resilient growth, inflation continuing its gradual decline, and downside risks subsiding after the debt ceiling was raised and bank stress has stayed contained. The net result of these developments is a more balanced distribution of possible macro outcomes over the next 6–12 months.

Another factor driving equity markets higher over the past month is that investors seem to be simultaneously expecting a recession, albeit delayed and mild, while also becoming more constructive on equities and risk-taking in general. This is evident in the market melt-up, the lowest VIX level since January 2020, and sentiment being its most bullish since late 2021, well before the Fed started hiking rates. Even investors who remain skeptical about a soft landing are feeling pressure to chase the rally because their "pain trade" is a continued grind higher. But as a result, current market pricing appears to be overshooting the improvement in the fundamental outlook, leaving little margin for the macro outcome to disappoint. For instance, the markets are pricing in a relatively low probability of a credit contraction based on high yield bond spreads now back to pre-banking-crisis lows in March.

The Fed paused its rate hikes in June as expected, while its "dot plot" for the federal funds rate indicated two more hikes this year. Whether additional hikes happen will depend on the data, with current conditions supportive of at least one more in July. But since the Fed is data-dependent, how markets perform from here will be a function more of the pace of disinflation and the resiliency of growth, not whether there is an additional 25 or 50 basis points of hikes.

Based on this combination of economic and policy conditions, market pricing, and investor sentiment, we maintain our overall asset allocation guidance, keeping bonds as more preferred and equities least preferred. While the macro outlook is more balanced, this is already largely reflected in equities at the broad index level, resulting in an underwhelming risk-return trade-off. Even though CIO revised higher its S&P 500 price targets from 3,800 to 4,100 for December, and from 4,300 to 4,400 by June 2024, the implied returns to those targets based on the current index level of 4,425 are largely unchanged from the past two months. Meanwhile, the yield on investment grade corporate bonds has gone up with the higher Treasury yields and is now about 5.5%.

This is why we continue to recommend that investors **buy quality bonds** as one of our key Messages in Focus. With the Fed on pause and rates likely near their peak, investors should adopt a barbell approach to their fixed income portfolio, combining high-quality, short-duration bonds for income with longer-duration bonds to hedge against potential equity downside. In addition to investment grade bonds, agency MBS are attractive for this purpose. But the better fundamentals have also made it attractive to add selectively to other income-generating assets, including preferred securities, which we upgraded to most preferred this month.

While we remain cautious on US equities and equities overall, we do see attractive opportunities even after the market rally. The S&P 500 performance this year has been heavily concentrated in seven mega-cap stocks. Without them, the rest of the S&P 500 is up just by low-single-digit rates. Consequently, a second key message is for investors to **look for equity laggards** as the best way to position for more upside, while also rebalancing and diversifying their portfolios. In particular, the equal-weighted S&P 500 index has lagged the market-cap-weighted index by 10 percentage points since the beginning of March—an extreme level of underperformance over such a short period. Allocating to such an index is an effective way to allocate to laggards, while still maintaining exposure to the mega-caps. Other equity laggards that are appealing include US value stocks, US energy stocks, and emerging market equities.

With stock markets pricing in a benign economic outlook and resilient earnings, we recommend investors look beyond traditional markets and consider **diversifying with alternative assets**. Alternative investments provide investors the opportunity to diversify their sources of return at a time of lower beta returns from equities. Within hedge funds, we like strategies that can perform in various economic conditions such as macro, multi-strategy, and credit. In private markets, we see attractive opportunities in buyout strategies and within secondaries.

While we move our view on commodities overall to neutral this month, we still view oil and gold as most preferred. The shift to neutral is based largely on weaker industrial metal demand than anticipated due to lower global growth forecast revisions and weaker Chinese economic data. Oil supply constraints are still expected in the second half, and demand could surprise to the upside, especially if US growth ends up beating expectations. From a long-term perspective, commodities are an attractive way to **invest in real assets**, and they remain an effective hedge against more persistent inflation.

Within US equity sectors, this month we shift our preferences from a defensive tilt to a more balanced profile. We do this by shifting consumer discretionary to neutral from least preferred, as the sector has benefited from the enthusiasm in mega-cap tech stocks this year. We also shift the energy sector to most preferred as it is relatively cheap and should benefit from tighter supplies later this year. And lastly, we move utilities from most preferred to least preferred as the sector tends to shine when economic uncertainty is high. As we get more resilient data than expected, the sector is at risk of underperforming. Elsewhere, we remain most preferred on consumer staples and industrials and least preferred on financials and information technology. With mega-cap companies far outpacing the rest of the market this year, we recommend looking toward the laggards and consider more cyclical areas of the market.