JANUARY 2024

Four Themes for the Year Ahead

Private Assets, Duration, Factor Exposure and the Trump Question

This is not an outlook in the traditional sense of what we expect to transpire in 2024. Instead, we address the key portfolio-allocation questions we think will need to be discussed this year, even if their effects may not play out for years.

One of the biggest allocation questions relates to the role of private assets. We suggest that the allocation will rise further for the average investor, but we expect marginal flows to favor debt over equity.

Investors have been increasing duration exposure as a reflection of higher yields. We distinguish between a tactical role of duration (in anticipation of interest-rate cuts) and a potentially diminished strategic role.

Within equities, we see a strategic case for Japan and emerging markets (EM), with the UK market an attractive tactical opportunity. We emphasize quality as a theme underlying equity positioning. In terms of factors, this means tilting to quality/profitability and low volatility. EM equities and US small-caps offer attractive opportunities for generating alpha through active management.

This is a year of elections, with the most significant one in the US. We discuss how a possible Trump victory may or may not impact allocation decisions.

Inigo Fraser Jenkins

Alla Harmsworth

Additional Contributors: Robertas Stancikas, Harjaspreet Mand and Maureen Hughes

The Ongoing Role of Private Assets

In our meetings with clients over the last two years, a high proportion of time has often been devoted to this question: "What is the appropriate allocation to private assets?" While we think the overall allocation to private assets should increase for many investors, we expect more focus on the appropriate allocation within private assets, with more of the marginal flow accruing to debt than to equity.

We argue that for most investors who care about a trade-off between real return and diversification, the allocation to private assets is likely heading up, though the mix may change. In the investment backdrop, we assume that lower nominal returns are likely across most assets compared with the norms of the last four decades, and that bonds will be less effective diversifiers of equity risk. We are also careful to note that stale prices do not constitute diversification (if investors are relying on that, there is a looming governance problem). By contrast, a return stream that is unavailable in public markets is potentially useful, and where the diversifying potential of private assets lies.

There is also a supply-based underpinning for investors allocating to private assets. Across both equity and debt, there has been a shift away from traditional sources of capital. In the case of equity, the size of public equity markets in developed countries is shrinking, as buybacks seem set to continue to outweigh issuance. So proportionately more equity capital is private, and—likewise—investors seeking to earn the equity risk premium need to devote more of their capital to private over public equity than they have historically. An analogous situation holds in private credit, where banks' retreat from traditional lending requires more loans to be sourced from private markets.

After the 2022 sell-off in public markets, questions arose about the denominator effect that "artificially" amplified the weight in private assets as other assets were marked lower. While this was a serious debate, we never felt it was the real strategic issue. Private assets are often criticized for not marking to market, but it's not always obvious to us that this should be critical: the frequency of pricing assets does need to be seen in the context of the investor's real time horizon. A more urgent issue is liquidity requirements. If there is a pushback on the case for private assets in aggregate, it is more likely on this topic—and in that context, not all private assets are alike.

We lay out the pros and cons for private asset allocation in *Display 1.*

DISPLAY 1: PROS AND CONS OF ALLOCATION TO PRIVATE ASSETS

A Need for More Private Assets

Demand (from Investors)
- Prospect of a lower nominal return on public markets
- Need for diversification
- Need for inflation protection
- Exposure to sectors not represented in public markets
- Need for active return streams

Supply
- Dearth of young, high-growth companies coming to market
- Buybacks have led to a shrinking stock of public equity
- Retrenchment of traditional providers of credit
- Borrowers recognizing greater flexibility of private capital

Emerging Limits on Private Market Allocation

- Denominator effect: Many funds are now overweight private assets vs. target
- Liquidity is a greater concern:
  - Quantitative-easing-to-quantitative-tightening transition
  - Asset-owner portfolios are more illiquid
  - More fragile liquidity in public markets
- Fees, which now constitute the lion's share of many fee budgets

Historical analysis does not guarantee future results.

Source: AllianceBernstein (AB)

We think there is a case to be made that future average returns on private equity will fall short of historically achieved levels, essentially due to higher debt costs and higher starting multiples. Moreover, if the major pushback against private assets is that investors are likely to place more weight on liquidity needs for an extended period, then private debt may have an advantage in requiring capital to be tied up for a shorter period of time, on average. This topic is, by construction, not a question of a trade that will come to fruition over the course of 2024, but a strategic asset-allocation question that we think will receive a lot of attention. The shift in likely returns and the time frame over which capital is tied up equates to a different "path of a dollar," with the potential for a more attractive net profile, at the margin, for private debt.

The growth of private debt as an asset class raises important issues. At the aggregate level, it means that the distribution of default risk across the economy is changing. If this shift has tilted the distribution of risk away from banks and more toward pension funds, which in *theory* have long horizons, it could be argued that this is not a bad thing. Nevertheless, it is a new development in terms of where credit creation takes place in the economy; its impact on the overall system is unproven. While pension plans may in theory have long horizons, they might well be highly averse to significant drawdowns in practice.

For an individual investor, this aggregate question might be less concerning; instead, the question revolves more around default and recovery rates in an industry that has not been through a significant default cycle in its current form and scale.

Return Expectation for Private Equity Funds

We can write an expression for the expected return from the average private equity investment as:

> *Real Private Equity Return = Unlevered Return + Financial Leverage * (Unlevered Return – Cost of Debt) + Multiple Expansion – Fees – Expected Inflation*

where

> *Unlevered Return = Income Yield + Real Growth + Inflation*

We assume an income yield of 2%, real income growth of 4%, leverage of 1.2x and no multiple expansion. The cost of debt is calculated as a base rate of 3.5% and a spread of 3.5%. We also assume a 3% inflation rate. We expect private equity firms to generate real-income growth above that available in the broader public market, because private equity investors are able to choose which sectors to invest in. We assume no multiple expansion, given the record level of buyout multiples.

According to the analysis of Trond Døskeland and Per Strömberg[1] using CEM Benchmarking data, total private equity fees have historically been 5.9%, comprising a 2.7% management fee, 1.9% carried interest/performance fee and 1.2% in other fees (such as fund setup costs). According to the latest Preqin data,[2] the median management fee for buyout funds is now around 2%, which is what we use in our analysis. For a performance fee, we assume an 8% hurdle rate over which a 17% carry fee is levied, with 1% in other fees.

The wide dispersion of possible outcomes is a key aspect of private asset returns. We try to capture this with a series of trees in the charts below. They show the expected outcome both for manager efficacy (top quintile, median and bottom quintile) and for macro paths—in this case, rates. In addition to the base case, we also model a scenario where the base rate is 1% higher (high rates) and 1% lower (low rates). Finally, we model three different return outcomes: median fund, top-quintile fund and bottom-quintile fund. The top and bottom quintile spread is calculated from historical data using a sample of 667 US buyout funds from the Preqin database, covering vintages from 1984 to 2020.

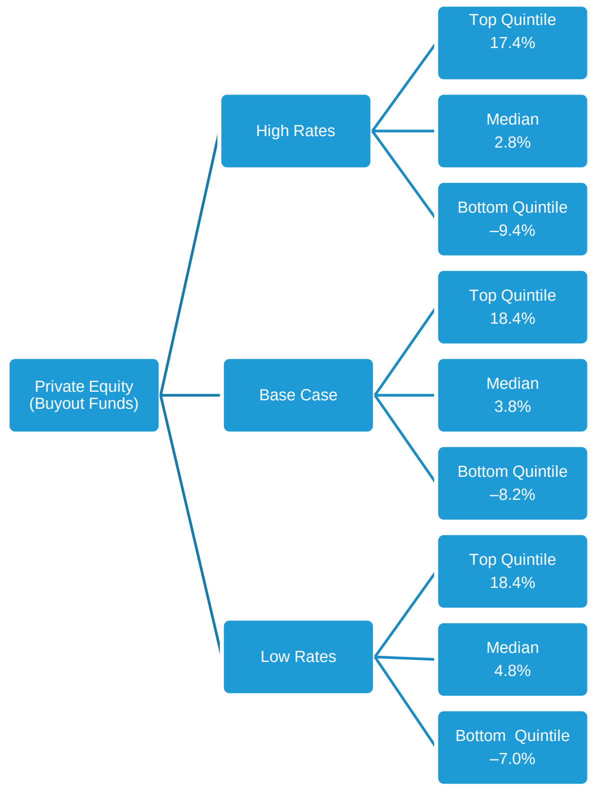
In our base case, the median nominal private equity return is projected to be 3.8% in real terms (*Display 2*), or 6.8% in nominal terms. This is significantly lower than returns over the past decade and not too far off from our expected public equity return. Moreover, there is a very wide band around the median expected return; for example, the bottom quintile of funds is expected to deliver a real return of –8.2% in the base case, with the top-quintile fund return exceeding 18%.

---

1 Trond Døskeland and Per Strömberg, *Evaluating Investments in Unlisted Equity for the Norwegian Government Pension Fund Global (GPFG)*, Swedish House of Finance Research Paper No. 23-03 (April 5, 2018).

2 The 2023 Preqin Private Capital Fund Terms Advisor, 3Q 2023.

DISPLAY 2: REAL NET-OF-FEE RETURN SCENARIOS FOR PRIVATE EQUITY FUNDS



Historical analysis does not guarantee future results.

As of November 30, 2023

Source: Preqin and AB

Return Expectation for Private Debt Funds

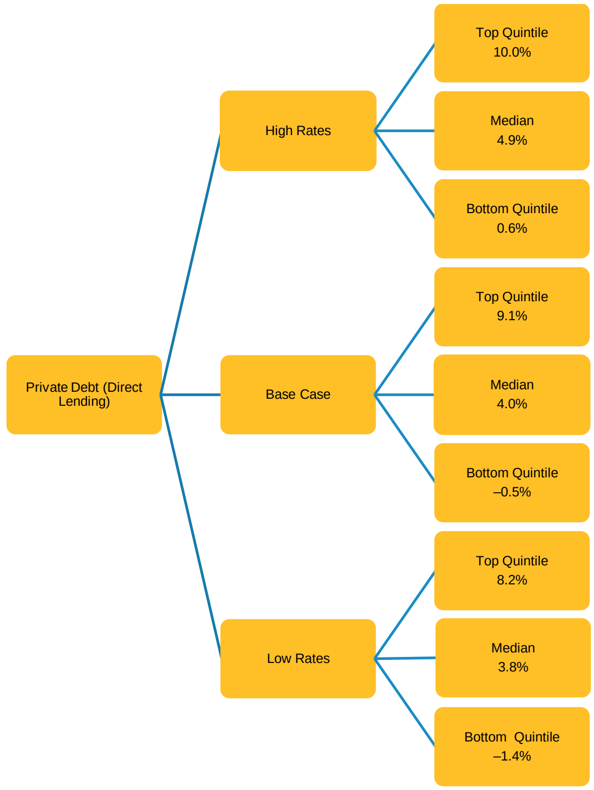
Similar to private equity, we can decompose the return expectation for private debt funds as follows:

Real Private Debt Return = Base Rate + Credit Spread – Default Loss – Fees – Inflation

For our base case, we assume the same 3.5% base rate as private equity, and a 5.5% credit spread. We assume a 0.5% annual loss from defaults and a 0.75% management fee. We use a 7% hurdle rate over which a 10% carry fee is levied. We also model a scenario where the base rate is 1% higher (high rates) and 1% lower (low rates). Finally, we model three different return outcomes: median fund, top-quintile fund and bottom-quintile fund. The top and bottom quintile spread is calculated from historical data using a sample of 103 US direct lending funds with vintages from 2004 to 2020.

The median net-of-fee return under the base-case scenario is projected to be 4% real (*Display 3*), or 7% nominal. The dispersion between top- and bottom-quintile funds is significant but much lower than the same spread for private equity funds. In the case of private debt, the base-case return from a bottom-quintile fund would still be slightly negative in real terms, at –0.5%, and the top-quintile fund return would be 9% in real terms.

DISPLAY 3: REAL NET-OF-FEE RETURN SCENARIOS FOR PRIVATE-DEBT FUNDS



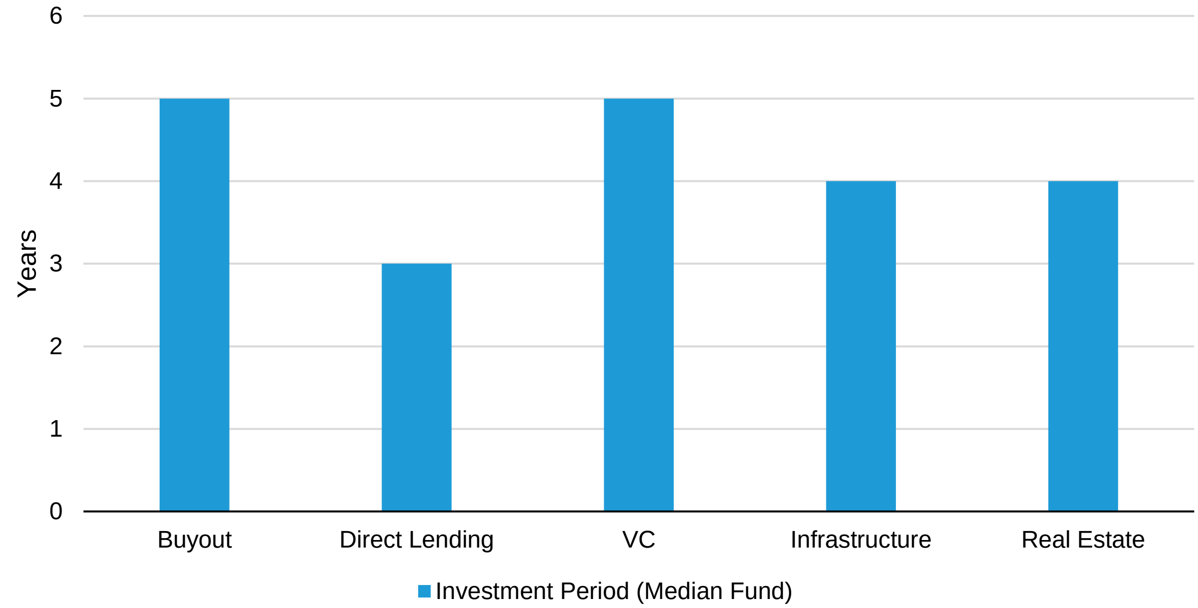
Historical analysis does not guarantee future results.

As of November 30, 2023

Source: Preqin and AB

Another crucial difference between private equity and private debt funds is the liquidity profile. While both are illiquid assets, the liquidity profile of private debt funds is much more favorable. The average investment period over which money is drawn down is three years for a median direct-lending fund versus five years for a typical buyout or venture-capital fund (*Display 4*). Thus, the initial drag on the investor's cash is significantly shorter for private debt funds.

DISPLAY 4: AVERAGE INVESTMENT PERIOD FOR DIFFERENT PRIVATE FUND CATEGORIES



Historical analysis does not guarantee future results.

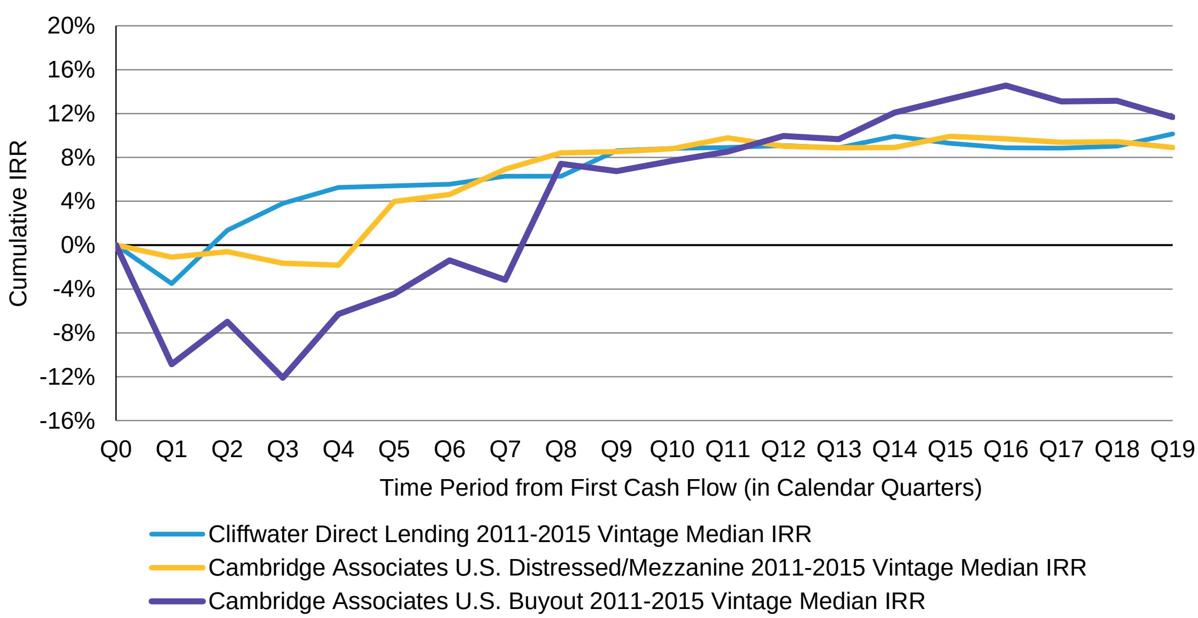
VC: venture capital

As of December 30, 2023

Source: Preqin and AB

Moreover, based on a study by Cliffwater, private debt has a much less pronounced J-curve effect, where internal rates of return (IRRs) for private debt funds turn positive much sooner than for buyout funds (*Display 5*).

DISPLAY 5: LIQUIDITY PROFILE OF DIFFERENT PRIVATE FUNDS



Historical analysis does not guarantee future results.

Through June 30, 2016

Source: Stephen L. Nesbitt and John Topor, *Corporate Direct Lending and J-Curve Mitigation*, Cliffwater Research, January 29, 2017.

This relationship is part of a broader issue: the risk profile of private equity versus private debt. One can debate the merits of using return volatility as a metric for return streams where the main risk is in tails and liquidity-related constraints, but the volatility of private debt is lower and the dispersion of outcomes narrower. We think the bigger risks for private debt are at the system level in aggregate, and in the unknown effect it may have on the business cycle. However, for investors' private asset exposure, we think that marginal flows should tilt to private debt.

We are not suggesting that investors avoid private equity. However, it should be clear that this is more an alpha or fund-selection decision than a story about the expected return from the "beta" of the asset class.

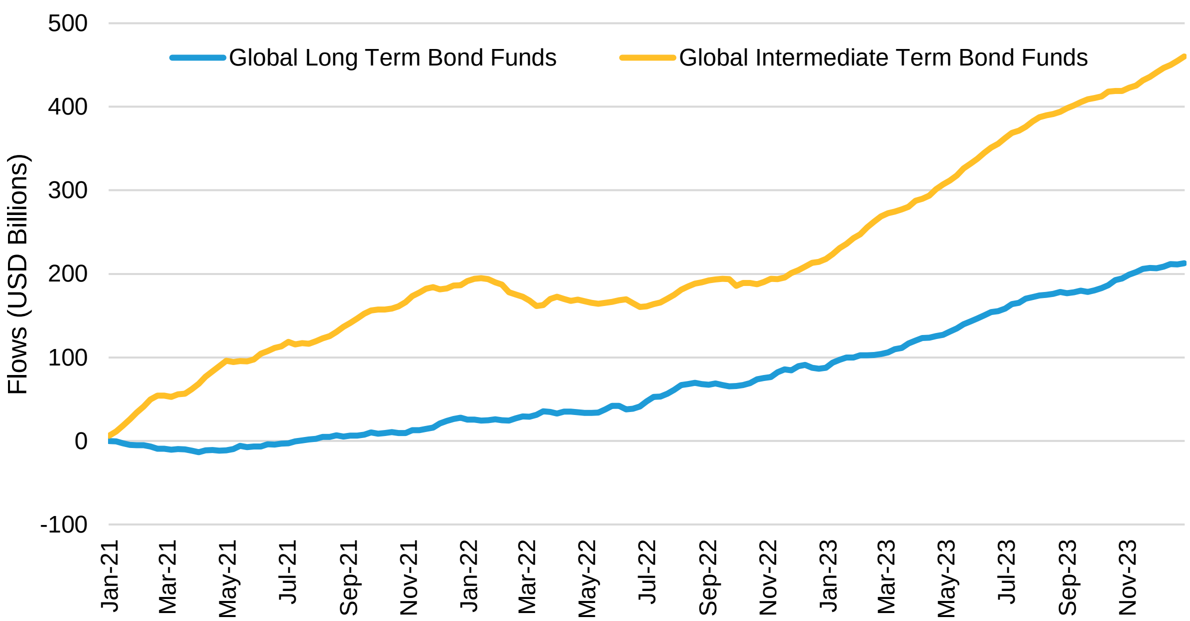
To Add Duration or Not to Add Duration?

The last half of 2023 saw record inflows into long-duration positions (*Display 6*) in the wake of duration exposure having been one of the largest sources of pain for investors over the preceding 18 months. A key question for allocators in 2024 is, "Should exposure to duration rise further?" (hence, the Hamletian subtitle of this section).

Exposure to duration is more attractive now than it has been over the last decade, so it is natural for it to increase from the positions set in recent years. But how large an exposure should it be, and should it constitute an overweight? That is a hard question, because there are different tactical and strategic perspectives. The tactical narrative is tightly linked to the projected path of rates, and we think the strategic narrative is likely to be dominated by the prospect of being in a new investment regime. Given the impossibility of any "natural" cross-asset benchmark (a topic we will return to in an upcoming note), it is hard to say what exposure would constitute an overweight from a strategic perspective.

The bottom line from our point of view is that duration exposure will likely increase from the levels set over the past five years. Also, the prospect of falling rates (albeit not as rapidly as the market expected a month ago) gives tactical support to long-duration flows. However, from a strategic perspective we think that duration is likely to be much less of a panacea than it has been during the careers of most people in the investment industry. That could demand a rethink.

DISPLAY 6: RECORD FLOWS INTO LONG-DURATION BOND FUNDS IN THE SECOND HALF OF 2023



Historical analysis does not guarantee future results.

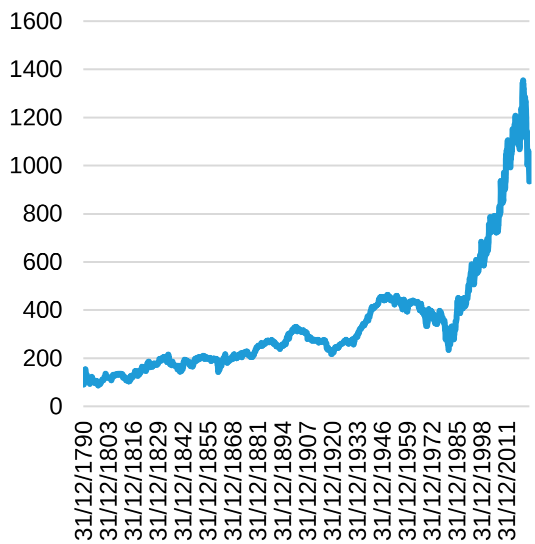
Through January 5, 2024

Source: Emerging Portfolio Fund Research (EPFR) Global and AB

Let's consider this strategic issue from the perspective of returns and contribution to risk. What return should one expect from duration? There is really no such thing as a "normal" return from duration, because it is very regime-specific. Long-run excess returns from 10-year US government bonds over cash were very strong in recent decades until the last few years (*Display 7*). However, for a long time preceding that period, returns were lower and more variable.

Display 8 shows the same excess-return data split by period. The 1980–2020 return was unusually strong in this context. The postwar period prior to 1980 saw an extended period of negative returns. Returns before that were positive, on average, but at a lower rate.

DISPLAY 7: EXCESS RETURN OF US 10-YEAR TREASURY BONDS OVER CASH, INDEXED

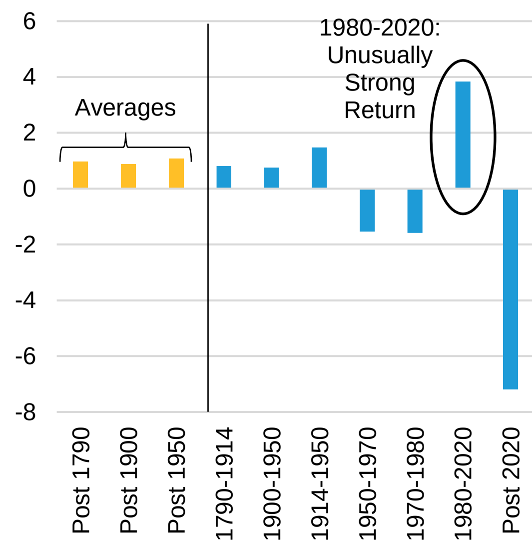


Historical analysis does not guarantee future results.

Through October 30, 2023

Source: Global Financial Data and AB

DISPLAY 8: EXCESS RETURN OF US 10-YEAR TREASURY BONDS OVER CASH BY PERIOD



Historical analysis does not guarantee future results.

As of October 30, 2023

Source: Global Financial Data and AB

The very high excess returns from duration in the 1980–2020 period reflect a special period when nominal yields fell, driven by a combination of higher growth, globalization, favorable demographics and central bank independence. None of these forces look set for an encore as a force for further declines in yields. In addition to these macro forces, the returns from duration in that exceptional period also reflect very special starting conditions. In that sense, the strength of duration as a source of return in recent decades is like the problem of the direction of time in thermodynamics being solved by relying on a very special case of a low entropy starting point at the Big Bang, rather than time's arrow being a fundamental artifact of existence. Those who assume a very high return from duration are essentially relying on the anthropic principle.

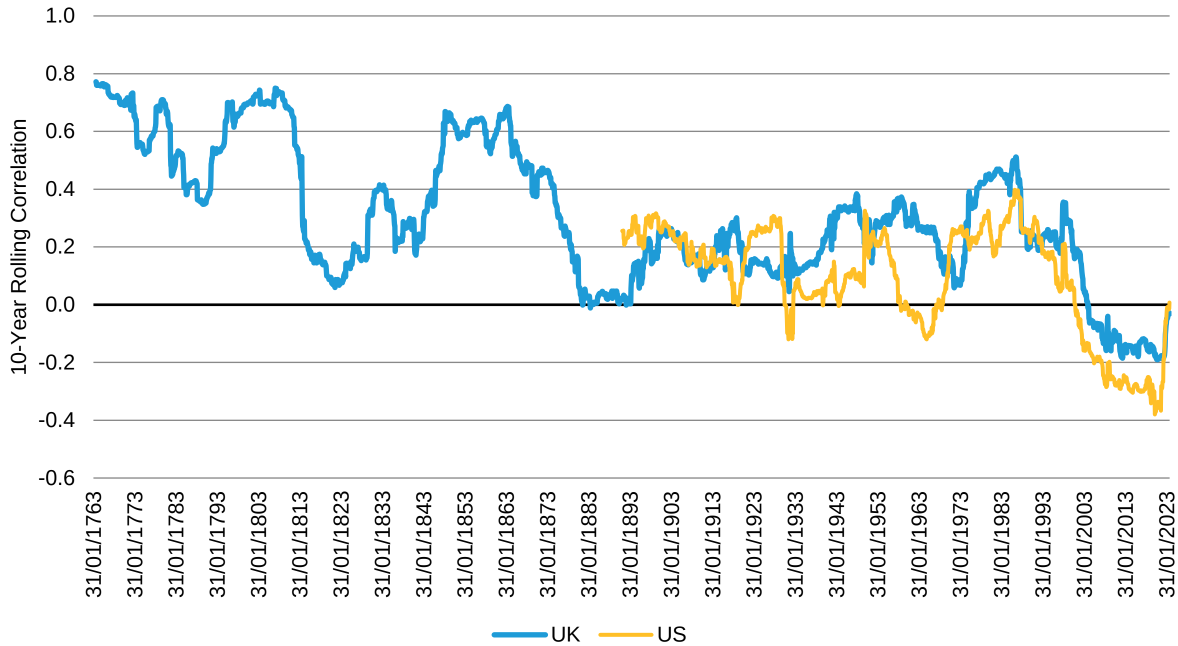
That said, there *should* be a return from duration given the inherent risk of sovereign default or inflation. In the absence of the very special starting conditions of the early 1980s, the very long excess return of 1% annualized seems a reasonable assumption for duration.

A second key part of the equation is the contribution to risk. We have made the case in previous work that the deeply negative correlation of stock and bond returns is unlikely to be repeated. A correlation in the range of zero to positive 0.2 is still helpful for diversifying portfolio risk, but is not the same no-brainer that recent decades' outright negative correlation presented. In the very long-run history of the correlation between stock and bond returns (*Display 9*), the negative correlation of the past 30 years was an aberration.

Looking forward, a crucial factor will be the extent of the link between inflation and growth. Over strategic horizons, there is a case to be made that some inflationary forces are not growth linked, or even consistent with lower real growth, such as deglobalization, demographic changes, and climate change and its response. In such an environment, a positive correlation between equities and bonds could be sustained. In strategic asset-allocation models, we think it is right to assume a slightly positive correlation between the asset classes.

From the point of view of the total portfolio, if we are right in assuming that the real Sharpe ratio over the next decade will be lower than in recent decades, then exposure to a range of risks that are imperfectly correlated is important. As a result, exposure to duration has a role to play alongside other sources of risk in this context.

DISPLAY 9: 10-YEAR ROLLING STOCK/BOND CORRELATION



Historical analysis does not guarantee future results.

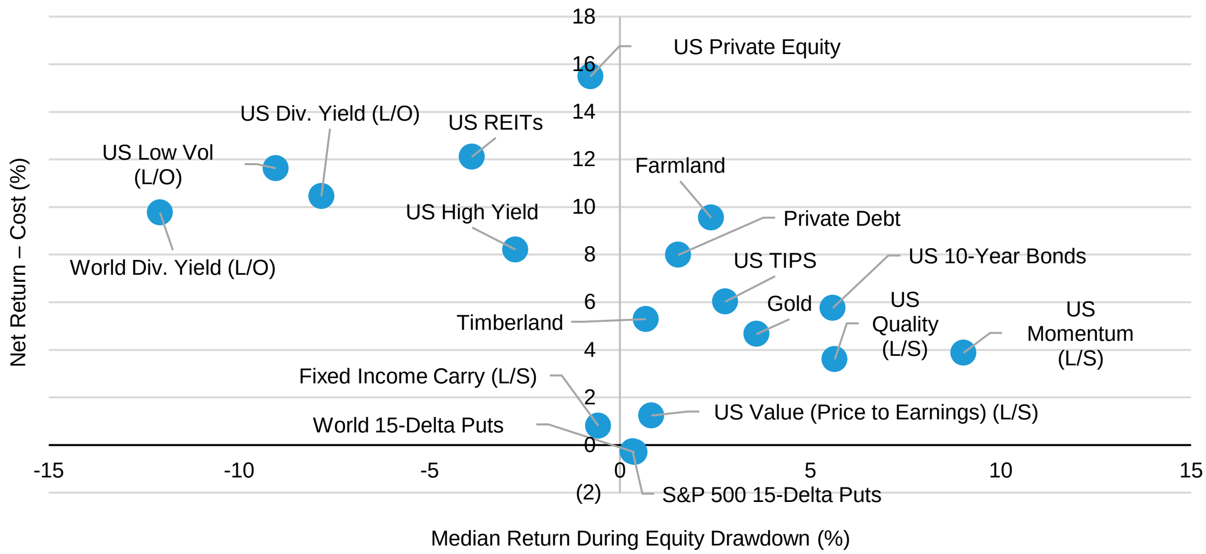
Through November 30, 2023

Source: Global Financial Data, Thomson Reuters Datastream and AB

There is a clearer role for duration in downside protection and as a source of liquidity, either for investors who have an explicit liquidity requirement to fund payments or as a source of funding for opportunistic investments in times of dislocation in markets. In *Display 10*, we show the historical long-run returns from a range of assets plotted against their return during the largest 10 US equity drawdowns from 1999 through 2020. On this basis, duration has a strong role to play for investors who are very drawdown-averse. The return/drawdown-protection trade-off role of duration is similar, on this basis, to that of gold as well as momentum and quality factors. This pointedly did not work in 2022–2023, so it is not a protection against that kind of sudden rebasing of inflation risks. However, there is good reason to believe that it would work during a shock caused by an adverse geopolitical event or a normal downturn in the business cycle.

With this in mind, duration has a role to play for investors who ultimately have a real return outlook, but it lies more in drawdown mitigation and liquidity provision. The resetting of yields in recent years means that one no longer pays for this feature, so the return versus drawdown-protection balance has shifted, implying a directionally higher exposure to duration.

DISPLAY 10: BONDS STILL HAVE A ROLE IN DRAWDOWN MITIGATION (AS LONG AS ONE AVERTS ONE'S GAZE FROM 2022)



Historical analysis does not guarantee future results.

Display uses monthly data since 1990. Private equity, private debt, farmland and timberland series are quarterly, and we match the drawdown periods to the nearest quarter. We assume a 10 bps fee for US 10-year bonds, gold, REITs, TIPS and high-yield bonds. We assume a 20 bps fee for long-only (L/O) factors and a 50 bps fee for long/short (L/S) factors. For timberland, farmland and private debt, we assume a 150 bps fee. The option strategies are shown for one-year 15-delta puts, market-cap-weighted and delta-hedged daily.

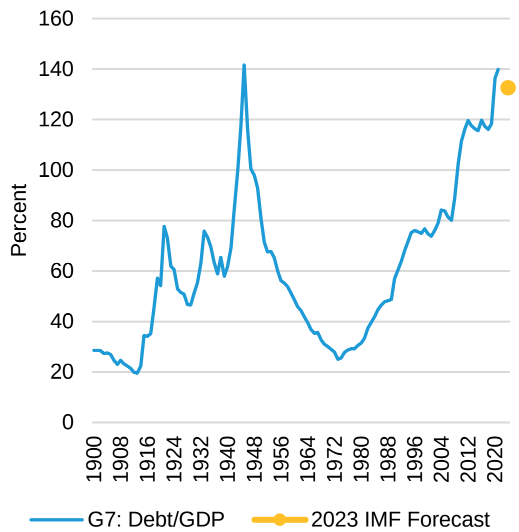
As of March 31, 2022

Source: Bloomberg, Cambridge Associates, Cliffwater, Global Financial Data, National Council of Real Estate Investment Fiduciaries, Thomson Reuters Datastream and AB

One question that has come up repeatedly in meetings over the past six months, and one that we expect to remain a topic of discussion, is whether the rapid rise in real yields over the past year represents the return of "bond vigilantes." What this question really refers to is the question of public-debt sustainability and the net supply/demand outlook for sovereign bonds. We showed recently that supply/demand balances for government bonds and equities seem diametrically opposed. While there is a shrinking supply of public equity in developed markets (DM), there will likely be an increase in demand from investors if equilibrium inflation is somewhat higher. Bonds stand in contrast: there will be a marked increase in supply as governments meet fiscal demands, while a period of elevated inflation reduces demand for bonds from many investor categories.

The ratio of public debt to gross domestic product (GDP) has been rising for a long time (*Displays 11* and *12*). What makes it matter now, of course, are the very different projections for rates and the realization that the unwinding of the secular forces that put nominal rates on a downward path in recent decades is gone. However, as Japan has pointedly shown, this is a can that may be kicked down the road for an undefined amount of time. This is especially true for the US: for all the desire in some countries to dislodge the dollar as a reserve currency, there is no plausible near-term equivalent. There is less scope to dodge this issue in other countries, as the UK liability-driven investing (LDI) crisis demonstrated. It would be hard to make a direct connection from this public debt profile to a "delta" on strategic asset-allocation positions. However, we would say that this is a reason to, at the very least, be conservative and assume that the realized volatility on duration will be in line with its long-run (say, post-1950) average, not the suppressed level of recent years. It also leaves open the possibility of a lower real return from duration.

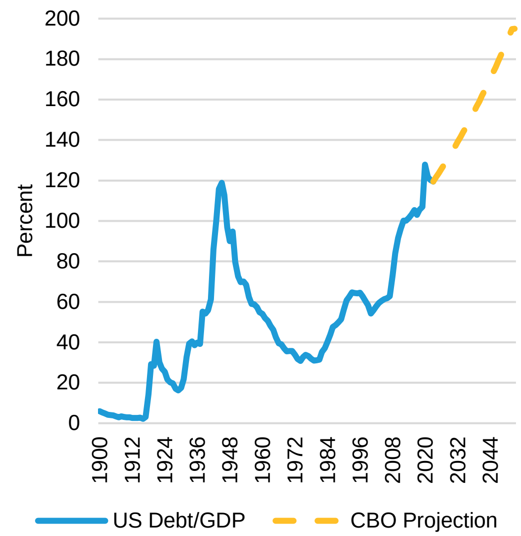
DISPLAY 11: G7 GOVERNMENT DEBT-TO-GDP RATIO (GDP-WEIGHTED)



Historical analysis and forecasts do not guarantee future results.

Display shows government debt/GDP for G7 countries, weighted by nominal GDP denominated in USD. Data from 1900–2021 are from Global Financial Data. The 2023 forecast is from the International Monetary Fund (IMF).
Through October 31, 2023
Source: Congressional Budget Office (CBO), Federal Reserve Economic Data (FRED), Global Financial Data, IMF and AB

DISPLAY 12: US GOVERNMENT DEBT-TO-GDP RATIO



Historical analysis and forecasts do not guarantee future results.

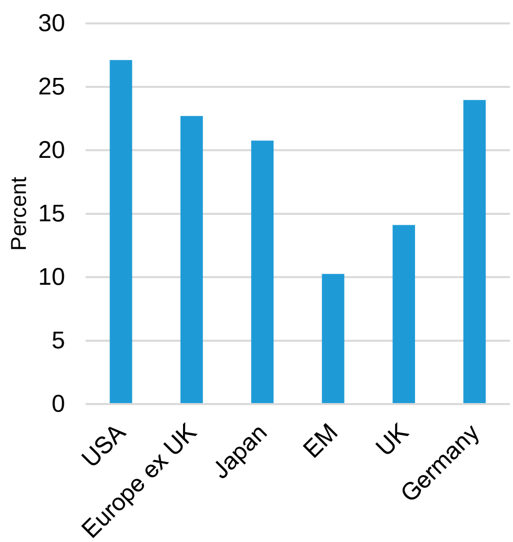
As of October 30, 2023
Source: CBO, FRED, Global Financial Data, IMF and AB

In client discussions, there is a difference in tone between tactical and strategic views, and we would argue that the distinction is important for this topic, despite the apparent absolute 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. In the last four major rate cycles since 1990, it has equaled or exceeded the peak fed funds rate before a definitive fall in bond yields materializes. However, odds are that rates move down rather than up; it's more a question of timing. This situation raises the possibility of a benefit from starting to add duration, or at least from implementing such a move over the coming quarters. The impediment is that the yield curve remains inverted, and the dispersion in potential macro outcomes seems unusually wide at the moment, given uncertainties about growth, inflation and geopolitics.

Opportunities Within Equities

Thanks to continued economic resilience, equities across the globe delivered positive returns in 2023 (*Displays 13* and *14*). We note the standout performance of Japan in local-currency terms (albeit much more modest in USD terms) and the strong performance of Germany both in USD and local-currency terms.

DISPLAY 13: POSITIVE EQUITY RETURNS IN 2023 (USD)

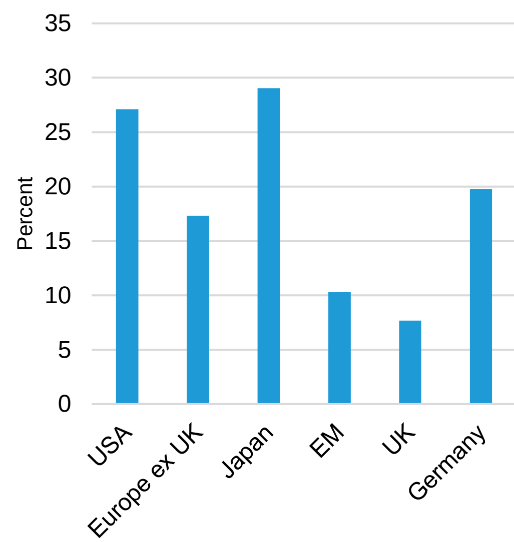


Historical analysis does not guarantee future results.

As of December 29, 2023

Source: MSCI, Thomson Reuters Datastream and AB

DISPLAY 14: POSITIVE EQUITY RETURNS IN 2023 (LOCAL CURRENCY)



Historical analysis does not guarantee future results.

As of December 29, 2023

Source: MSCI, Thomson Reuters Datastream and AB

Displays 15 and *16* look at the valuations of US and other key markets across a range of metrics on both an absolute basis and versus long-term history. The US is the unsurprising exception to the otherwise broadly benign valuations in other regions, trading at a considerable premium versus both its own history and that of other regions. Japan, the UK and China offer the largest discounts to historical averages.

DISPLAY 15: REGIONAL EQUITY VALUATION SUMMARY

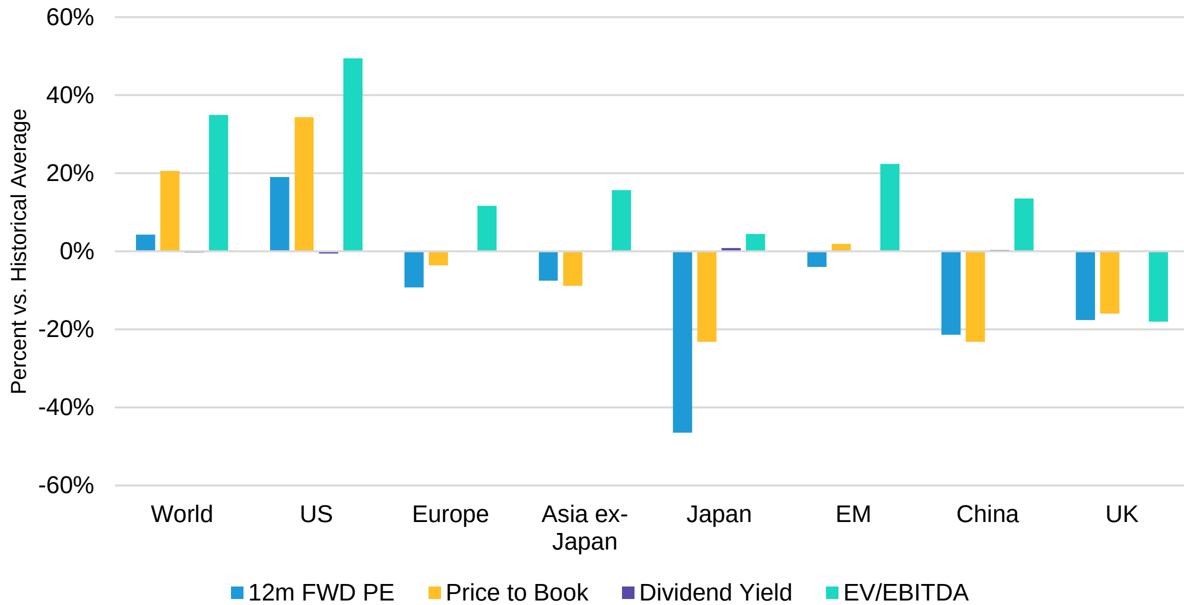
Current Multiple	World	US	Europe	Asia ex Japan	Japan	EM	China	UK
12m Forward P/E	17.38	20.00	13.05	12.99	14.30	12.65	10.91	11.36
Price to Book	2.89	3.92	1.97	1.75	1.46	1.82	1.62	1.82
Dividend Yield	2%	1%	3%	3%	2%	2%	2%	4%
EV/EBITDA	11.97	14.79	8.25	9.71	9.10	9.42	9.66	6.40
% vs. Average	**World**	**US**	**Europe**	**Asia ex Japan**	**Japan**	**EM**	**China**	**UK**
12m Forward P/E	4.3%	19.0%	-9.3%	-7.5%	-46.5%	-4.0%	-21.4%	-17.6%
Price to Book	20.6%	34.3%	-3.6%	-8.9%	-23.2%	1.9%	-23.2%	-16.0%
Dividend Yield	-0.3%	-0.6%	0.0%	-0.1%	0.8%	0.1%	0.3%	0.0%
EV/EBITDA	34.9%	49.4%	11.7%	15.7%	4.4%	22.4%	13.5%	-18.0%

Historical analysis does not guarantee future results.

As of December 30, 2023

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

DISPLAY 16: REGIONAL EQUITY VALUATION



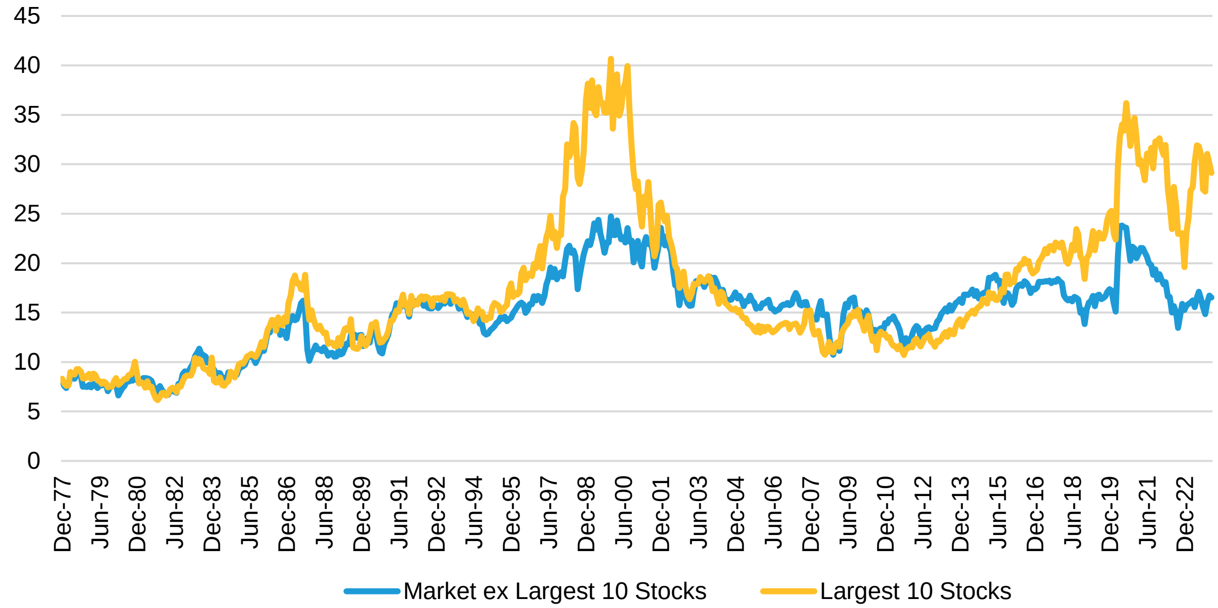
Historical analysis does not guarantee future results.

As of December 30, 2023

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

Of course, US valuations remain massively skewed by mega-caps; after stripping out the top 10 stocks, it still does not exactly scream “cheap,” but the multiple is considerably less extreme (*Display 17*).

DISPLAY 17: US MARKET VALUATION EXCLUDING TOP 10 STOCKS



Historical analysis does not guarantee future results.

Through January 5, 2024

Source: FactSet and AB

How worried should we be about these multiples? With a consensus of roughly 12% earnings growth for the US market in 2024, expectations are high (*Display 18*). The bar is highest, of course, for the "Magnificent Seven," which are expected to deliver 20% growth this year—very nearly double the rest of the market, which, excluding the top 10 names, is expected to grow earnings by 11% (*Display 19*).

DISPLAY 18: 2024 EARNINGS AND SALES GROWTH FORECAST

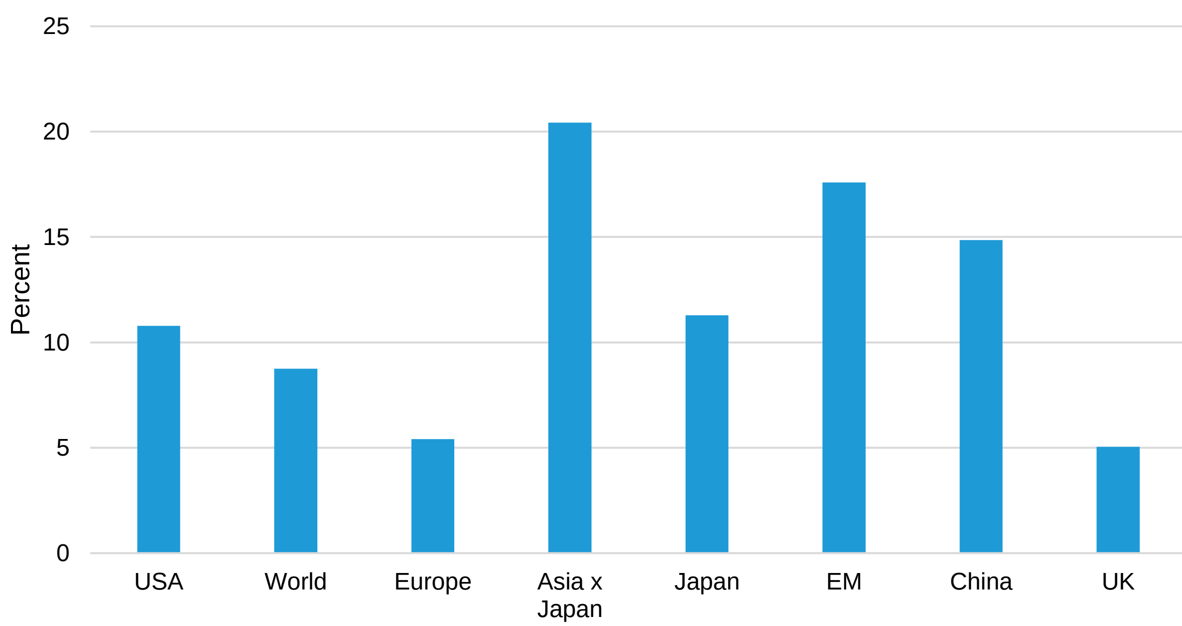
	2024 Estimates vs. 2023 Actual	
Sector	**Earnings**	**Sales**
Energy	2.3%	2.0%
Materials	5.6%	1.6%
Information Technology	13.1%	7.1%
Financials	6.7%	6.0%
Communication Services	16.3%	7.0%
Industrials	11.2%	4.8%
Consumer Discretionary	13.7%	6.4%
Consumer Staples	4.8%	2.6%
Healthcare	18.0%	5.6%
Real Estate	–2.0%	6.0%
Utilities	8.4%	2.8%
Largest 10 Stocks	20.0%	11.8%
S&P 500	12.5%	5.9%
S&P 500 ex Largest 10 Stocks	11.0%	5.1%

Historical analysis and forecasts do not guarantee future results.

As of January 3, 2024

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

DISPLAY 19: CONSENSUS EARNINGS EXPECTATIONS FOR 2024 (USD)



Historical analysis does not guarantee future results.

As of December 30, 2023

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

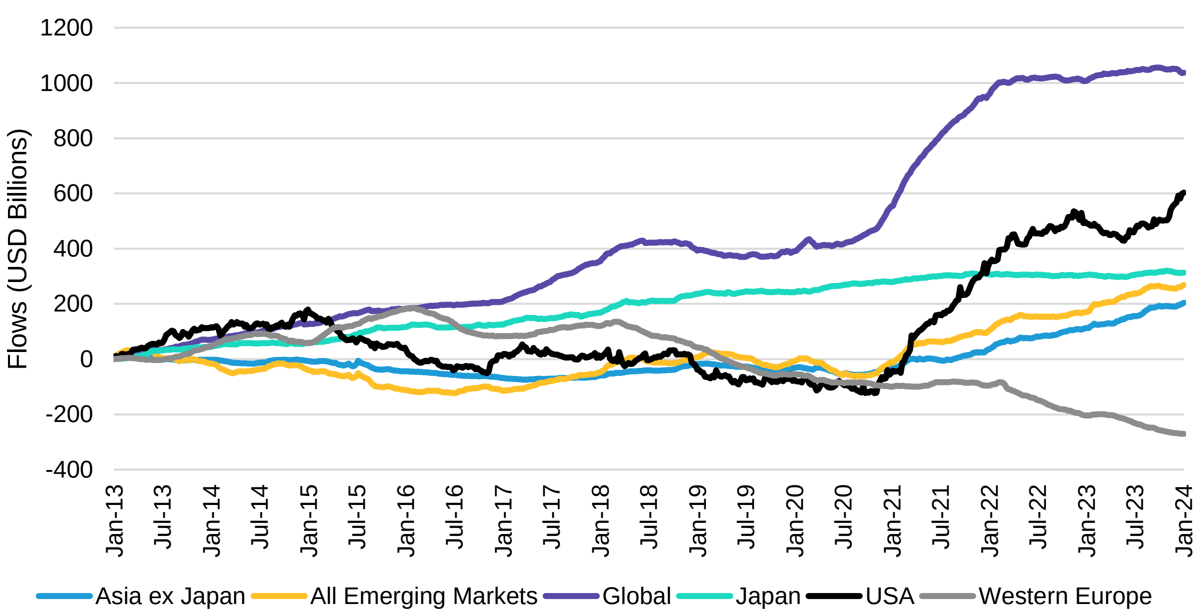
We stress that we are not bearish on US mega-caps. Indeed, they can continue to provide an important source of growth, quality earnings and stable margins, which is a key theme underlying our equity positioning for the coming year (see below). Nor do we think that expectations for the rest of the US market are necessarily grievously unachievable. Indeed, our own models—based on a broad array of macro and industry variables with an ability to predict corporate earnings over different time horizons—suggest a more modest but still robust 9% earnings growth for 2024. But these expectations are lofty enough to merit a degree of caution. If revenues slow and/or margins remain under pressure as the economy decelerates, and with so much hinging on the continued ability of the top 10 to meet and beat expectations to drive US outperformance, we want to meaningfully diversify our equity exposure across regions.

This means we want weights roughly close to the benchmark for both US and international equities. As mentioned earlier, over a strategic horizon we see these assets offering exposures to different kinds of risk: the US market faces greater valuation risk but potentially better growth prospects, largely thanks to more favorable demographics. International equities offer attractive valuations but greater risks to the growth outlook.

More tactically, we acknowledge the near-term momentum behind the US market, and the continuing tailwinds for growth stocks, as rates decline. Companies with stable profits, resilient balance sheets and solid growth potential will likely be rewarded by investors as the economy slows. Against this, we think international equities offer an attractive breadth of earnings and sources of return, compelling valuations and yields/income, and—in some regions at least—better economic momentum. There is thus a tactical case for both US and international exposure in portfolios, and it is finely balanced.

European equities are attractively valued, both versus history and compared with the US, trading at an historically wide discount of over 30%. Although the macro picture has disappointed, we think current multiples and still-weak flows into the region (*Display 20*) suggest that much of the negative news flow may be in the price. We also think that some upside can come from a modest reacceleration in earnings (as falling inflation and the fading energy-price shock encourage consumers to spend their pent-up savings) and multiple expansion. Attractive yields (with the total yield at 4% for the European market) offer another boost to returns. That said, we remain concerned about the geopolitical risks facing the region and, in the run-up to the US election, would prefer to keep exposure to the region in line with, or modestly below, benchmarks.

DISPLAY 20: EQUITY FLOWS BY REGION SINCE 2013



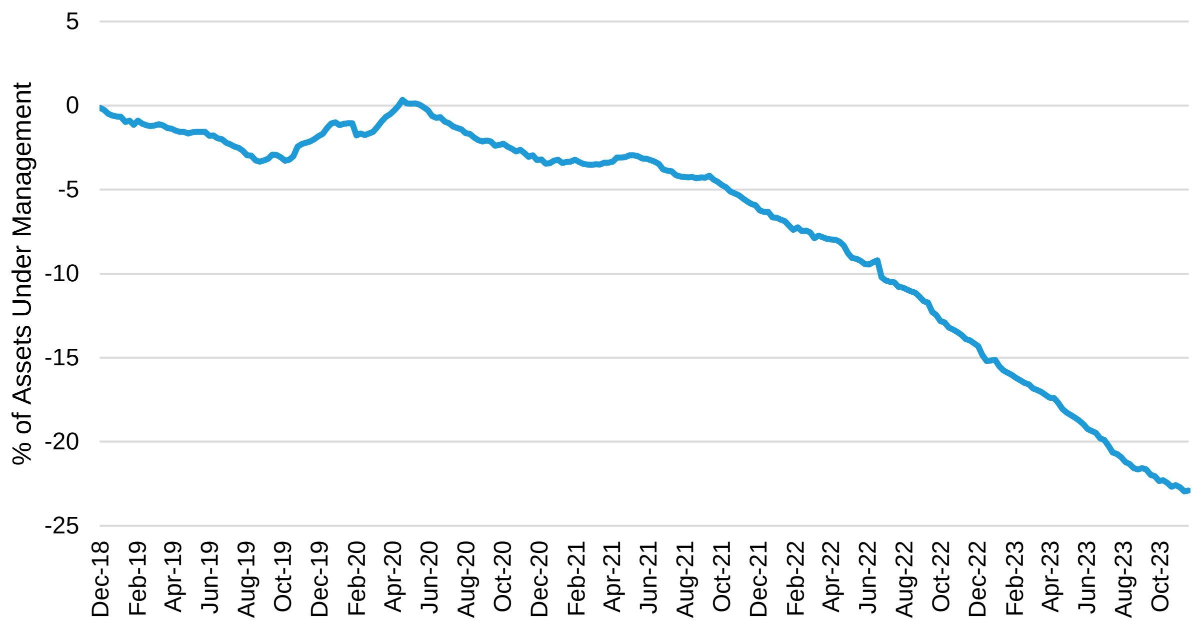
Historical analysis does not guarantee future results.

Through January 3, 2024

Source: EPFR Global and AB

We have higher conviction on the bull case for the UK. The market offers an even steeper discount to history than the rest of Europe; investor sentiment and flows have been extremely weak (*Display 21*); and analysts covering UK stocks are still downgrading their earnings estimates (with only Chinese stocks experiencing worse earnings momentum). While this negative sentiment has prevailed for some time, the market can play a key role in portfolios in the coming months as a potential inflation *and* recession hedge, thanks to its high exposure to energy and defensive sectors such as healthcare and staples. The UK market also offers extremely attractive yields (*Displays 22* and *23*), with both dividend and free-cash-flow yields the highest among key equity markets, making it particularly appealing to income investors.

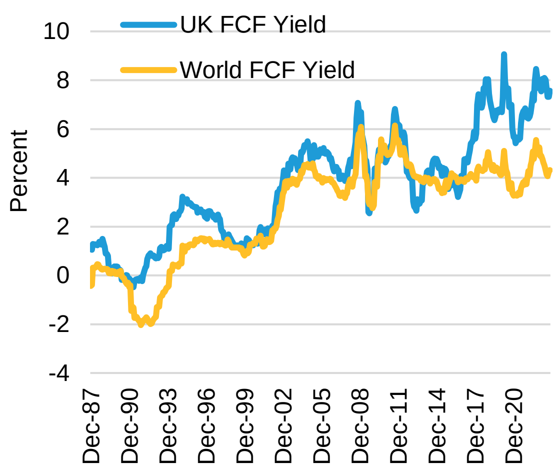
DISPLAY 21: UK EQUITY FUND FLOWS



Historical analysis does not guarantee future results.

Through November 22, 2023
Source: EPFR Global and AB

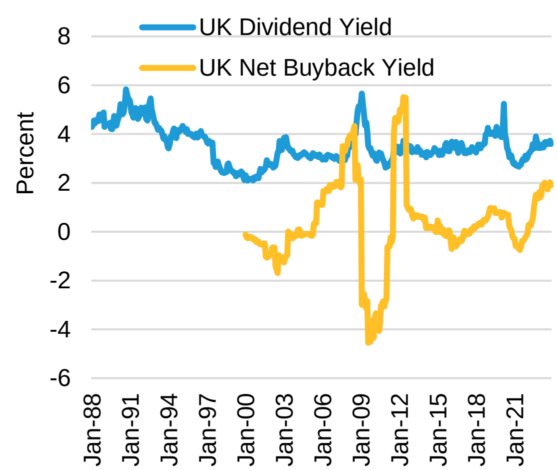
DISPLAY 22: UK AND WORLD FREE-CASH-FLOW YIELD



Historical analysis does not guarantee future results.

Through October 31, 2023
Source: FactSet, Thomson Reuters I/B/E/S and AB

DISPLAY 23: UK DIVIDEND YIELD AND NET BUYBACK YIELD



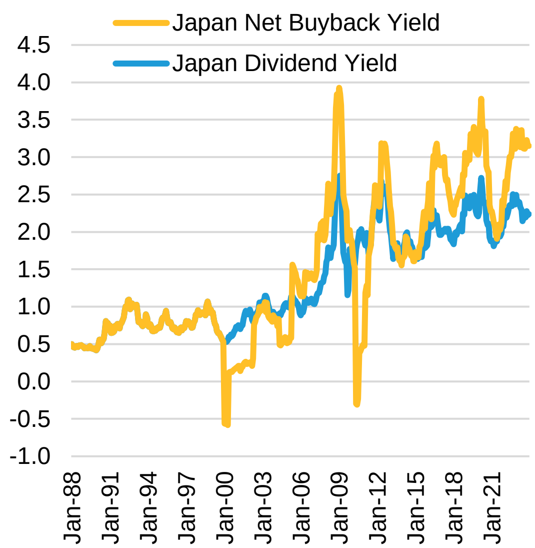
Historical analysis does not guarantee future results.

Through October 31, 2023
Source: FactSet, Thomson Reuters I/B/E/S and AB

We see an interesting strategic case for Japan equities based on the long-term mean reversion in valuations, which remain extremely benign despite the market's strong performance last year. Tactically, investor interest has been revitalized by the renewed focus on corporate reform and shareholder value, the prospect of better economic growth and stronger domestic consumption thanks to robust wage growth (following years of stagnation), and net buybacks that are close to record highs (*Display 24*) and well supported by free-cash-flow generation (*Display 25*). They have also helped the market perform extremely well, buoyed also—and crucially—by the weak yen. At the same time, the majority of active managers are still underweight the region, according to data from eVestment. Many of these factors may continue to provide tactical and longer-term support should they persist.

However, the end of yield-curve control and its impact on the currency is a key risk for the market, which tends to be negatively correlated with the direction of the currency (*Display 26*). Given this, and the strength of recent returns, we see Japan as an attractive strategic opportunity rather than a trade to be entered into for tactical upside.

DISPLAY 24: JAPAN NET BUYBACK YIELD AND DIVIDEND YIELD

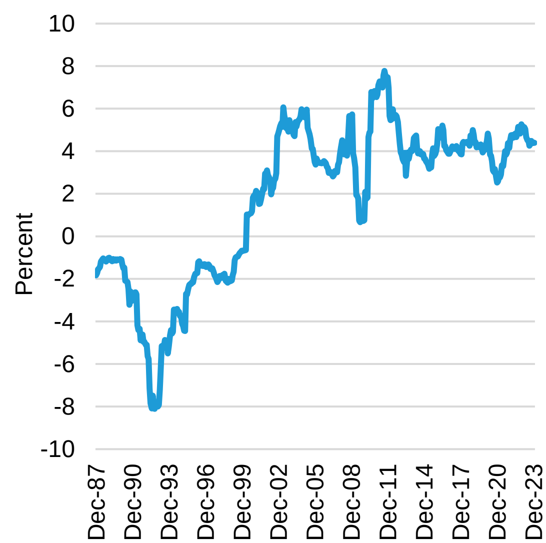


Historical analysis does not guarantee future results.

Through December 31, 2023

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

DISPLAY 25: JAPAN FREE-CASH-FLOW YIELD

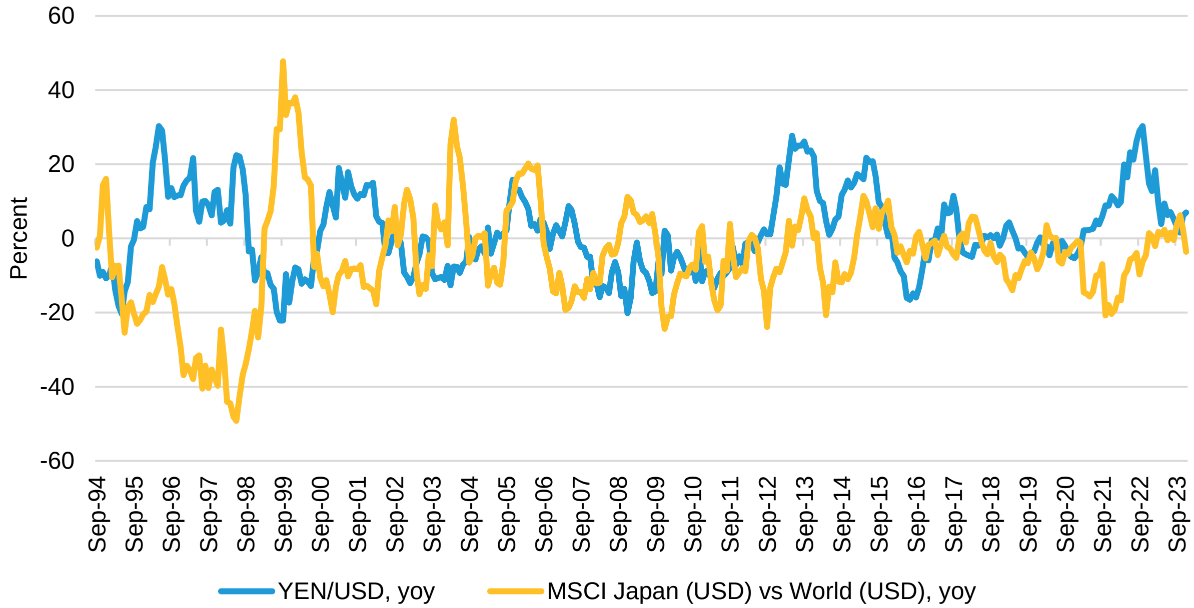


Historical analysis does not guarantee future results.

Through December 31, 2023

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

DISPLAY 26: JAPAN EQUITY PERFORMANCE AND YEN/USD RATE



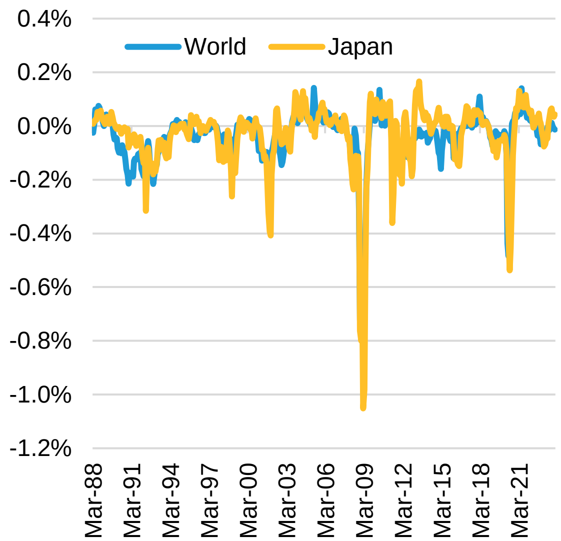
Historical analysis does not guarantee future results.

Through December 31, 2023

Source: FactSet, MSCI and AB

We continue to see compelling opportunities within EM, but emphasize a selective, active approach to investing in this segment. Many parts of EM are benignly valued, although a big valuation spread remains between EM ex China—where aggregate valuations are broadly neutral—and China, which is trading at a deep discount to history. China's valuations do seem to be pricing in a lot of the risks facing the market, as well as recent macro disappointments. China is also undergoing the sharpest earnings downgrades among DM and EM (*Displays 27* and *28*).

DISPLAY 27: WORLD AND JAPAN EARNINGS REVISIONS (THREE-MONTH MOVING AVERAGE)

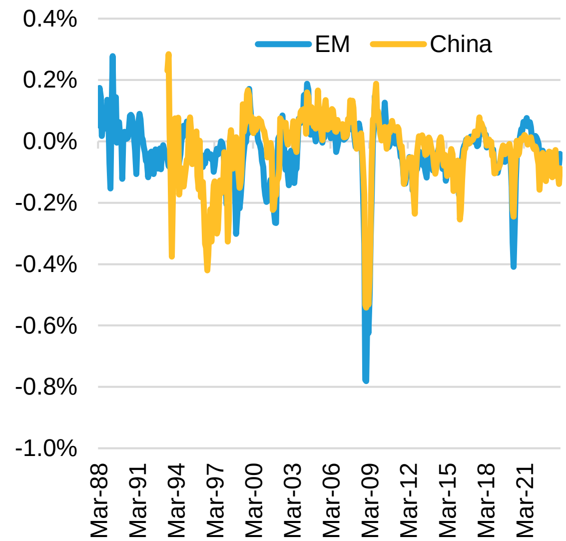


Historical analysis does not guarantee future results.

Through December 31, 2023

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

DISPLAY 28: EM AND CHINA EARNINGS REVISIONS (THREE-MONTH MOVING AVERAGE)



Historical analysis does not guarantee future results.

Through December 31, 2023

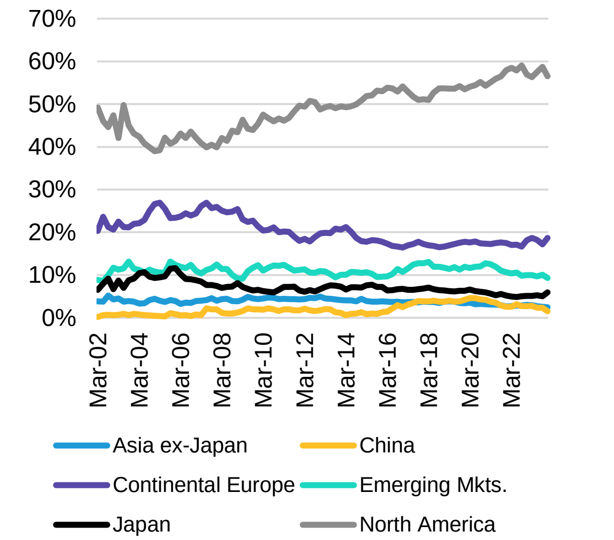
Source: FactSet, Thomson Reuters I/B/E/S and AB

We think that a meaningful re-rating in China may be difficult to call at this point, but recent fiscal stimulus should help support growth and improve both depressed earnings and investor sentiment toward the market. Elsewhere in EM, the macro and earnings outlooks present divergent pictures, as do valuations, and we continue to favor markets that:

- Are "ahead" of other economies in terms of the *policy tightening cycle* (Brazil, Mexico)
- Have their *inflation rates* contained or declining (China, Indonesia)
- Have seen *multiples and earnings expectations adjust* enough to be well-positioned for a rebound (China, Indonesia, Brazil)
- Are well-positioned for the net zero transition and/or are benefiting from the *reconfiguration of global supply chains* (Brazil, Mexico, India, Indonesia)

Investor positioning in EM remains light (*Display 29*), and weak flows (*Display 30*) continue to suggest tactical upside. If the near-term macro picture surprises positively, this could be a powerful catalyst for EM, as would a weaker dollar. This balances out our more defensive allocation to the UK (and the general preference for quality and income), which should outperform if the economic outlook deteriorates.

DISPLAY 29: GLOBAL PM EXPOSURE BY REGION



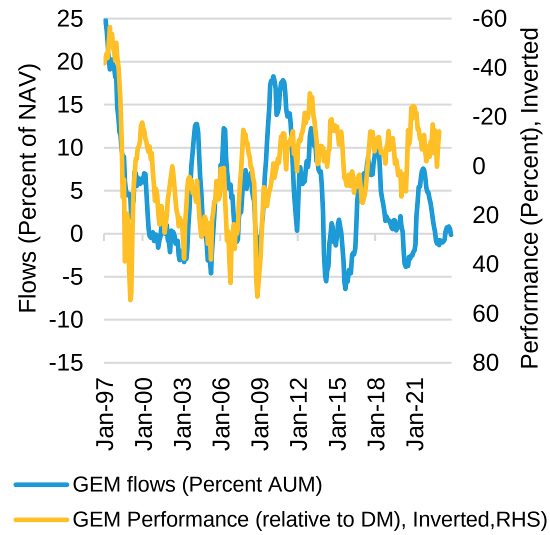
Historical analysis does not guarantee future results.

For a sample of global funds including EM, we analyzed the aggregate exposure to different regions.

Through December 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 30: EM PERFORMANCE AND FUND FLOWS



Historical analysis does not guarantee future results.

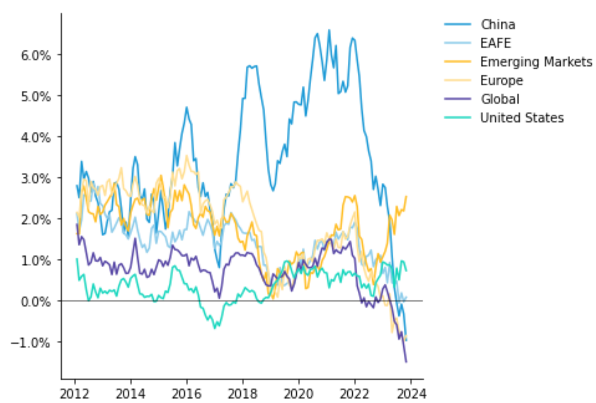
The EM flow series is the cumulative value of net inflows into global EM equity funds (GEM) as a percentage of the aggregate NAV for GEM equity funds.

AUM: assets under management; DM: developed markets; NAV: net asset value

Through November 30, 2023

Source: EPFR Global, Thomson Reuters Datastream and AB

DISPLAY 31: THREE-YEAR EXCESS RETURN BY REGION

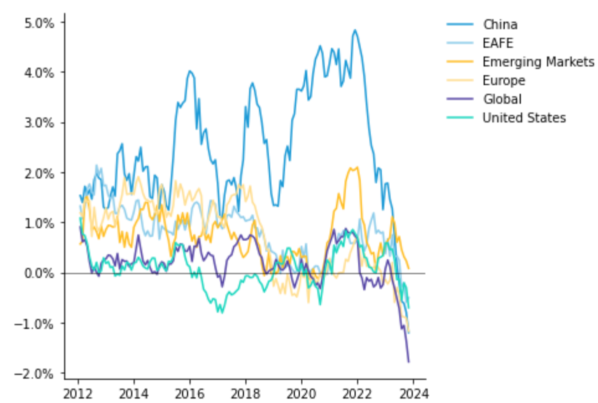


Historical analysis does not guarantee future results.

Through October 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 32: THREE-YEAR IDIOSYNCRATIC ALPHA BY REGION

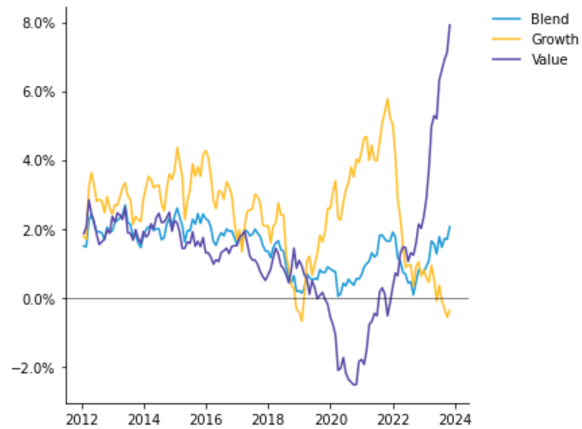


Historical analysis does not guarantee future results.

Through October 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 33: THREE-YEAR EM EXCESS RETURN BY STYLE

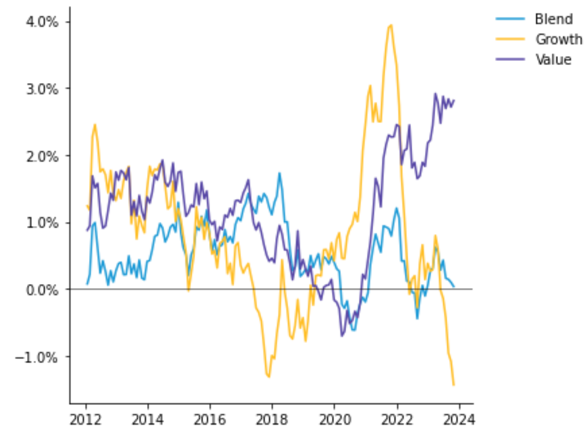


Historical analysis does not guarantee future results.

Through October 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 34: THREE-YEAR EM IDIOSYNCRATIC ALPHA BY STYLE



Historical analysis does not guarantee future results.

Through October 31, 2023

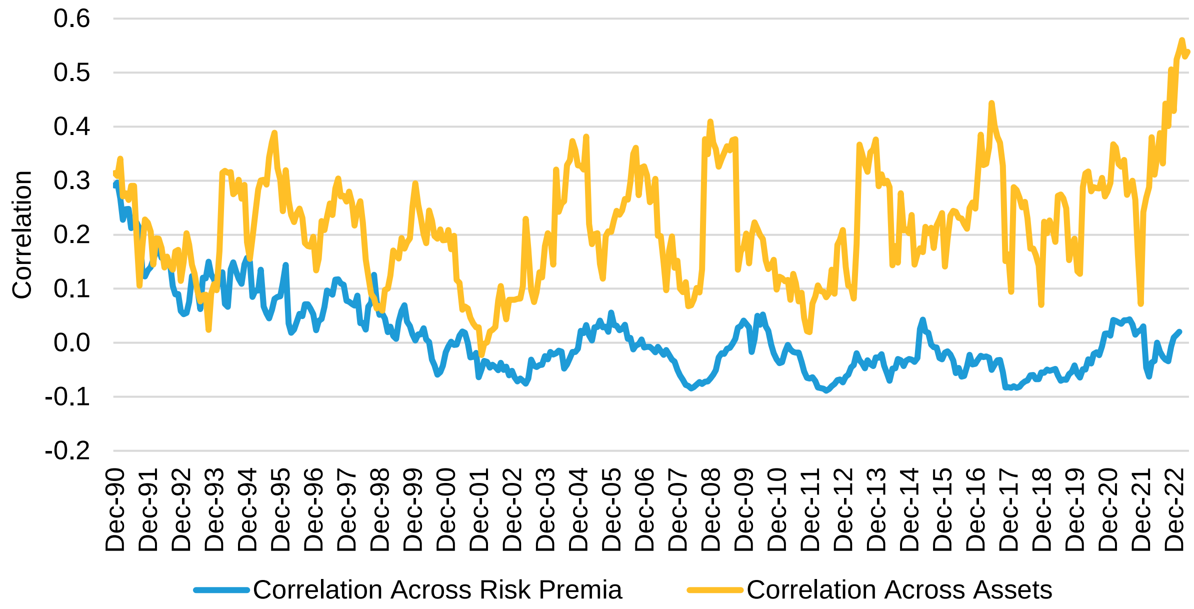
Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

Factor Positioning

When we think about factor allocations, as with other assets, it involves two sets of decisions. There is strategic positioning, or long-term core factor holdings anchored by our views on the long-term effectiveness of factors and their structural drivers that span multiple cycles. But also, at any given point in time, there is the consideration of how that strategic positioning may need to be adjusted dynamically. This includes how we may want to tilt around, or deviate from, strategic factor weights in order to exploit tactical factor opportunities that may arise over shorter investment horizons.

Strategically, we think that factors have a key role to play in portfolios, both for enriching returns and for achieving greater diversification. *Display 35* compares the 12-month rolling correlations among key equity and fixed-income factors with the correlations among assets. Correlations among factors are not just lower but also much more stable through time—even during periods of market stress, when correlations among other assets tend to spike.

DISPLAY 35: INVESTORS NEED FACTORS ALONGSIDE ASSET CLASSES—12-MONTH ROLLING CORRELATION OF ASSET CLASSES AND FACTORS



Historical analysis does not guarantee future results.

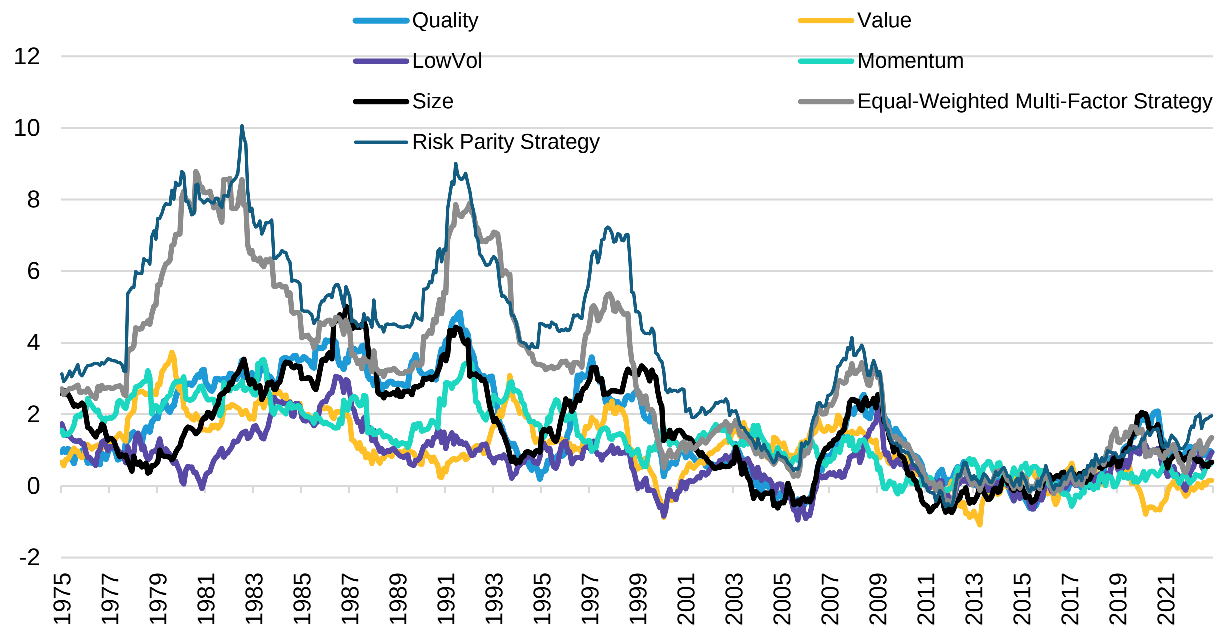
The risk premia series includes global equity composite value, return on equity (ROE), long-term growth, momentum and low-volatility long/short factors as well as fixed income and FX momentum, carry and value. Asset-class series includes global, US, EM and Japan equities; US and Japan 10-year government bonds; US investment-grade and high-yield credit; and gold.

Through May 31, 2023

Source: FactSet, MSCI and AB

Display 36 shows the three-year rolling information ratios of the simple long-only US Fama-French factors (because they afford us the longest return history) versus the US market since the 1970s. The past 10 to 15 years have seen most factor information ratios compress considerably. Of course, the return profile for factor premia based on different definitions and implementations (e.g., long/short, cross-asset, sector or industry-neutral and pure factors) will look different. However, the general fact remains that, although we may be more conservative in what we expect from factors compared with long-term history, factors still generate positive returns versus the broad market or asset class, and they are categorically not "dead"—not even value (as last year's strong performance of international value reminded us). A risk-parity-weighted multifactor allocation (the performance of this strategy using Fama-French factors is also shown in *Display 37*) or another thoughtfully constructed diversified factor portfolio can be a good default or benchmark strategic allocation to factors, which can then be enhanced by strategic or tactical tilts.

DISPLAY 36: LONG-ONLY US FAMA-FRENCH FACTORS—ROLLING THREE-YEAR INFORMATION RATIOS



Historical analysis does not guarantee future results.

Through December 31, 2022

Source: eVestment, FactSet, Kenneth R. French Data Library, Morningstar, MSCI, S&P and AB

DISPLAY 37: LONG-TERM INFORMATION RATIOS

	Quality	Value	Low Vol	Momentum	Size	Equal-Weighted Multifactor Strategy	Risk-Parity Strategy
Last 10 Years	0.50	0.00	0.27	0.25	0.50	0.59	0.73
Since 1975	1.60	1.04	0.72	1.35	1.55	2.98	3.60

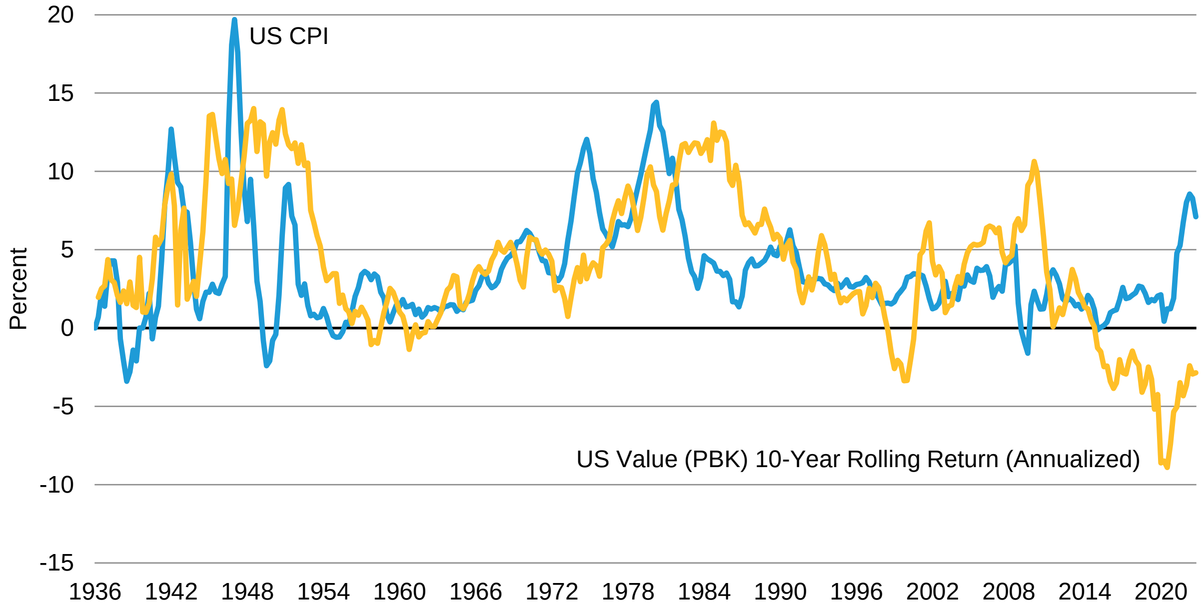
Historical analysis does not guarantee future results.

As of December 31, 2022

Source: eVestment, FactSet, Kenneth R. French Data Library, Morningstar, MSCI, S&P and AB

We continue to believe that value, despite structural challenges (such as the growth in intangible assets and the implications for the relevance of book value as a valuation measure), represents a genuine risk premium. We also believe that there is medium- and long-term support for value coming from valuations (valuation spreads remain unusually wide globally) and from a strategic regime of higher inflation (*Displays 38–40*).

DISPLAY 38: 90 YEARS OF INFLATION AND VALUE—IS INFLATION ALL THAT WAS MISSING? US CONSUMER PRICE INFLATION AND US VALUE RETURNS



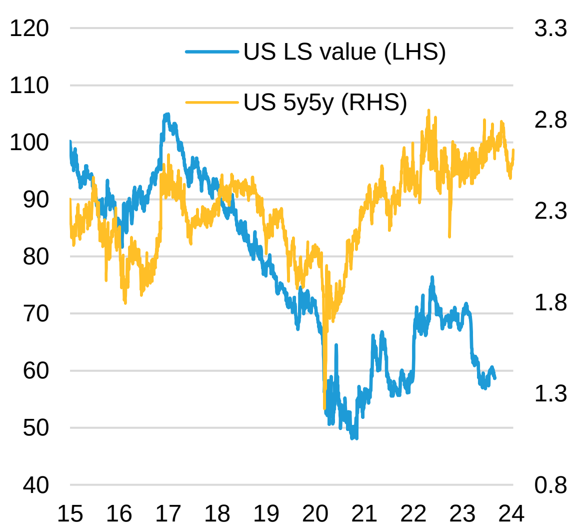
Historical analysis does not guarantee future results.

PBK: price-to-book value

Through December 31, 2022

Source: Kenneth R. French Data Library, Thomson Reuters Datastream and AB

DISPLAY 39: VALUE PERFORMANCE AND US INFLATION EXPECTATIONS



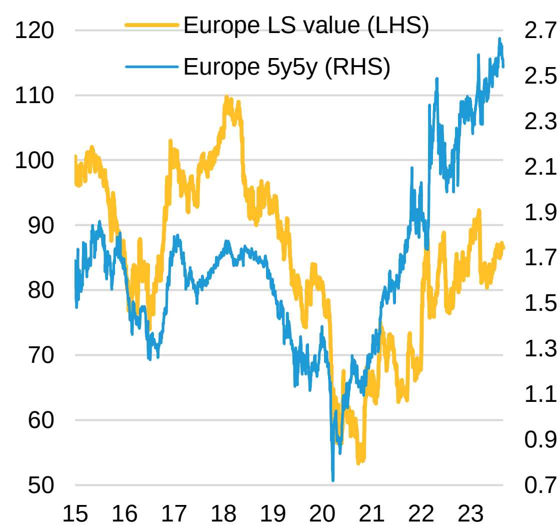
Historical analysis does not guarantee future results.

Display shows the daily performance of cheap price-to-book stocks relative to expensive price-to-book stocks versus the regional 5y5y inflation swap.

Through January 15, 2024

Source: Bloomberg, MSCI and AB

DISPLAY 40: VALUE PERFORMANCE AND EUROPEAN INFLATION EXPECTATIONS



Historical analysis does not guarantee future results.

Display shows the daily performance of cheap price-to-book stocks relative to expensive price-to-book stocks versus the regional 5y5y inflation swap.

Through January 15, 2024

Source: Bloomberg, MSCI and AB

DISPLAY 41: GLOBAL FACTOR VALUATIONS— Z SCORES (VS. HISTORY) OF LONG-ONLY FACTORS RELATIVE TO MARKET

Global	Z-scores
Comp Value	-1.64
P/B	-1.55
Div Yield	-1.91
ROE	0.37
Comp Growth	1.46
Momentum	-0.60
Low Vol	0.68
Small	-2.30

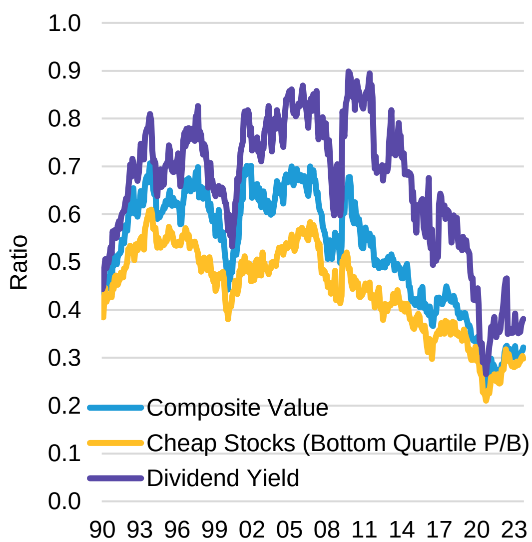
Historical analysis does not guarantee future results.
Through October 31, 2023
Source: Thomson Reuters I/B/E/S and AB

DISPLAY 42: US FACTOR VALUATIONS— Z SCORES (VS. HISTORY) OF LONG-ONLY FACTORS RELATIVE TO MARKET

US	Z-scores
Comp value	-1.22
P/B	-1.20
Div Yield	-1.75
ROE	-0.41
Comp Growth	0.34
Momentum	-0.09
Low Vol	1.76
Small	-1.99

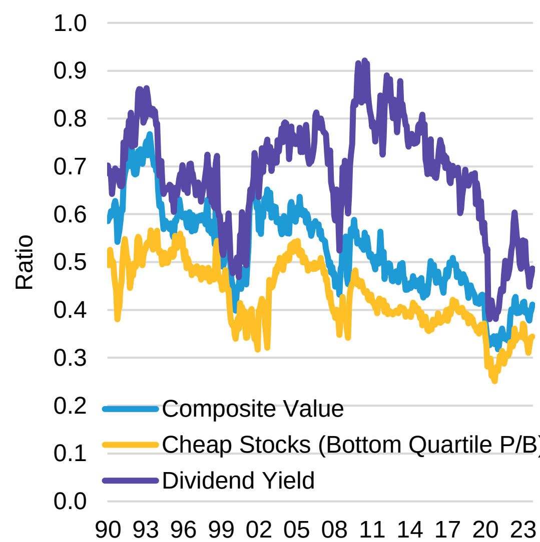
Historical analysis does not guarantee future results.
Through October 31, 2023
Source: Thomson Reuters I/B/E/S and AB

DISPLAY 43: GLOBAL VALUE FACTORS: VALUATION (MEDIAN PRICE/BOOK)



Historical analysis does not guarantee future results.
Through October 31, 2023
Source: FactSet, MSCI and AB

DISPLAY 44: US VALUE FACTORS: VALUATION (MEDIAN PRICE/BOOK)

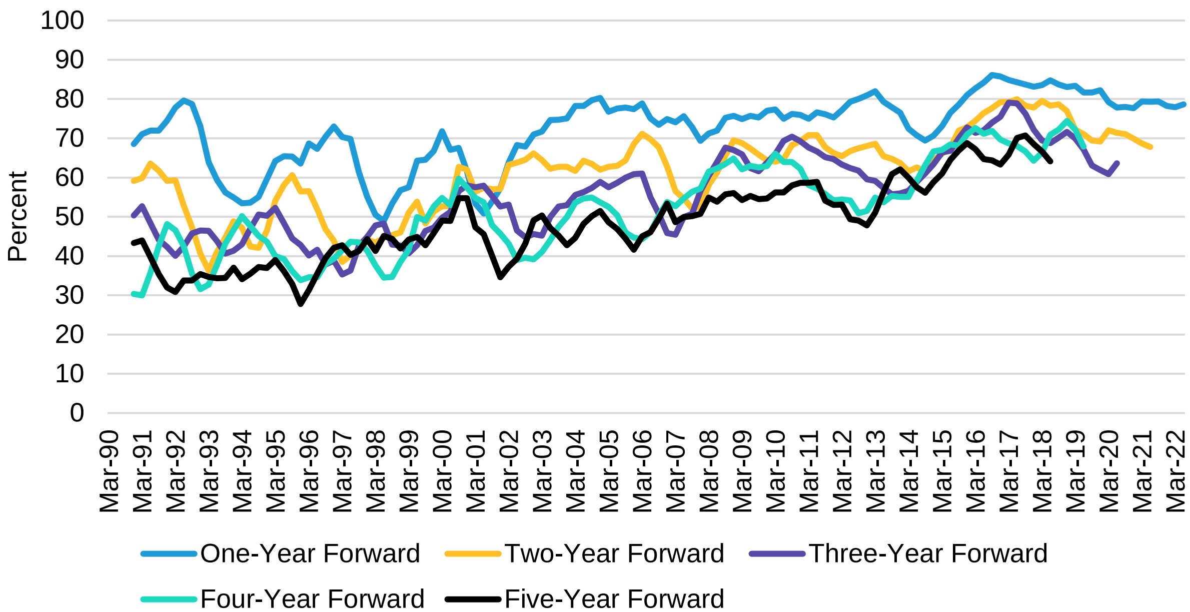


Historical analysis does not guarantee future results.
Through October 31, 2023
Source: FactSet, MSCI and AB

Tactically, cyclical value measures (like price to book value) prefer economic recovery phases to all others, and tend to struggle in slowdowns and recessions. Value also likes rising bond yields and inflation, and if both are expected to moderate over the coming months, this could be something of a headwind for value. Therefore, now may not be the time to take big tactical pro-value tilts; instead, consider a balanced allocation to value and growth as part of a strategic allocation. One exception is the more defensive value, or "income" factors: dividend yield or free-cash-flow yield. They can hold up well in a slowdown or a recession, and currently offer even more extreme valuation upside than other value measures (*Displays 41–44*), so this is a position we would be happy to take tactically as well as strategically. Tactical upside for the more cyclical or deep-value measures may come if the economy sees a reacceleration. That is not our base case, but in such a scenario, international value might be expected to perform particularly well, extending last year's gains.

Strategically, growth is set to benefit from long-term structural trends such as technology and climate change, and from the fact—which we can show—that for US companies at least, profitability is becoming more persistent through time (*Display 45*).

DISPLAY 45: HIGH-PROFITABILITY US COMPANIES ARE STAYING THAT WAY FOR LONGER—PERCENTAGE OF HIGH ROE–DECILE US STOCKS THAT REMAIN IN THE TOP TWO DECILES ONE TO FIVE YEARS LATER

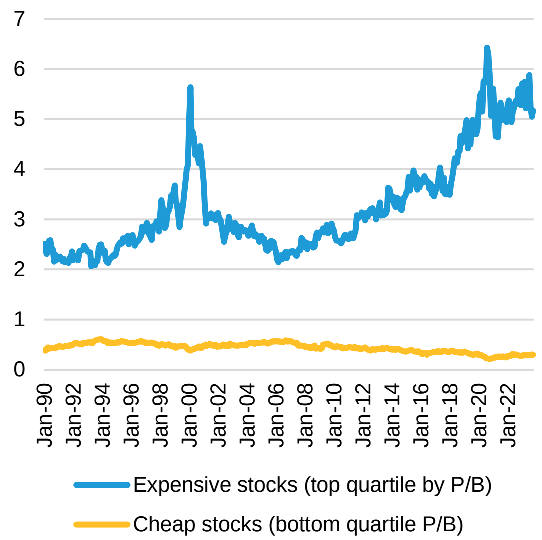


Historical analysis does not guarantee future results.

For each quarter since 1990, we separated the stocks in the MSCI USA Index into groups by ROE deciles (within sectors), and calculated the percentage of stocks in the high-ROE decile at a specific point in time that were in the highest two deciles over the next 1–5 years. A four-quarter smoothing was applied to the quarterly percentages.
Through June 30, 2023
Source: FactSet, MSCI and AB

Valuations are challenging, which may prove a headwind in the medium term. As seen in Displays 41 and 42 above, the median multiple of stocks in the high-growth basket is considerably above historical averages. Also, both globally and in the US, the spread between the cheapest quartile (e.g., value stocks) and the most expensive quartile (which has a very high overlap with growth) has never been higher. This is not just an issue for US growth mega-caps: as mentioned, the median multiple of stocks in the growth universe is stretched by historical standards and, interestingly, more so for international growth names than for their US counterparts.

DISPLAY 46: CHEAP VS. EXPENSIVE STOCKS—GLOBAL

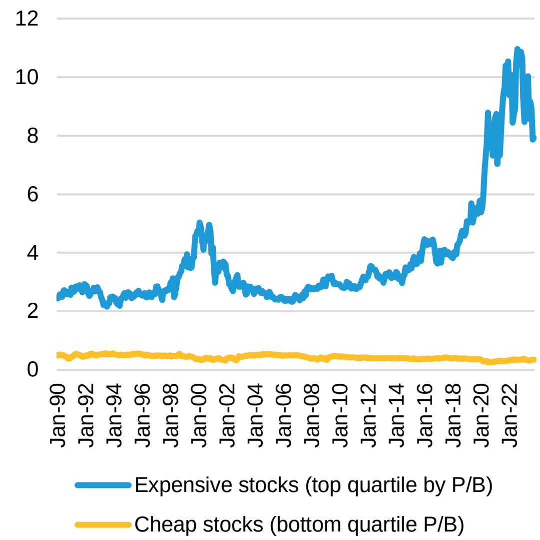


Historical analysis does not guarantee future results.

Through October 31, 2023

Source: FactSet, MSCI and AB

DISPLAY 47: CHEAP VS. EXPENSIVE STOCKS—US



Historical analysis does not guarantee future results.

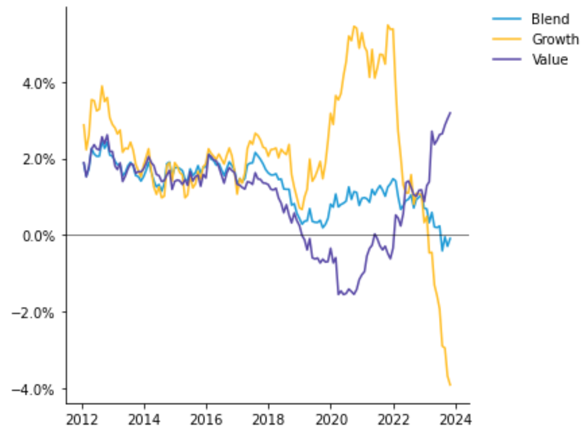
Through October 31, 2023

Source: FactSet, MSCI and AB

Tactically, the long-duration nature of these stocks may make them relatively more attractive if rates have peaked and bond yields decline from here. But over this shorter horizon, growth exposure should be focused on the more stable, sustainable, “quality growth” names that can outperform as economic activity decelerates, unlike the more cyclical measures of growth, which tend to peak in late expansions.

There is also a tactical challenge with implementation. *Displays 48* and *49* show that active managers with growth tilts—especially those with international (developed-market ex US) benchmarks—have, on average, delivered startlingly poor performance recently. This is the case both in excess-return terms and in idiosyncratic-alpha terms (i.e., with the impact of the style beta performance removed from the active returns). This means that the average growth manager has generated negative alpha through stock selection, and suggests that the performance of this manager cohort may, on average, remain challenged. All of this put together suggests that in the near term, we think investors should focus on growth exposure in the US or EM; look for stable, high-quality names within the universe; and, if done actively, pay particular attention to manager selection, given that beating growth benchmarks has proven to be extremely challenging recently.

DISPLAY 48: THREE-YEAR EAFE EXCESS RETURN BY STYLE

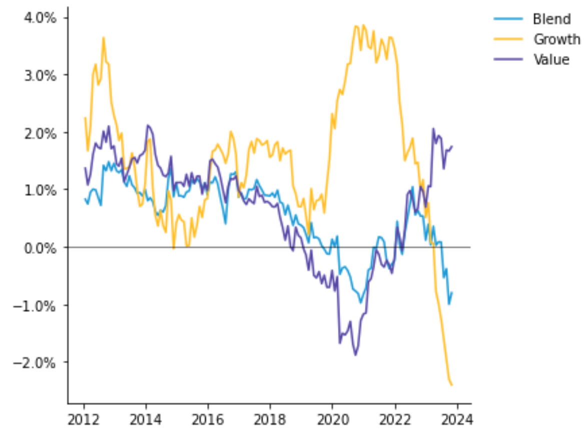


Historical analysis does not guarantee future results.

Through October 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 49: THREE-YEAR EAFE IDIOSYNCRATIC ALPHA BY STYLE



Historical analysis does not guarantee future results.

Through October 31, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

Our highest-conviction calls for tactical factors in the coming months are low volatility and quality. Both styles are attractive strategically but also tactically. They outperform in slowdowns and recessions but can also hold up if we see continued economic expansion: low-volatility equities tend to perform well at moderately high inflation levels, which is where we expect inflation to settle strategically. There are regional nuances: broadly, we think exposure to low volatility is better achieved via international strategies, where these names are more benignly valued and less crowded than they are in the US. Quality—proxied, for instance, by profitability or simple return on equity—is, by contrast, more attractively valued in the US than internationally.

DISPLAY 50: ECONOMIC CYCLE (BASED ON OECD LEAD INDICATOR) VS. US FACTOR RETURNS

Economic Cycle (OECD lead indicator)									
Factor	All Periods	Recession	Recovery	Expansion	Slowdown	t-stat			
US: Composite Value	2.80	6.08	9.99	-7.09	4.77	0.46	1.19	-1.67	0.27
US: Price to Book	0.22	-4.21	17.15	-4.45	-4.73	-0.71	2.66	-0.97	-0.87
US: 12m FWD PE	4.98	9.29	7.32	-3.55	8.76	0.53	0.38	-1.55	0.54
US: DY	-1.35	4.15	-6.68	-8.52	7.52	0.65	0.92	-1.27	1.19
US: ROE	3.97	12.19	-6.38	0.03	11.16	1.51	-2.37	-1.11	1.75
US: LTG	0.38	-5.13	1.99	8.98	-4.88	-0.67	0.27	1.65	-0.84
US: Internal Growth	1.17	4.73	-5.79	3.84	1.47	0.78	-1.83	0.78	0.07
US: FY0FY3 Growth	-0.54	-11.00	8.55	8.38	-7.33	-1.88	1.72	2.19	-1.20
US: Composite Growth	1.42	-1.12	-0.90	9.60	-3.12	-0.35	-0.41	1.37	-0.70
US: Momentum	2.86	8.20	-12.84	8.79	7.19	0.49	-1.76	0.96	0.63
US: FCF Yield	6.89	15.80	7.70	1.77	8.04	1.50	0.15	-2.01	0.21
US: Low Vol	-0.67	13.32	-20.84	-7.49	17.04	1.28	-2.66	-1.26	2.65
US: Low Leverage	1.74	0.37	-1.54	11.10	-4.10	-0.18	-0.61	1.56	-1.02
US: Residual Value	1.11	0.76	12.69	-4.09	-3.01	-0.07	2.51	-1.27	-1.02
US: Combined Yield	4.03	13.98	-2.19	-6.11	14.16	1.02	-0.88	-1.74	1.20
US: Combined Sustainable Yiel	1.09	11.36	-1.95	-4.78	2.26	2.04	-0.67	-2.25	0.34

Historical analysis does not guarantee future results.

Display shows the annualized return for factor portfolios in different economic cycles from January 1990 to September 2019. Factor returns are defined as the long/short return of the top-minus-bottom quintile from the 500 largest stocks in the MSCI USA Index. Portfolios have been rebalanced quarterly, and returns are on an equal-weighted total-return basis. Economic cycle periods are defined by the normalized seasonally adjusted composite leading indicator from the OECD. The universe of the indicator is based on the OECD plus the six major non-member economies. We divided the world economic cycle into four phases: an expansionary level (>100) and the positive first differential of the leading indicator are classified as an "expansion," an expansionary level with a negative first differential is a "slowdown," a contractionary level (<100) and positive first differential are classified as a "recovery" and a contractionary level with a negative first differential is a "downturn."

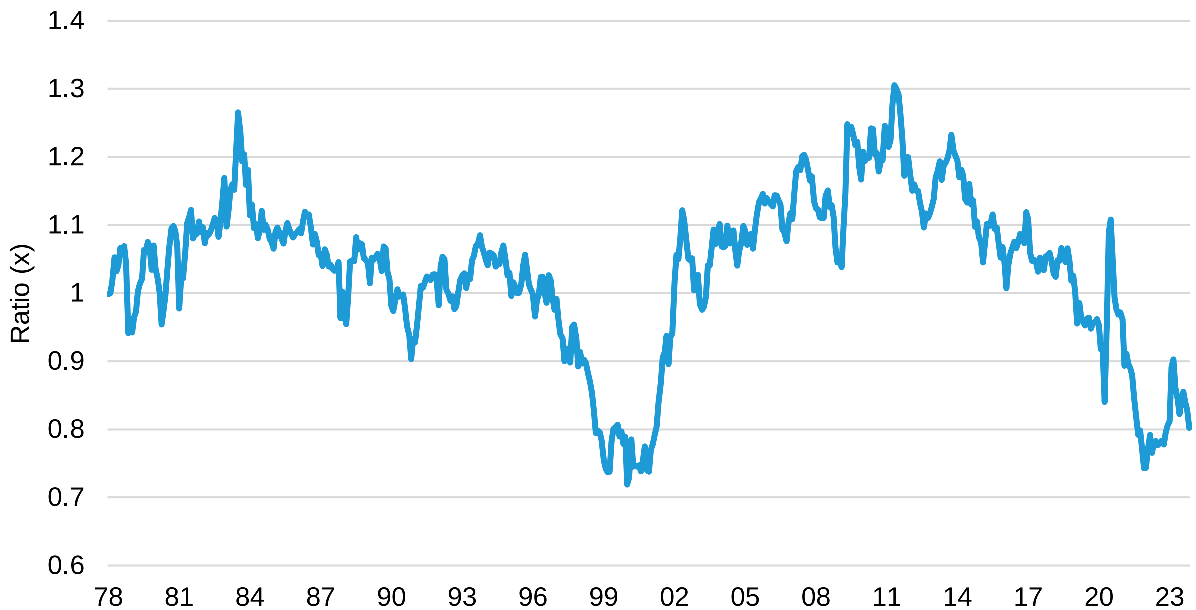
As of December 31, 2020

Source: FactSet, MSCI, Thomson Reuters Datastream and AB

If the quality trade is structured in a non-sector-neutral way, it would imply exposures in technology (which has the largest weight in the simple quality factor indices in the US), healthcare, telecom and staples, but also in financials and industrials. Outside of the US, the quality basket is somewhat broader based, with a greater presence from cyclical sectors such as consumer discretionary and materials. Low-volatility stocks are more diverse in terms of sectors, especially outside of the US, where the exposure is less about technology and more about financials (the highest weight), and where utilities and energy have a presence too.

Finally, what about small-caps? These names appear very cheap versus history (*Display 51*) and "unloved," and would seem to promise a big upside if the economy manages to surprise positively without stoking inflation. There is also a "risk-on" rally. So this could be a diversifying position to more defensive tactical exposures to quality, low vol and income (another defensive factor we like).

DISPLAY 51: SMALL-CAP STOCKS ARE CHEAP—US "NEXT 1,000" RELATIVE TO TOP 1,000 BASED ON FORWARD P/E RATIO



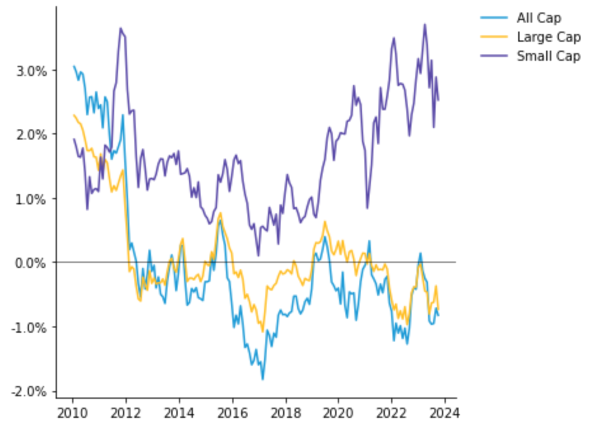
Historical analysis does not guarantee future results.

Through November 10, 2023

Source: Thomson Reuters I/B/E/S and AB

However, we still see considerable downside risks, despite cheap valuations. Small-caps tend to be more domestically oriented with less diversified sources of earnings, so they are more vulnerable to a potential slowdown. These firms may feel cost pressures (e.g., higher interest costs) more acutely, putting greater pressure on margins. Rather than suggesting a tactical bias to small-cap beta, we prefer a strategic allocation to small-caps—actively, where possible. Our research on active-manager alpha shows that small-cap managers have tended to generate strong alpha versus benchmarks *and* strong idiosyncratic alpha (alpha adjusted for small-cap factor exposure). Indeed, this area offers some of the greatest opportunities for long-term alpha generation across asset classes. In the US, small-cap managers have been faring even better than usual recently (*Displays 52* and *53*). In our view, this is one area that "deserves" an active risk allocation on a strategic basis.

DISPLAY 52: THREE-YEAR US EXCESS RETURN BY MARKET CAP

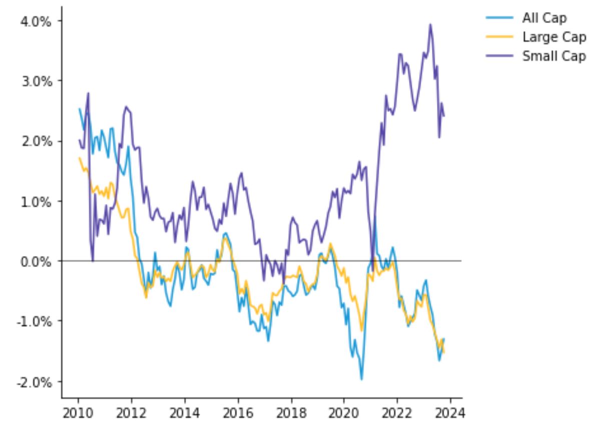


Historical analysis does not guarantee future results.

Through September 30, 2023

Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

DISPLAY 53: THREE-YEAR US IDIOSYNCRATIC ALPHA BY MARKET CAP



Historical analysis does not guarantee future results.

Through September 30, 2023

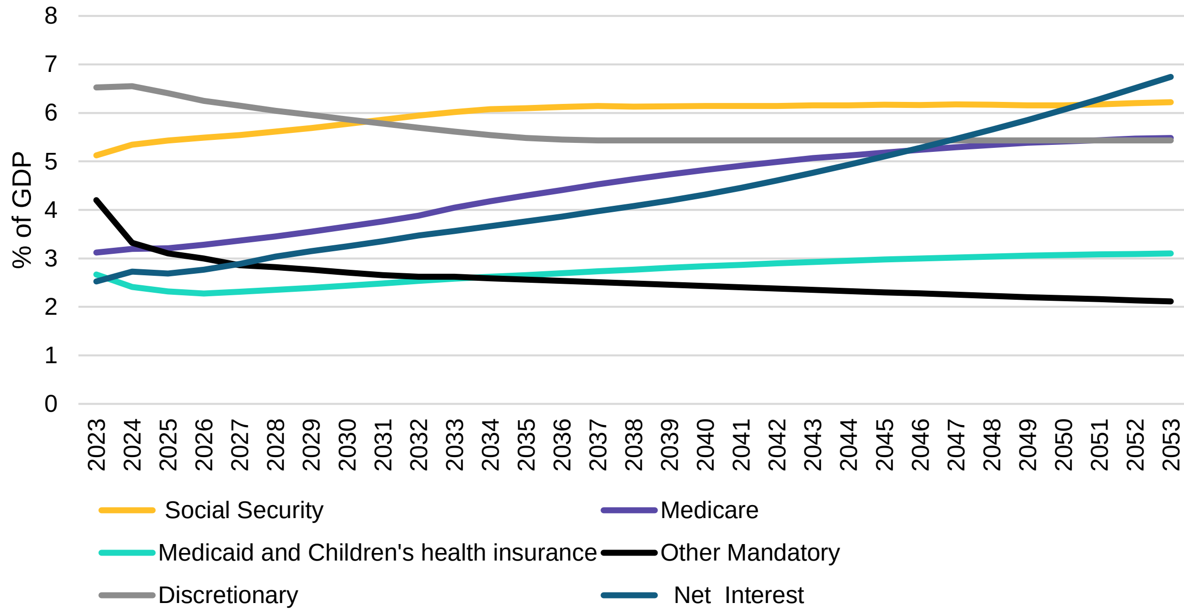
Source: eVestment, FactSet, Morningstar, MSCI, S&P and AB

The Trump Factor

It is not possible to talk about the investment environment for the year ahead without discussing the elephant in the room: the US election. We will not comment on who we think will win, as we have no extra information edge on that topic. Instead, our focus is narrow: what impact could this election have on tactical and strategic asset-allocation decisions?

Some macro features are likely to be common to both potential outcomes. For one thing, there is likely to be an increased focus on fiscal constraint. This topic has come up in multiple recent meetings with clients, and by no means applies only to the US. The public debt/GDP ratio for the US, and the G7 in aggregate, has been rising for decades and has reached the same level it was at the end of WWII. Now that the interest cycle has turned, this matters. Based on current trends, debt-service costs are set to be the fastest-growing share of tax spending in the coming decades, and are set to overtake social security as a share of the US federal budget by 2051, according to Congressional Budget Office projections (*Display 54*). It is Trump's stated wish to "cut taxes," though at the moment this objective is not specific, and we assume that the fiscal outcome might be similar no matter who wins.

DISPLAY 54: CBO SPENDING PROJECTIONS BY CATEGORY



Historical analysis does not guarantee future results.

Based on the CBO's extended baseline projections as part of *The 2023 Long-Term Budget Outlook* report.
As of October 30, 2023
Source: CBO and AB

The policy implications of the debt burden are likely to include a prolonged period of fiscal constraint. But at the margin, it also contributes to the likelihood that policymakers (governments, not central bankers) may be very comfortable with letting inflation run higher than the target to, in effect, monetize debt. This is a common issue across developed economies, and we do not think that it is materially altered by the election outcome.

The other major macro topic that is likely to be somewhat common to both outcomes is US policy toward China. The Biden administration effectively continued many of the Trump administration's policies. And the response to the Russian invasion of Ukraine has shown that the US is willing to weaponize dollar access, which presumably provides a template for any major conflict in the future. This, in turn, implies a long-term attempt by China and other countries to move away from a world defined by dollar hegemony, regardless of who is in the White House. While we think the difference between a Trump and a non-Trump outcome could have a profound impact on the concept of a US-led multilateral order (see below), a push by some countries to find dollar alternatives will persist no matter who wins. For the foreseeable future, we think it is highly unlikely that any plausible currency alterative can emerge (the sterling, euro and yen cannot play this role, as they are controlled by US allies). Hence the high level of central bank gold purchases, which we think are set to continue.

What aspects of the investment outlook might change with a victory of one side or the other?

The portfolio allocation questions that arise from a Trump win fall into a few areas. The first is the impact on the global economy. Trump is proposing a 10% across-the-board tariff on all imports. Presumably, such a move would lead to retaliation from trading partners and create long-term damage to the World Trade Organization. We recently reviewed the evidence regarding the impact of trade on global growth, and such a move would likely have negative consequences.

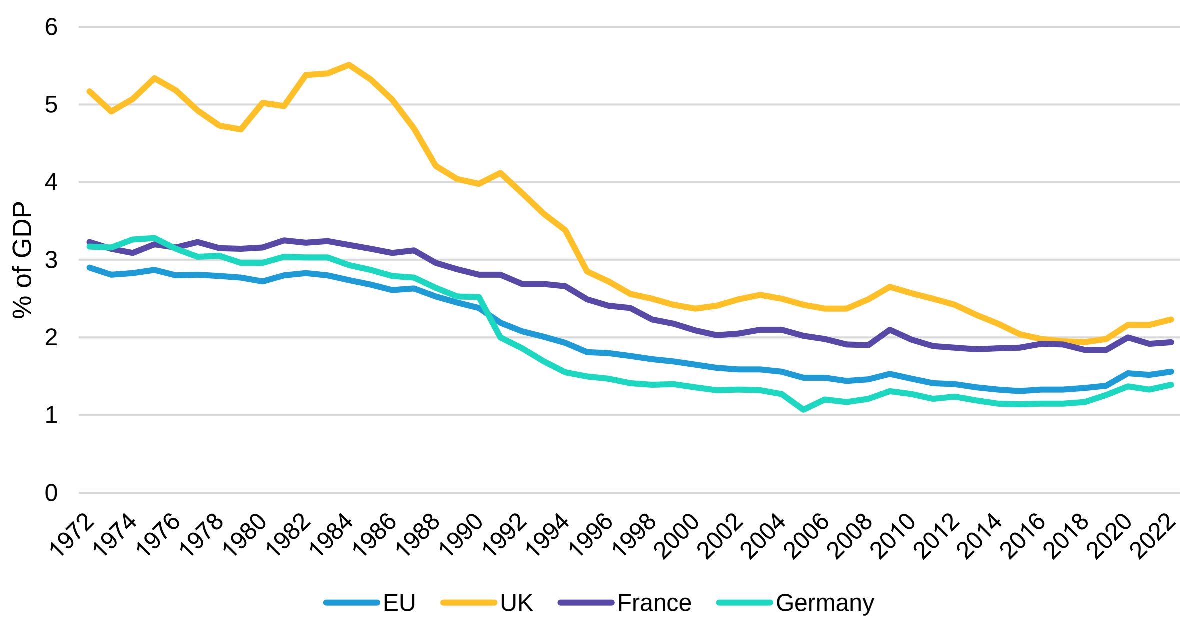
There is a somewhat obvious trade around "green" investments in the US that will no doubt be a focus of discussions in the finance community, especially in terms of equity market thematic flows. This topic will likely receive copious coverage. Indeed, it may well be the dominant animus of the inevitable lists of stocks to buy and sell for election outcomes, so we are not going to add to that discussion here.

The other global investment implications relate to topics that markets have a hard time pricing, so they might receive less attention. There is a marked divide between the candidates on foreign policy. We do not think that markets can easily price an undoing of the multilateral institutions of the postwar US-led order. Instead, we think any change on that front will likely foster potentially higher-amplitude shocks to financial markets further down the road, and hence an arguably higher-equilibrium equity risk premium. But risk premia have not tended to adjust smoothly to such changes in regime, so we think any realization of that new landscape is more an input for long-term equilibrium return assumptions, not a feature of near-term forecasts. Likewise, a Trump win is likely to alter the course of global attempts to tackle climate change. The projected *aggregate* impact of climate change on growth is highly uncertain and likely nonlinear. The GDP-weighted aggregate central-case impact could be smaller than it is for other forces, such as demographics. However, it is the kind of force that is likely to lead to a markedly wider dispersion of outcomes, and hence yet another route to higher fundamental volatility. This, again, is something that markets are unlikely to assign a price to in the near term, but it raises different long-term questions.

In addition to the impact on global trade policy, there are more region-specific aspects of a potential Trump win that have tangible consequences for portfolio allocation. The potential for a marked shift in foreign policy seems unambiguously negative for US allies, and Europe in particular. If a Trump win becomes more likely over the course of the year, we think this could lead to a further allocation away from European assets (adding to the significant shift over the past two years). The most tangible impact would be on trade and the need to increase defense spending that would be the necessary consequence of any doubting of the NATO security guarantee. There would also be significant questions on the ability to continue funding the Ukraine conflict: at one level, this issue would impose further fiscal constraints on Europe, but it also raises existential questions about Europe's role and degree of influence.

In *Display 55*, we show defense spending as a percentage of GDP since the end of the Cold War. In 1990, the UK spent 4% of GDP on defense, while the rest of the EU spent an average of 2.5%. Since then, the "peace dividend" caused defense spending to fall significantly. Spending started to rise after 2015, but remains far below the Cold War level. EU defense spending likely has to increase anyway given the changed geopolitical realities, but a Trump win would give this a high degree of urgency.

DISPLAY 55: DEFENSE SPENDING AS A PERCENTAGE OF EU AND UK GDP



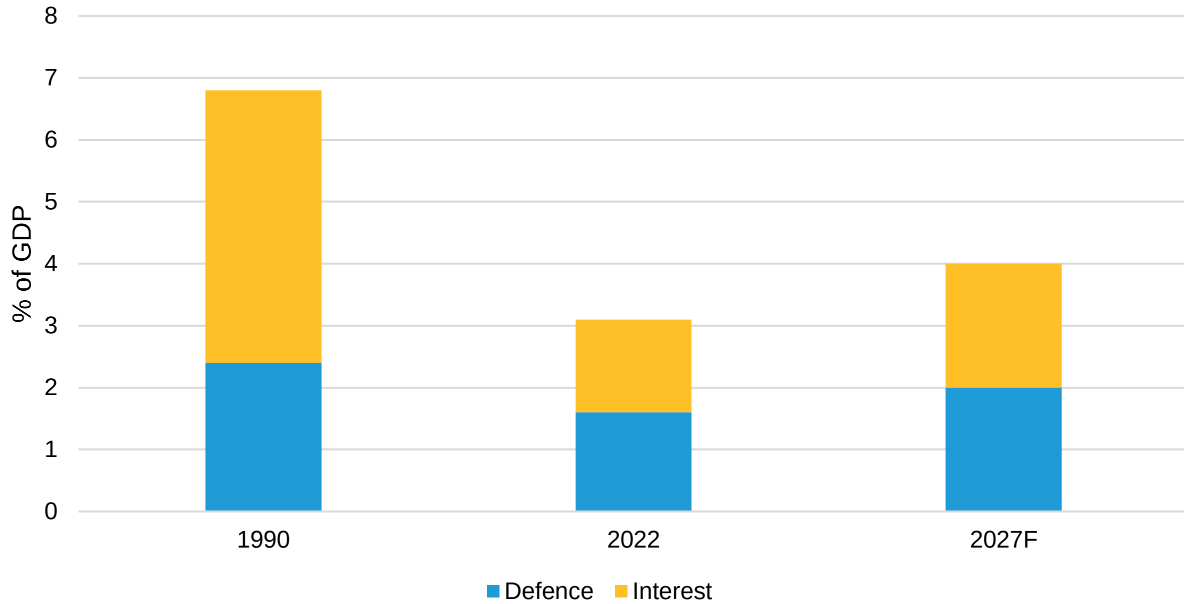
Historical analysis does not guarantee future results.

Through December 30, 2023

Source: Thomson Reuters Datastream, World Bank and AB

However, any potential further increase comes at a time of significant growth in the share of government spending devoted to debt servicing (*Display 56*). This implies a very real level of fiscal constraint that makes it harder to offer a spending cushion for any future downturn. The EU currently spends 1.6% of GDP on defense, which we presume would have to rise to the NATO target of 2% in a more tough geopolitical context. Currently, interest expense takes about a similar share at 1.5% and, according to OECD projections, is forecast to rise to around 2%. However, the average masks a wide dispersion within countries: for example, the cost for Germany is projected to be 1% of GDP, while Italy's is forecast to top 4%.

DISPLAY 56: DEFENSE AND INTEREST COSTS MAY RISE AT THE SAME TIME



Historical analysis does not guarantee future results.

The 2027 interest number is the OECD forecast for the end of 2025.
As of December 30, 2023
Source: OECD, World Bank and AB

This outcome, while likely viewed askance in many European capitals, at one level may lessen an existential risk. This constraint will likely force the EU to seek more cohesiveness and, hence, may lessen long-term risks to the survivability of the euro as a construct.

By contrast, we think there is an argument that a Trump win could be a near-term positive for US risk assets and corporate shareholders. Slashing federal regulations has been one of Trump's long-standing campaign promises, with key focus areas in energy and banking. He has promised to withdraw from the Paris Climate Accords and ease regulations for domestic energy production. Tougher bank regulations requiring higher total capital and stricter rules for long-term debt financing are due to be implemented in 2025; Trump is expected to appoint regulators that would roll back this new stricter regulation.[3]

Longer term, any unstitching of the postwar US-led order has implications for the risk premium that investors should demand. We have long worried about investors' level of recency bias; on one level because the assumption of low inflation and rates that held for over a decade has received a battering in the past two years. But another level of recency bias is the last 70 years of a rules-based international order. Markets tend to do a terrible job at pricing this kind of risk, so we suspect that it would be unlikely to be "priced" anytime soon. Nevertheless, this risk should be a concern to genuinely longer-term investors.

[3]For more details, see: https://www.ft.com/content/59acb713-de32-4436-8c23-723dbe1bef87.

INVESTMENT RISKS TO CONSIDER

The value of an investment can go down as well as up and investors may not get back the full amount they invested. Capital is at risk. Past performance does not guarantee future results.

Important Information

ICN20240136