NOVEMBER 2023

4Q 2023 Strategic Investment Outlook

The Allocation Controversies for the Turn of the Year

This short note reviews what we see as some of the key allocation controversies that have come up in recent client meetings and that are likely to underpin flows in coming quarters.

The allocation to private assets is a key point of debate. There has been something of a slowdown in demand for private equity, which we think makes sense. However, we do see a real return and diversification case for flows into private assets more broadly.

There has been a recent flow back into longer-duration fixed income, given the significant upward move in yields. We do, however, see a split in views about tactical versus strategic duration—especially for government bond allocations.

The past year has been tough for many active strategies. We point out that stock and factor correlations are surprisingly quiescent; in the past, this has often been a good entry point for active strategies to fare better.

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The key asset allocation questions at the moment, as we see them, are:

- Does the allocation to private assets still need to increase?
- Is it now time to increase duration and what is the case for government bonds?
- What is the near-term case for active management?
- What do thematic flows in emerging markets (EM)/China, ESG, sectors and factors mean?

In addition to these topics, which will determine the possible need for allocation changes over the next 12 months, other strategic topics come up in client meetings on a regular basis. Foremost among them is whether we are indeed in a new investment regime, particularly from the perspective of equilibrium inflation and real growth. The closely linked allocation question centers on the prospects for stock-bond correlation; we believe that it is likely to return to its long-run norm in positive territory. This shift will initiate a bigger focus on sources of diversification in strategic asset allocation methodology.

We hear a host of client questions on the linked topics of the dollar's future global role, the reason why central banks picked 2% as their inflation target and whether central banks are truly independent anymore (they are arguably somewhat less so than before). The other topic that surfaces often in meetings with a strategic focus is the potential role of artificial intelligence (AI), particularly as a potential offsetting force against secular macro themes that suggest lower real growth and higher inflation—and what all that might mean for strategic asset allocation. We addressed this topic in our recent AI note.

Perhaps just as interesting as the topics we are often asked about are those that do not appear on clients' lists at the moment. Notable among these are environmental, social and governance (ESG) and crypto: we have had almost no demand to cover these topics in recent meetings, and the relevant pages of our marketing deck have remained unthumbed.

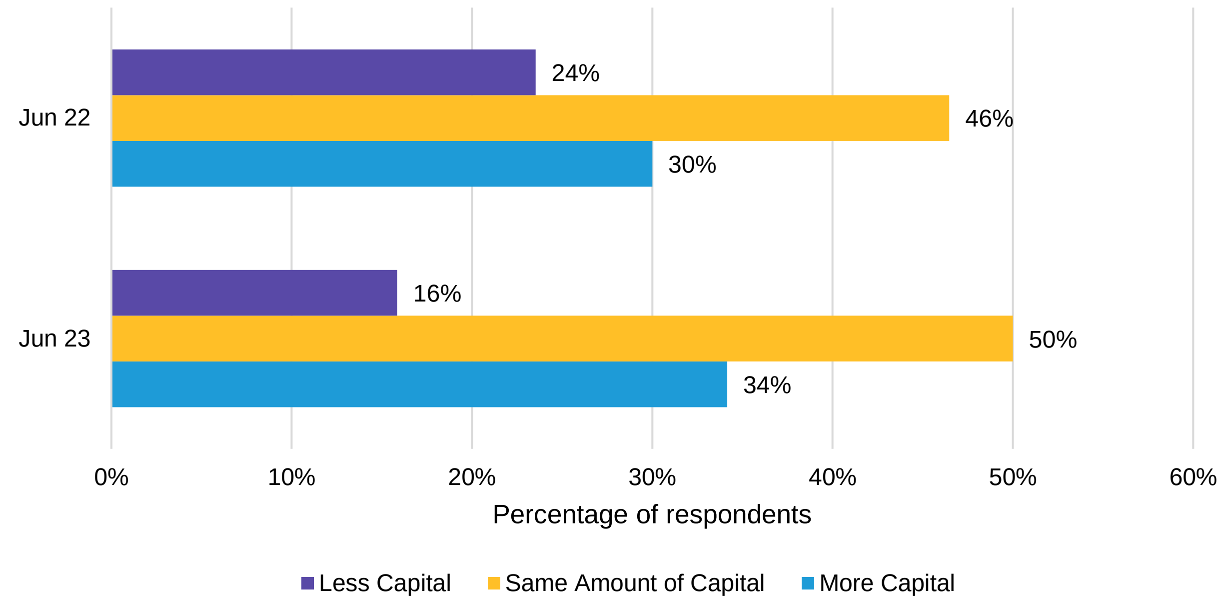
Allocations to Private Assets Remain Part of the Conversation

What is the appropriate allocation to private assets? This probably remains the key strategic-allocation question. Earlier in the year, the explicit incarnation of this question referred to the denominator effect: public markets sold off while private markets had (largely) not seen similar markdowns, creating an apparent rise in the weight of illiquid assets in portfolios. This denominator effect has been a very live issue for some investors, though we have always been somewhat dismissive of it as a real argument. Firstly, for investors with long time horizons, a deviation in weights caused by business-cycle shifts in prices of liquid assets relative to illiquid ones should not matter. Secondly, it really reveals an underlying governance question in the way investors think about the fair value and volatility of public and private assets, which ideally should be placed on the same footing.

By contrast, the real issues that will ultimately shape this allocation are 1) the likelihood that investors' liquidity needs will remain elevated; 2) the case for sustained real returns from different categories of private assets in a higher capital cost and higher-inflation regime; and 3) the case that private assets can offer diversification (real diversification, not merely the faux diversification of not marking to market).

We have sensed a marked decline in appetite for private equity over the course of the year. This is partly reflected in recent investor survey data from Preqin (*Display 1*), which show a larger increase in respondents who want to either allocate less capital or maintain their current level than in respondents still looking to increase their allocations. The hesitation on private equity reflects higher buyout multiples, a higher cost of credit and the prospect of lower internal rates of return from the new tranches of deals taking place.

DISPLAY 1: ALLOCATIONS INTO PRIVATE EQUITY APPEAR TO BE STABILIZING



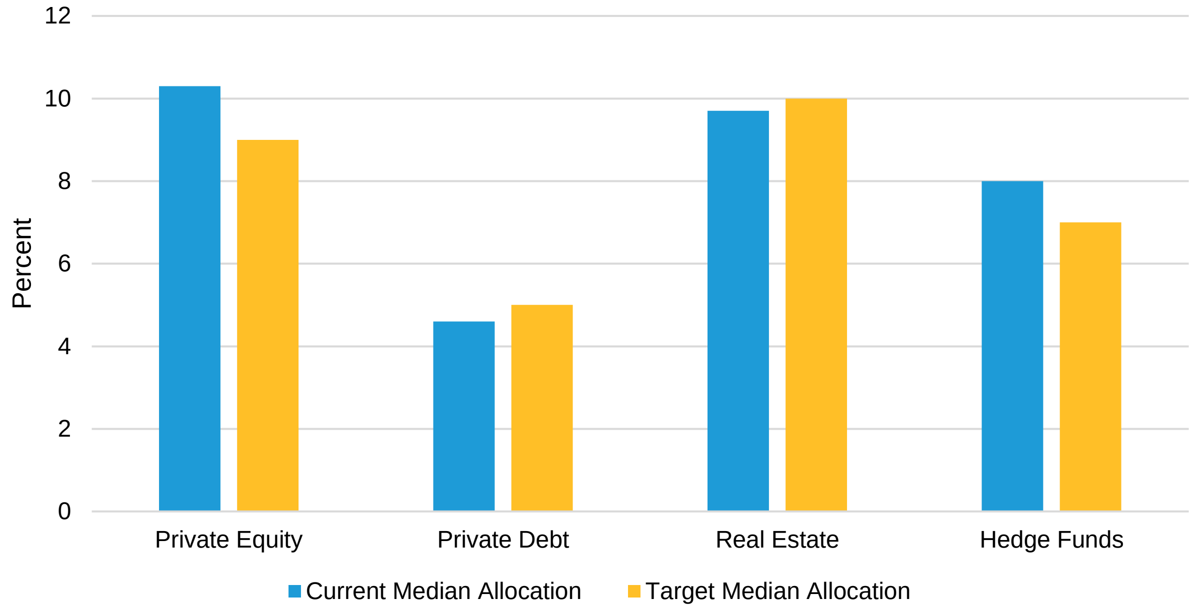
Historical analysis and current estimates do not guarantee future results.

As of June 20, 2023

Source: Preqin and AB

The current median pension-fund allocation to private equity is above target globally; the same is true for hedge funds. Interestingly, private debt and private real estate are the only two categories with further scope for increased allocations compared with the target (*Display 2*).

DISPLAY 2: GLOBAL PUBLIC PENSION FUNDS' CURRENT AND TARGET ALLOCATION TO ALTERNATIVES



Historical analysis and current estimates do not guarantee future results.

Global public pension plans with >$2 billion in assets under management (only funds that have disclosed both their current and target allocations to alternative assets).

As of June 15, 2023

Source: Preqin and AB

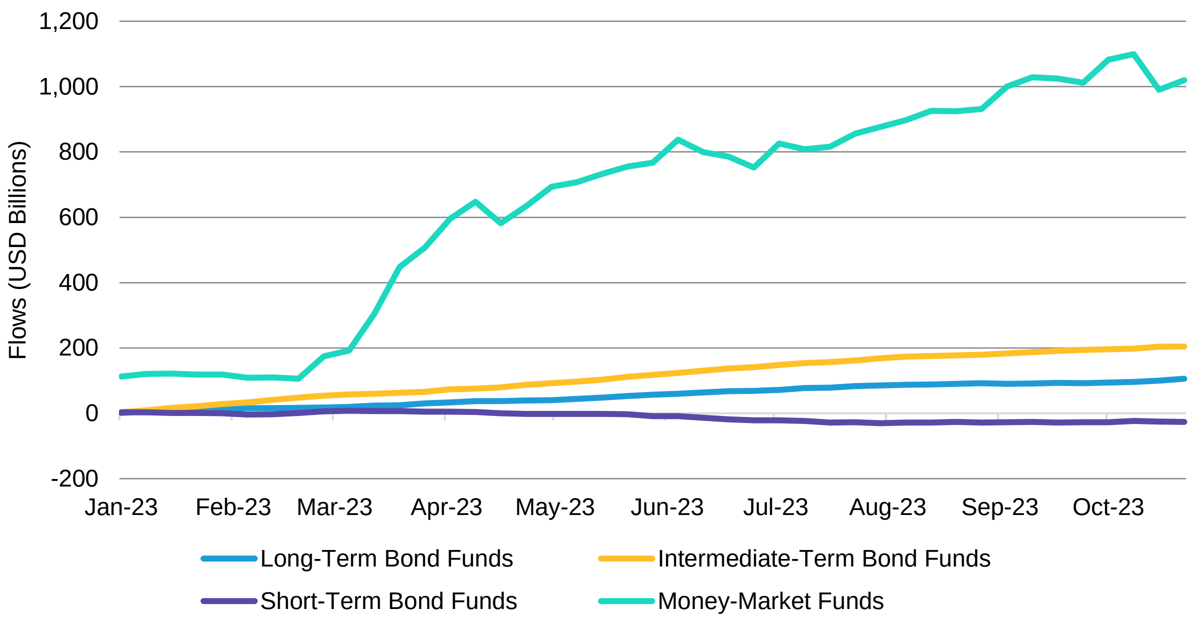
We believe private equity still has an important role to play in investors' portfolios, especially as the wide dispersion of outcomes suggests that there is a case for "alpha" from top-quintile fund selection. However, we expect that *average* private equity returns going forward will be considerably below their long-term history, and that future net-of-fee returns will be in line with our expectations for public equities. The lower expected return is primarily driven by the sharp rise in the cost of debt and a very limited scope for multiple expansion, in our view, because recent private equity acquisitions were made at the top of a historical range for enterprise-value-to-EBITDA multiples. Slower economic growth should also be a drag on expected returns.

On the other hand, the outlook for private debt seems more positive, with strong structural support from the retrenchment of traditional credit providers. In the US, all net credit growth over the last 30 years has come from nonbank sources. Stringent capital requirements will continue to constrain banks' ability to lend in the middle market segment. Most private lending is based on floating rates, which offer protection from higher inflation. Moreover, because short-term rates have risen sharply over the past year, current yields for middle market loans are over 11%—highly attractive compared with history. Thus, we think the marginal dollar allocated to private assets should be going toward private debt.

Is It Now Time to Increase Duration?

With the 10-year US Treasury bond yield having reached 5% and currently fluctuating in the upper 4% range, there is inevitably the question of whether now is the time to add to duration, and a related question around the role of government bonds in portfolios. The asset-flow picture for much of 2023 has been dominated by flows into shorter-duration assets (*Display 3*). Admittedly, roughly half of the flows into money-market funds are replacing bank deposits, so they are not investment flows per se. But even excluding that trend, until recently flows have been skewed to shorter durations.

DISPLAY 3: FIXED-INCOME FLOWS BY DURATION



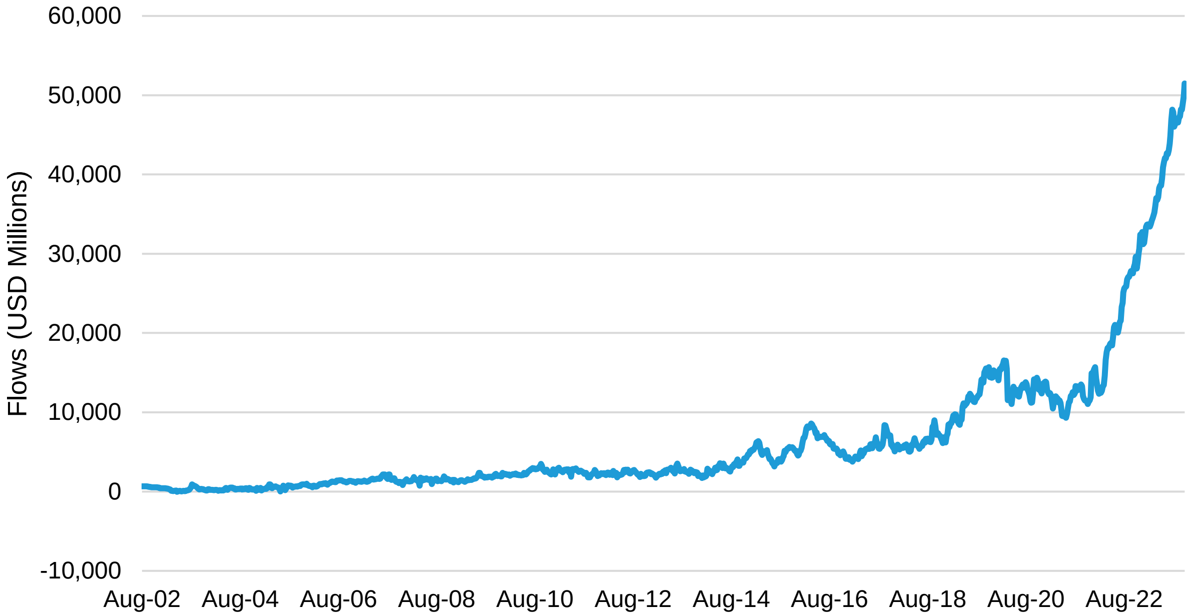
Historical analysis does not guarantee future results.

Through October 25, 2023

Source: EPFR and AB

The size of money-market flows in 2023 has swamped everything else, but there has also been a recent strong pickup of flows into long-duration bond funds (*Display 4*); during the past month, these have included the largest weekly inflows to long-duration funds in a decade. Thus, the upward shift in yields appears to have brought about a recent change in investor preferences.

DISPLAY 4: FLOWS INTO ISHARES 20+ YEAR TREASURY BOND ETF



Historical analysis does not guarantee future results.

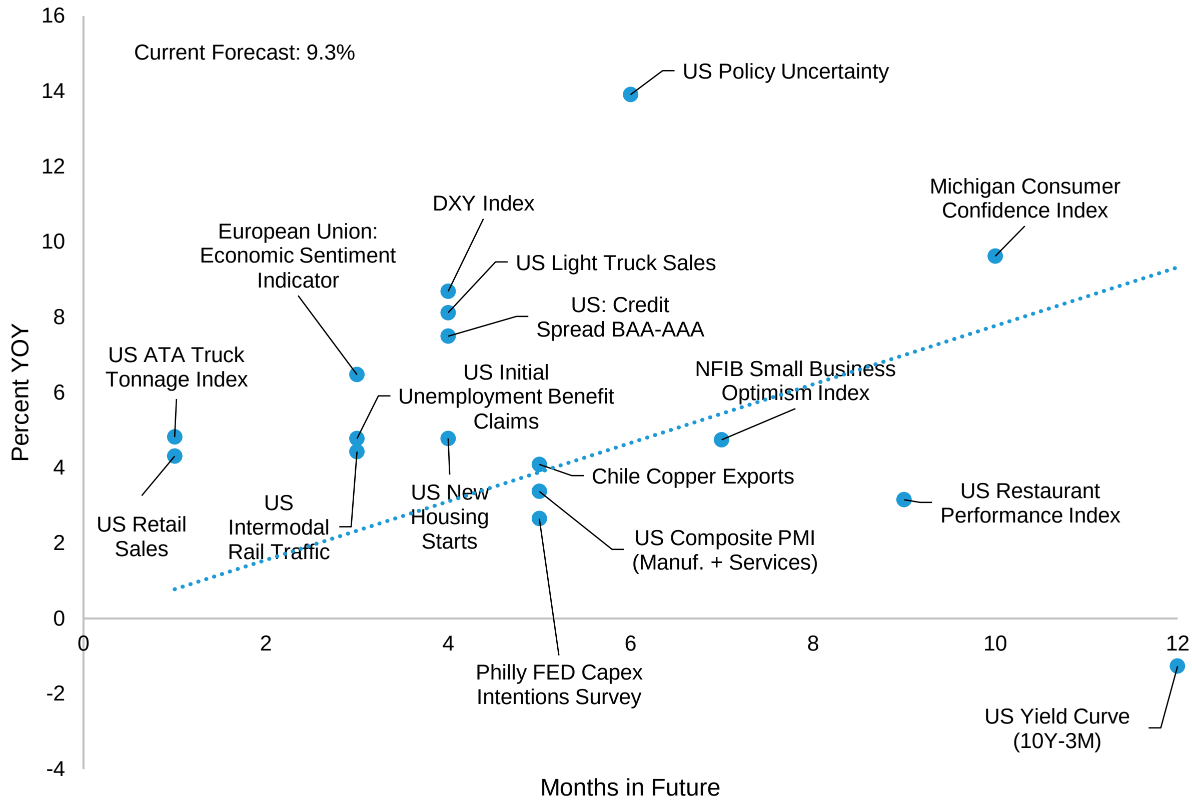
Through June 30, 2023

Source: Bloomberg and AB

In client discussions, there is a difference between tactical and strategic views, and we would argue that this distinction is important—despite the apparent attractiveness of higher yields. The recent rate surge changes the balance of probabilities for the direction of future moves. The 10-year US Treasury yield has not quite reached the level relative to the fed funds rate that is typical at a turn in the cycle, so there is still some potential for yields to rise somewhat. However, the oft-cited view is that the odds have increased that a larger yield move will be down rather than up, raising the possibility of a benefit for starting to add duration, or at least implementing such a move over the coming quarters. The impediment is that, despite the recent steepening, the yield curve is still flat and there's a "risk" of continued strong economic growth, which would make equities and short duration more attractive. We would also point out that the dispersion in potential macro outcomes seems unusually wide at the moment, given uncertainties about growth, inflation and geopolitics.

The tactical view could come down to the odds of slowing economic growth. If it does, our tactical earnings indicator (*Display 5*), which assesses the one-year forward EPS growth rate that is most consistent with the current slew of macro variables that have historically had predictive power, is currently consistent with a remarkably soft landing and earnings growth of more than 9% in the US one-year forward. In other words, the indicator implies that the current bottom-up consensus could be right. This is, unsurprisingly, in part dependent on strong US consumer data.

DISPLAY 5: US TACTICAL EARNINGS INDICATOR



Historical analysis and current estimates do not guarantee future results.

As of September 29, 2023

Source: Bloomberg, Economic Policy Uncertainty Index, National Restaurant Association, Thomson Reuters Datastream and AB

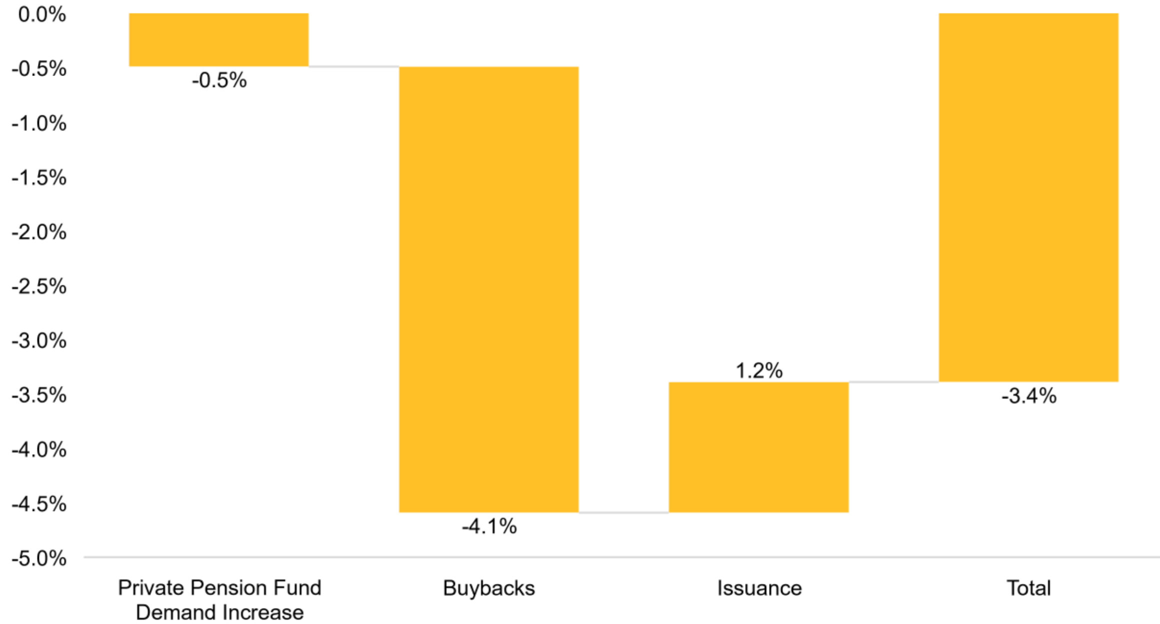
Strategically, however, the case for duration is more mixed. Yes, this is clearly a more attractive entry point than any in the last two years, but what about compared with a longer horizon? For government bonds, in particular, we find this caution appears to be echoed by many of the clients we speak to who are of a more strategic disposition.

We have had many questions in meetings about who is going to absorb the supply of government debt in the coming years. The violence of the recent yield surge has spurred queries about whether this marks the return of "bond vigilantes." What this really refers to is the net supply/demand outlook for sovereigns. What interests us even more, in a portfolio context, is how this supply/demand balance stands relative to that for equities.

In the next two displays, we show some of the fundamental drivers of demand and supply for stocks and bonds in the next five years. For equities, we believe that DC pension plans or other inflation-sensitive investors should increase their allocation to equities to protect their purchasing power. The main determinant of net supply/demand, though, will be that buybacks are highly likely to exceed issuance far into the future. This leads to a forecast of an overall decrease in equity supply of about 3.4% (*Display 6*).

For bonds, we see an opposite situation, with both a decrease in demand from foreign investors and the potential for a lower strategic allocation from inflation-sensitive investors (though perhaps not tactically). In addition, the high and growing primary deficit will drive a large increase in the supply of treasuries at a time when the Fed continues to shrink its balance sheet. Overall, we expect this all to add up to an increase of approximately 17% in the net supply of US bonds (*Display 7*).

DISPLAY 6: EQUITY SUPPLY/DEMAND CONTRIBUTORS

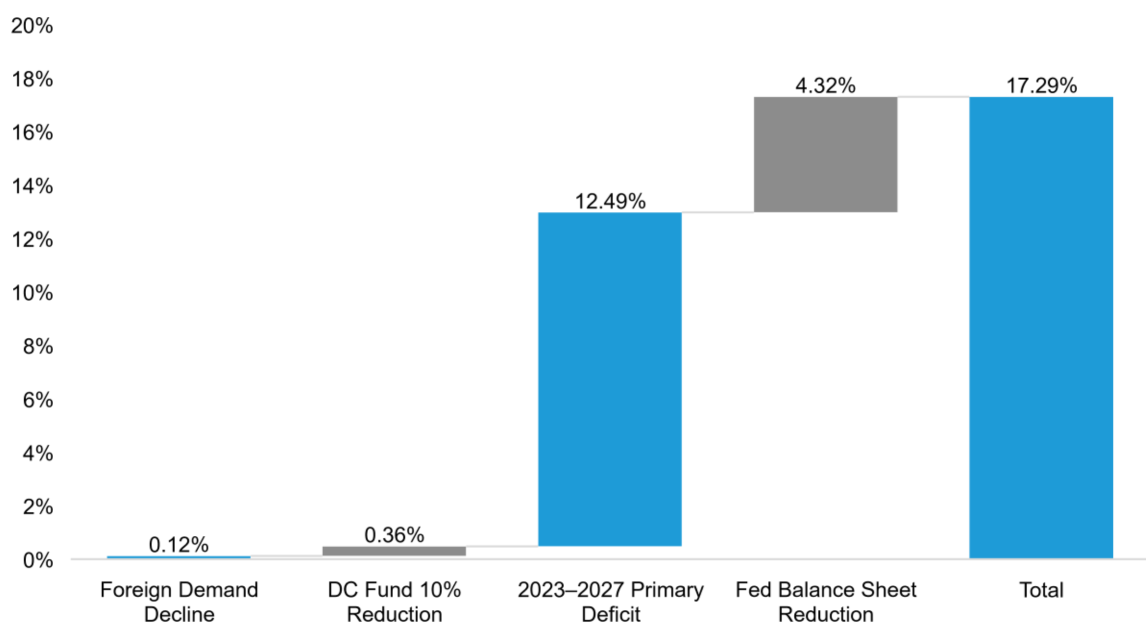


Historical analysis and current estimates do not guarantee future results.

As of December 20, 2022

Source: EPFR, Thomson Reuters Datastream, US Federal Reserve and AB

DISPLAY 7: BOND SUPPLY/DEMAND CONTRIBUTORS



Historical analysis and current estimates do not guarantee future results.

As of December 20, 2022

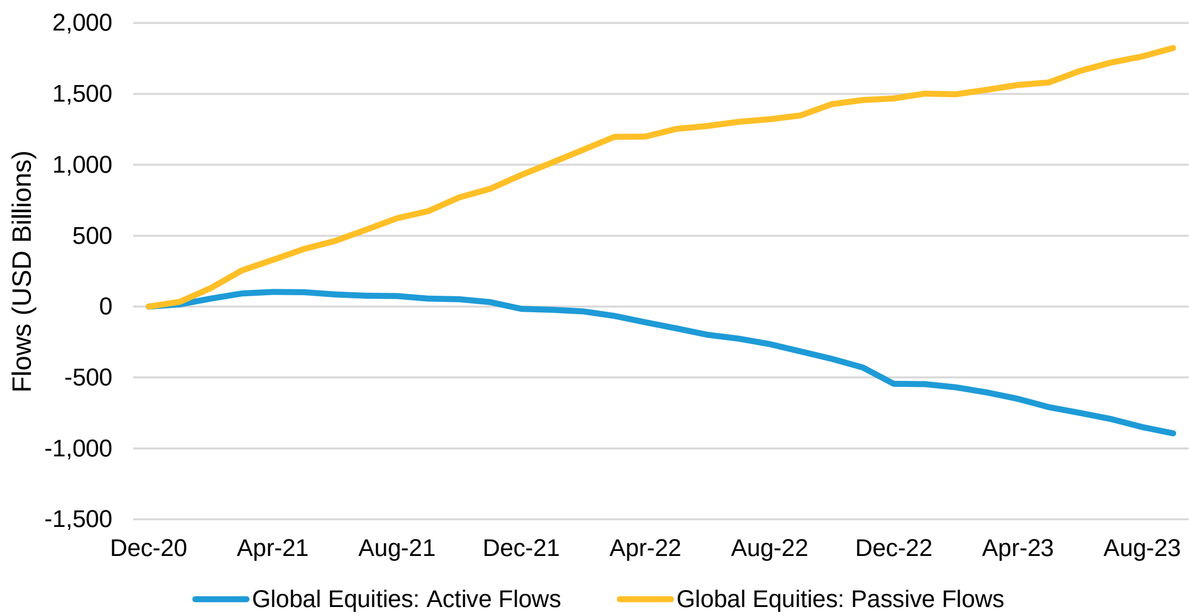
Source: Securities Industry and Financial Market Association, Thomson Reuters Datastream and AB

It is debatable how much the supply situation has driven the latest moves in bond markets. After all, this is hardly new news, is it? Also, net supply/demand does not enter the valuation equation for either equities or bonds. Nevertheless, we think it is an important aspect for asset allocation over the next five years. We face structurally higher inflation and the likelihood that bonds no longer enjoy a negative correlation with equities, reducing their role as a diversifier. In absolute terms, the case for nominal government bonds is indubitably stronger than it was a year ago, but their *relative* strategic attractiveness in a portfolio is moot. We think that the relative merits of this will be a key debate over the coming years.

2023 Has Been Bad for Active So Far—What's the Prognosis for 2024?

The past 12 months have been tough for actively managed funds, mainly as a result of the strong returns from US mega-cap tech companies. While a right-hand skew to the cross-section of stock returns is not unusual, and we would argue is usually a benefit to managers with genuine skill, it becomes a problem if the leadership is from the very largest companies. This pattern has led to a further upswing in the share of equity assets managed on a passive basis (*Display 8*).

DISPLAY 8: AN UPSURGE IN ACTIVE VS. PASSIVE FLOWS



Historical analysis does not guarantee future results.

Through September 30, 2023

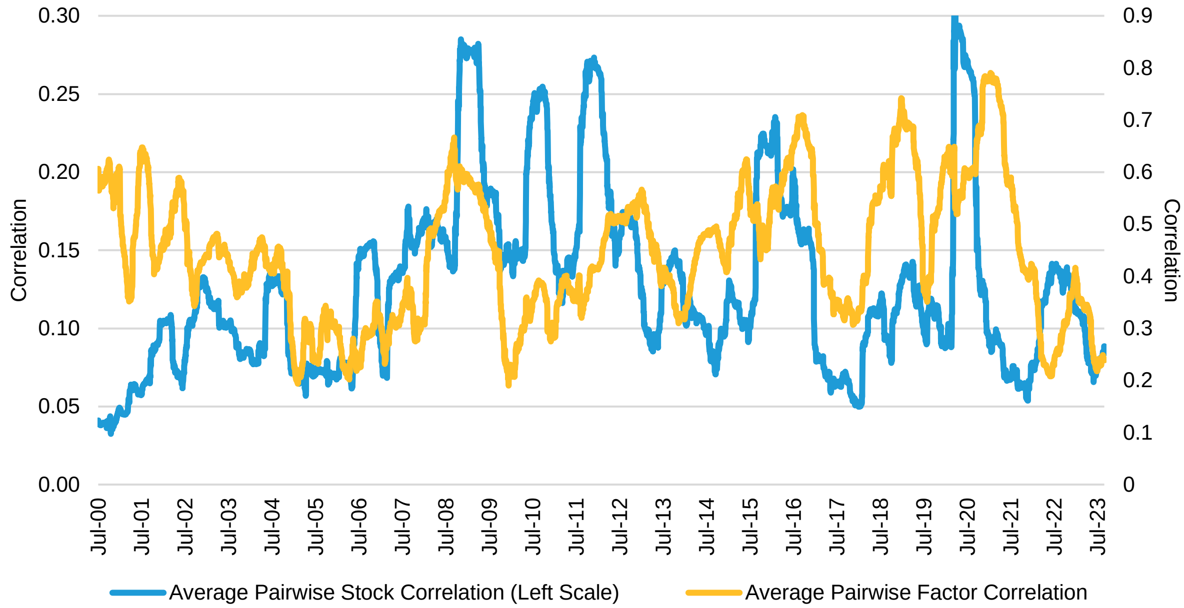
Source: EPFR and AB

It would be a brave strategist who called a tactical turning point in the leadership of tech mega-caps, and we are not going to do that here. We would merely point out that the valuation of the 10 largest stocks relative to the rest of the market is far beyond the bounds of previous experience, and hence presumably unlikely to persist over strategic time frames.

A more tangible point about the prospects of active management in the near term can be made with regard to the structure of market correlation. The average pairwise correlation of global stocks and the average pairwise correlation of factors are low (*Display 9*), which is somewhat surprising because this correlation tends to be elevated when macro uncertainty is high. But we can show that levels of low correlation tend to act as good entry points for active strategies.

One can think about low correlation in theoretical terms as increasing the number of independent investment opportunities (*n*) in Grinold's so-called fundamental law of active management, which states that $IR = IC\sqrt{n}$, where *IR* is the information ratio of the fund and *IC* is the information coefficient, which can be thought of as skill. So, assuming constant skill, an increase in the number of independent investment opportunities implies a higher IR. In practice, we have shown in previous research that active funds tend to fare better than usual starting from low correlation levels such as those we see now.

DISPLAY 9: AVERAGE PAIRWISE FACTOR AND STOCK CORRELATIONS ARE DOWN



Historical analysis does not guarantee future results.

The stock correlations are the average pairwise correlations of daily stock returns for the constituents of the MSCI All Country World Index over a rolling six-month window.

Through August 31, 2023

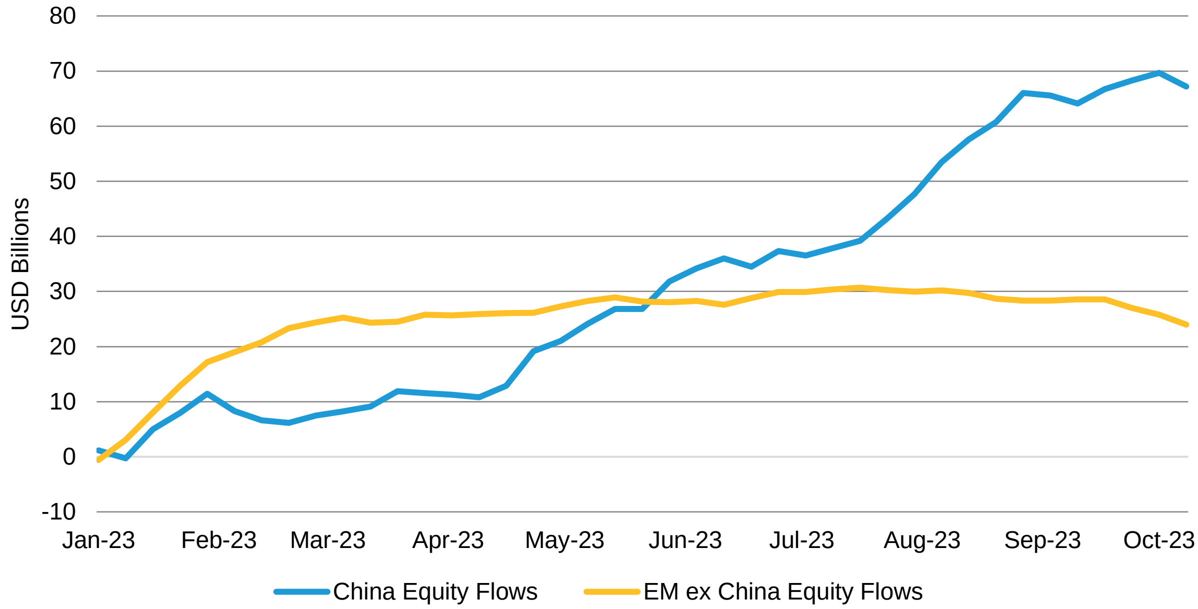
Source: FactSet, MSCI, Thomson Reuters I/B/E/S and AB

Interpreting Recent Thematic Flows

Among other controversies allocators face is the question of EM exposure, and China in particular. A vocal subset of the client base has cited its willingness to reallocate to China, given the size of the underperformance and prior outflows. This is apparent in data that show China flows decoupling from the lackluster flows for the rest of EM (*Display 10*).

This is, yet again, an area where discussion in client meetings draws a marked distinction between the tactical and the strategic. The tactical case is a bounce back for a possibly oversold asset, for which the authorities may offer support. More strategically, a strong consensus is appearing among clients we speak to that Chinese allocations must be separated from the rest of EM. This view reflects a number of factors: the relative size of China; the unknown/artificial benchmark weight of China in “passive” indices due to the necessary arbitrariness of index-inclusion factors; the recognition that forces driving the Chinese market differ from those of other EM (which depend more on local policy and less on foreign flows, etc.); and the risk that, at some point, end clients or regulators may place limitations on Chinese investment.

DISPLAY 10: CHINA AND EM (EX CHINA) EQUITY FLOWS



Historical analysis does not guarantee future results.

Through October 11, 2023

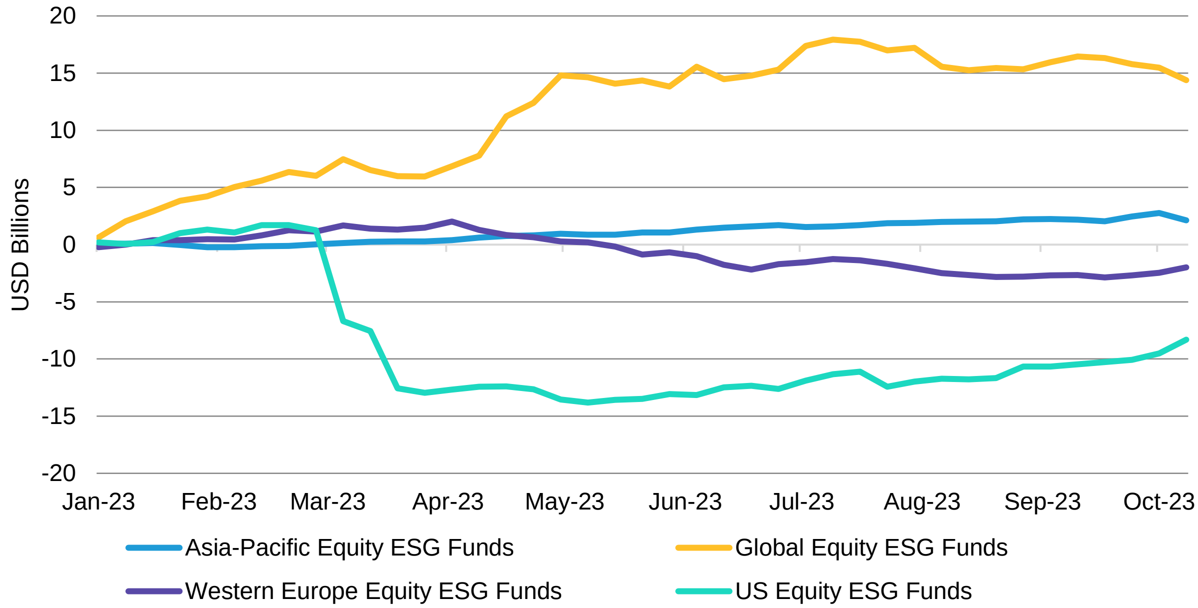
Source: EPFR and AB

ESG Flows

In our recent note on ESG, we made a point that a different investment regime featuring higher equilibrium inflation may well drive a sharper distinction between the different approaches to ESG investing. There is a very broad spectrum of what investors mean by ESG, ranging from approaches that integrate issues that happen to fall under the aegis of ESG into broader investment topics or ESG-as-engagement to interpretations of ESG that translate into omitting investments in certain sectors.

The most stark ESG approach is when certain investments are excluded outright from a universe. It seems uncontroversial from an asset-manager perspective to exclude investments if the client has asked for it, but harder to justify if they have not. However, such considerations cannot be divorced from the overall investment environment. For example, if certain sectors are excluded, it can materially affect the duration of the resulting portfolio and its ability to preserve purchasing power in higher-inflation environments—an issue that was not high on the agenda in the first decade of ESG's evolution. Approaches based on engagement, for example, can yield a very different performance profile. Globally speaking, we have seen a divergence of ESG flows in the US versus other regions since 2023 began (*Display 11*).

DISPLAY 11: DIVERGENCE IN 2023 EQUITY ESG FUND FLOWS BY REGION



Historical analysis does not guarantee future results.

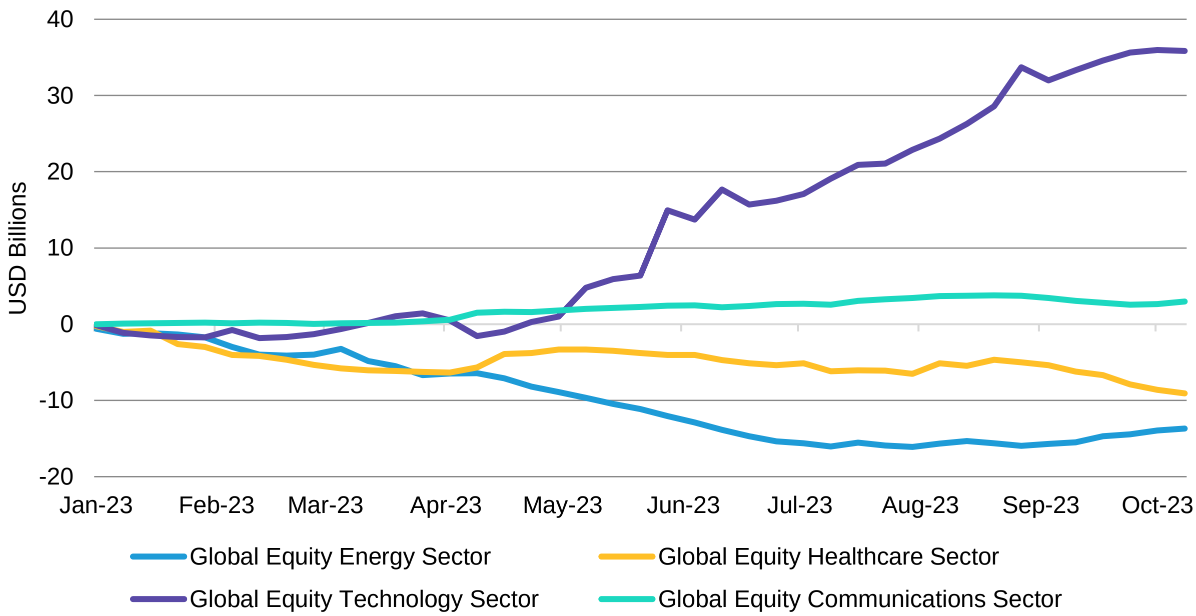
Through October 11, 2023

Source: EPFR and AB

Sector and Factor Flows

Finally, we note a recent divergence in flows to different sectors and factors. It is perhaps no surprise that the equity sectors experiencing the largest inflows globally have been technology and communications (*Display 12*), standing in stark contrast to outflows from energy and from the equity value factor (*Display 13*). While there may be fears about commodity demand in the face of any risks to growth, the cash-flow characteristics of the sector do look attractive for investors seeking income or investors of a pro-value disposition. For investors seeking income or an exposure to "value," we think the cash-flow properties of energy appear attractive, and the free-cash-flow-yield factor appears attractive in its own right.

DISPLAY 12: EQUITY SECTOR FLOWS

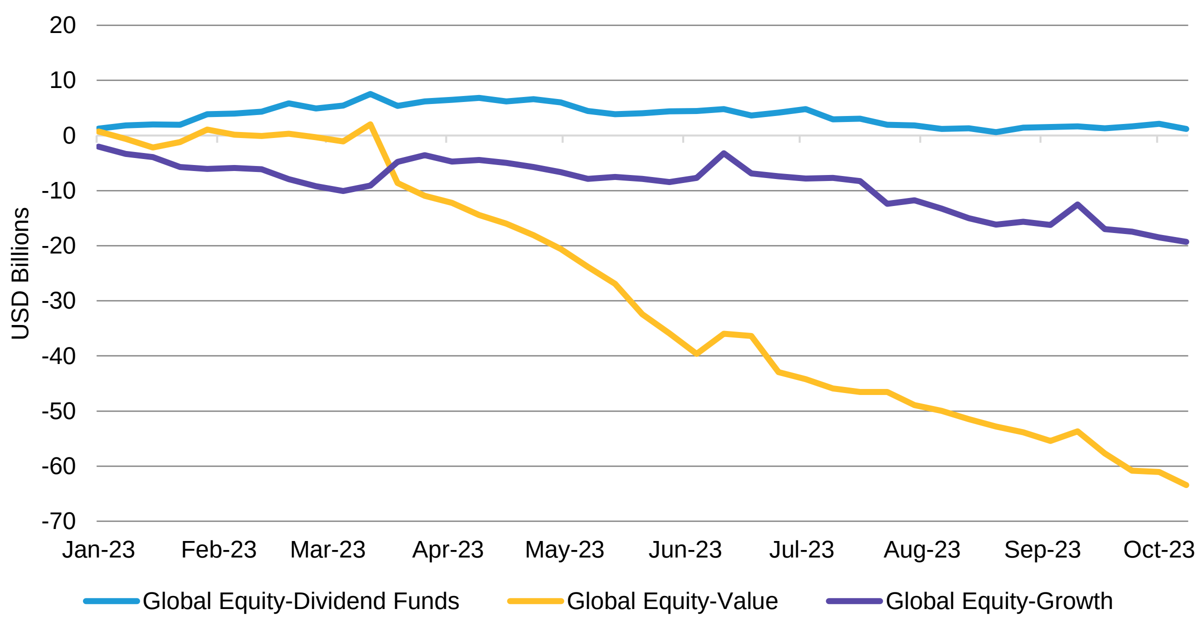


Historical analysis does not guarantee future results.

Through October 11, 2023

Source: EPFR and AB

DISPLAY 133: EQUITY FUND FLOWS BY FACTOR



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Source: EPFR and AB

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