Dynamic Allocation Strategy

OCTOBER 2023

Macro/Market Update

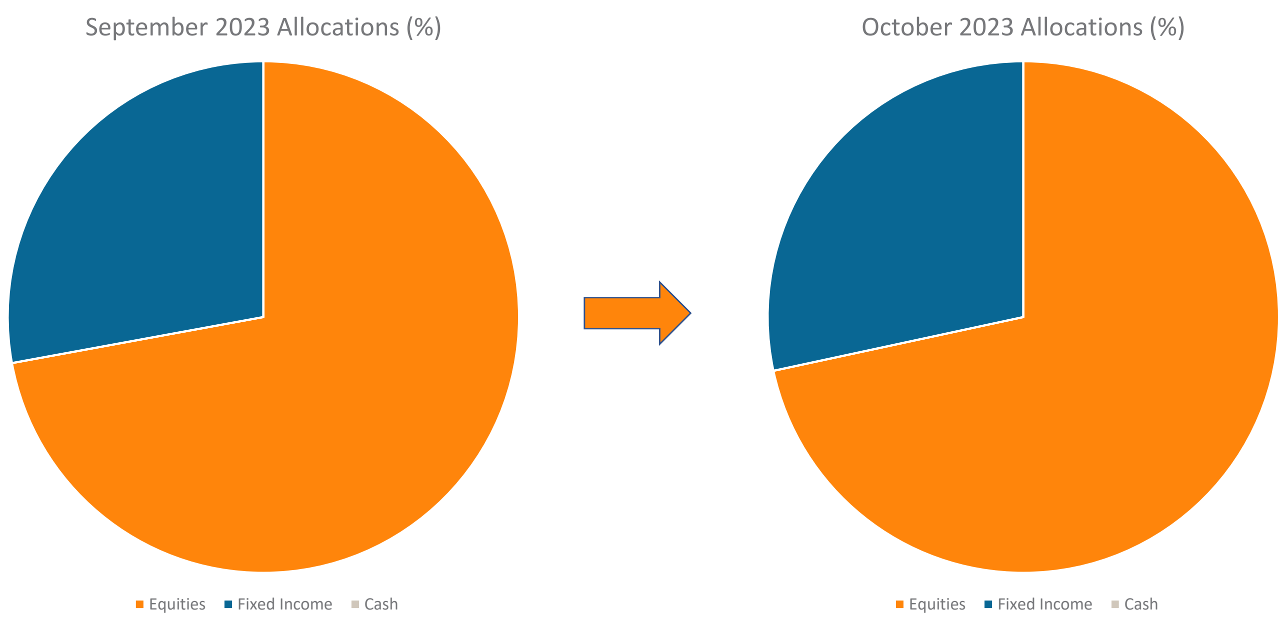
The global economy saw momentum ease for a third straight month in August, according to the S&P Global Purchasing Managers' Index (PMI) data. The global composite (services and manufacturing) PMI fell for a third straight month to its weakest reading since January. Despite the moderating expansion, there isn't sufficient evidence to suggest that the global economy is entering a severe recession, which historically has been associated with the worst equity bear markets.

However, the risk of sustained moderate global slowdown is a real possibility amid diverging trends among the world's economies. Europe, which was a major source of rising momentum in the first half of the year, has seen activity ease markedly in recent months, and is even flirting with the prospect of recession. Trends in China and the U.S. remain positive, but not as much as the first half of the year, while Japan and several large emerging markets, such as India, continue to report robust activity.

Services growth has slowed significantly since peaking in May, while the manufacturing sector, which has been in the doldrums for a year, appears to be stabilizing. Although it was the 12th straight month of contraction, it was the first time in six months that manufacturing activity shrank at a slower pace, indicating some stabilization in the sector. Both output and new orders contracted at their slowest pace in three months, while employment grew at its fastest pace in six months. The global bullwhip, which assesses the balance of new orders relative to inventories, moved up to its best level since March, with a rising share of economies contributing to the improvement.

During September, the MSCI All Country World Index (ACWI) underperformed the Bloomberg Barclays Global Aggregate Bond Index by over 115 basis points (bps). It was the first time since the beginning of 2022, where global stocks underperformed bonds by more than 100 bps for two consecutive months. Also, it was only the third month this year where global bonds outpaced stocks. Still, global stocks have outpaced bonds for eight of the last twelve months.

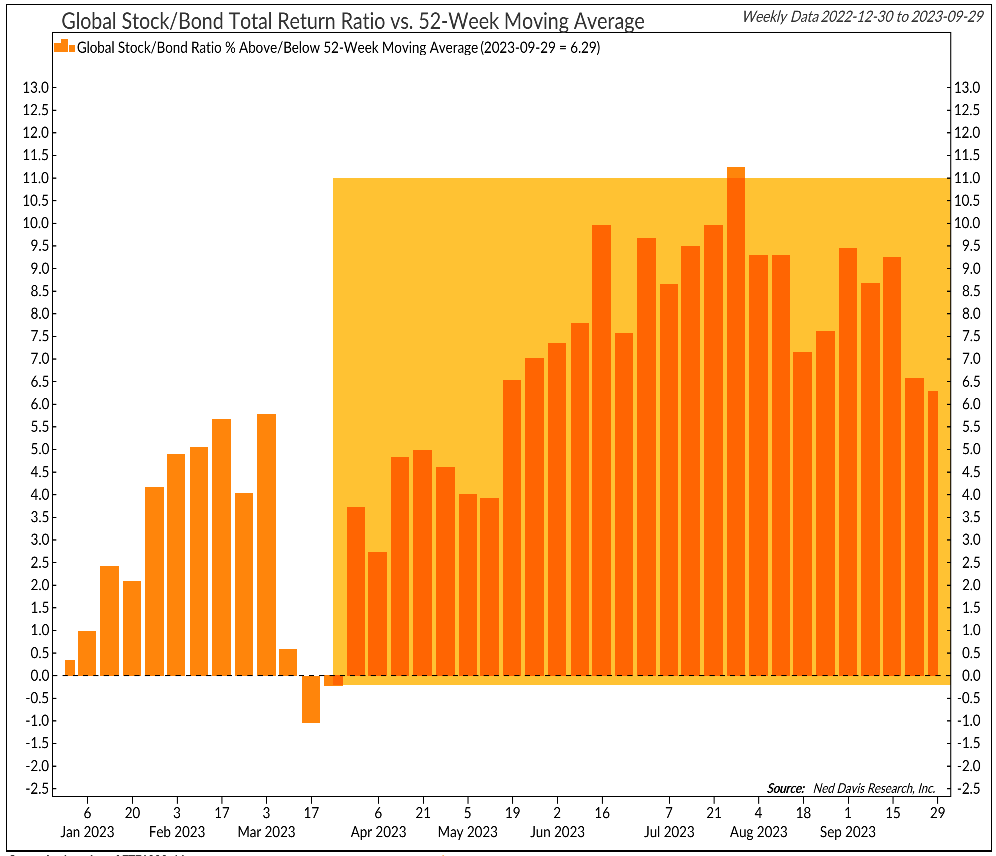
Asset Allocation Summary



* See Equity Allocation Summary for how the equity allocation is distributed
** See Fixed Income Allocation Summary for how the fixed income allocation is distributed

The equity allocation remained above benchmark weighting, as the model did not trade this month. The model uses a turnover reduction mechanism, which reduces trading. The proposed allocations did not deviate enough from the existing weightings to warrant a model rebalance. The model has not changed positioning since the end of June. Such a stretch of low trading activity last occurred in 2021.

The stock/bond relative strength indicator, which receives the greatest weighting in the model, compares the stock/bond ratio to its 52-week moving average. The stock/bond ratio is more than 6.2% above its one-year moving average. The spread between the relative strength ratio and its trend has been positive since the end of March (chart right). The trend continues to be equity's friend relative to fixed income.



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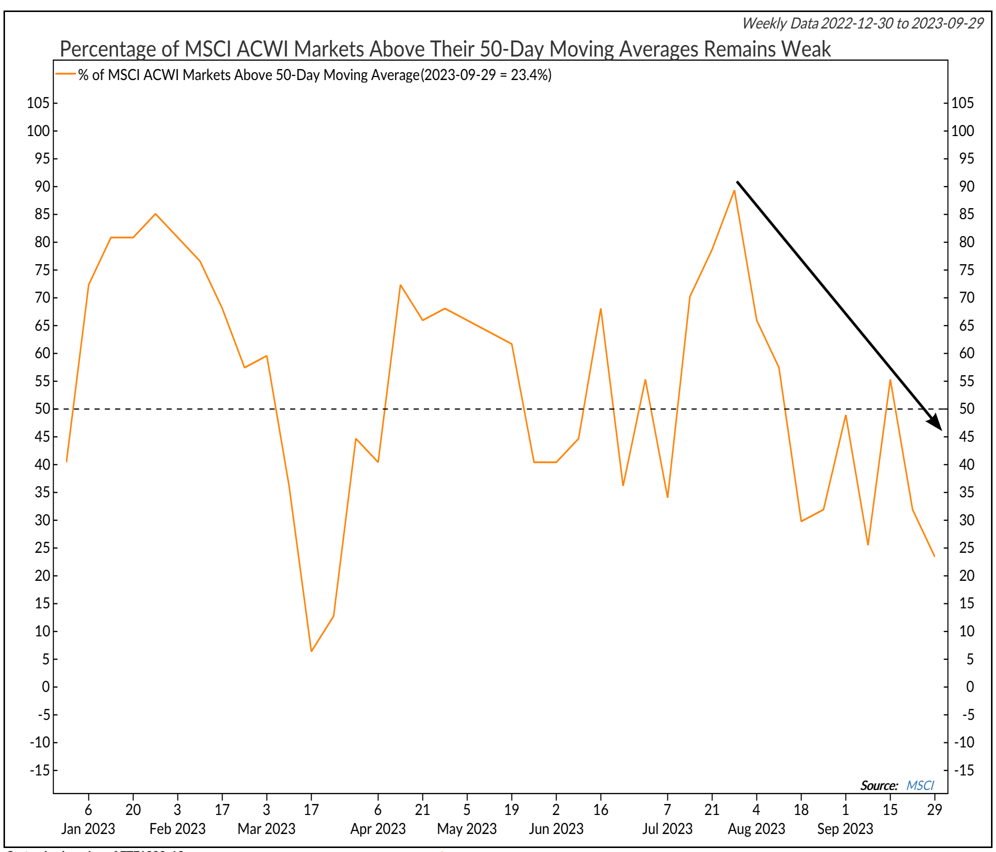

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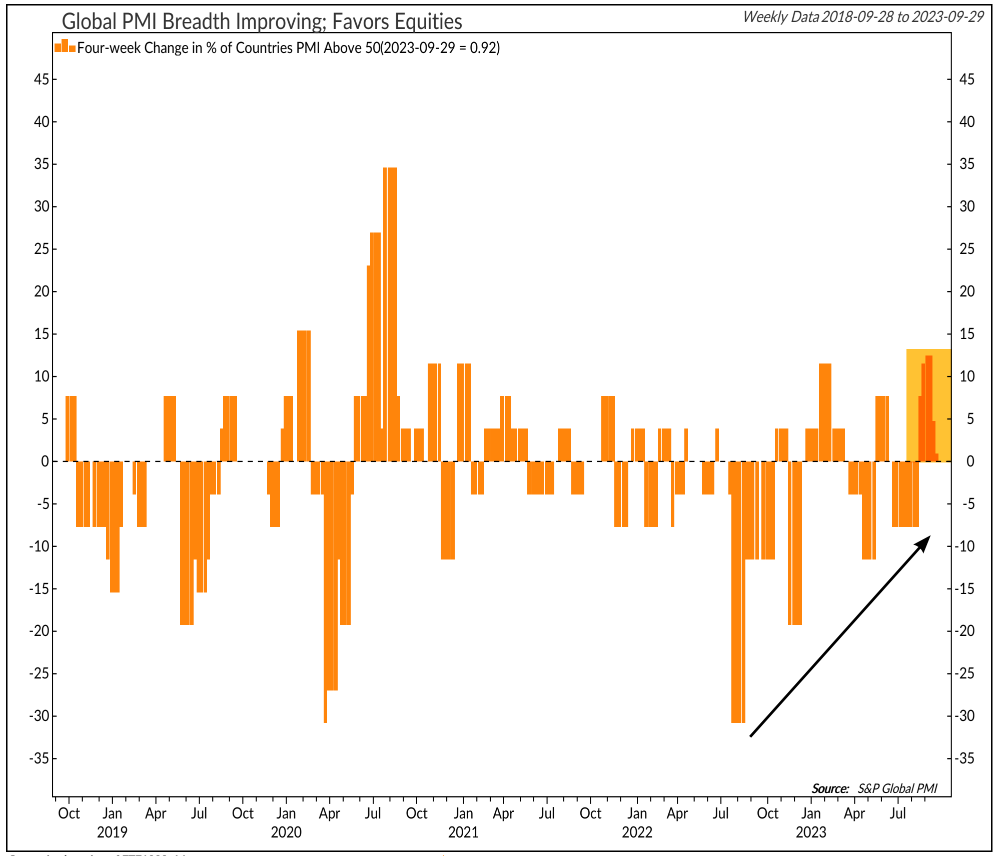
The percentage of global equity markets trading above their 50-day moving averages has experienced significant volatility in 2023. After jumping to almost 90% at the end of July, its highest level since November, the percentage of markets above their intermediate trends declined to less than 24% in September (chart left).

This indicator describes the underlying health of global equities, since it tracks the number of markets participating on the upside. Elevated breadth is important because if many stocks rally, even if a few run into trouble, enough stocks remain in uptrends that they can support the popular averages. Although declining upside participation is a risk, this could be a short-term move for this indicator due to the market pullback in what is still an uptrend.

Two macroeconomic measures turned bullish on stocks. The Purchasing Managers' Index (PMI) breadth indicator measures the four-week point change of the percentage of economies with a PMI greater than 50 (expanding activity). The PMI is based on a survey sent to executives regarding their outlook on areas such as inventories, production, and employment. A change greater than zero favors stocks, while a change less than zero supports bonds.

Equities typically outperform fixed income when there is widening improvement in the economic outlook. This economic momentum breadth indicator (chart right) improved to its highest level since the 2020 economic reopening as Brazil, China, and Ireland rose above 50.



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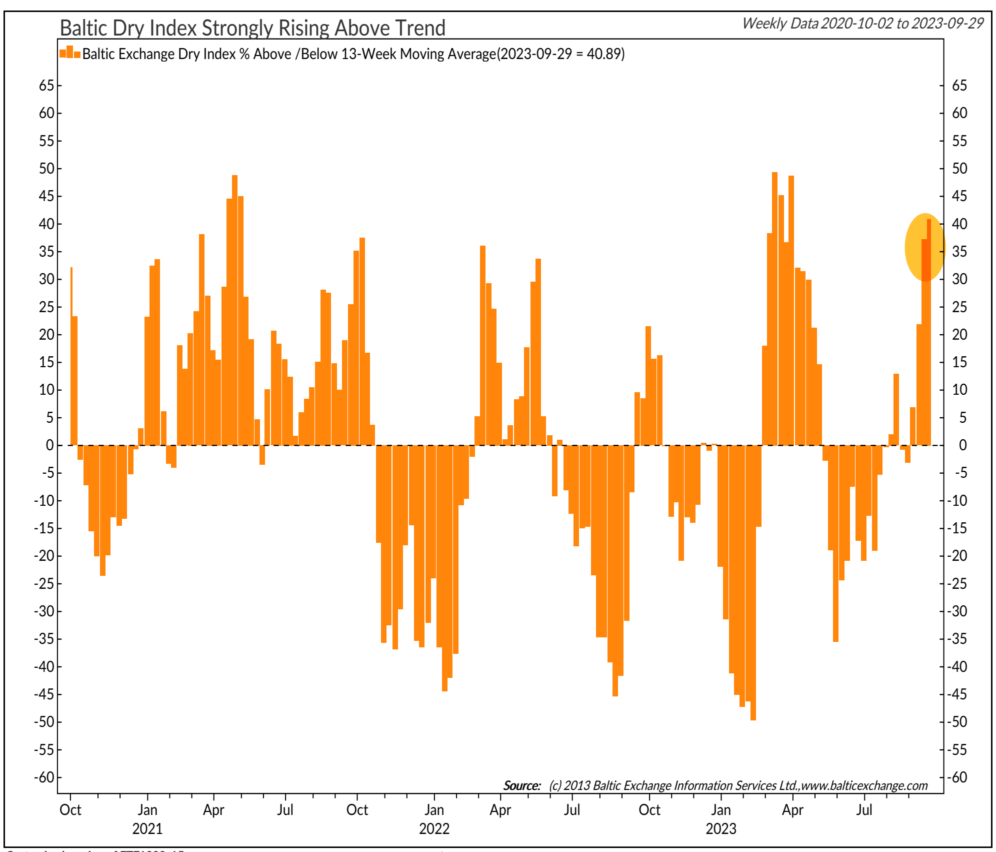

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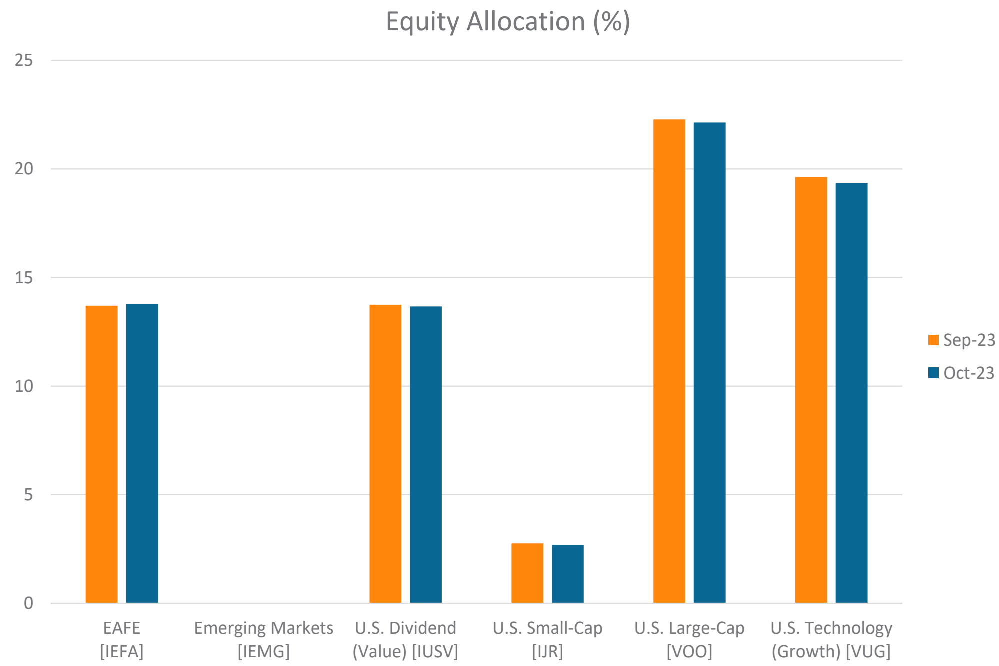
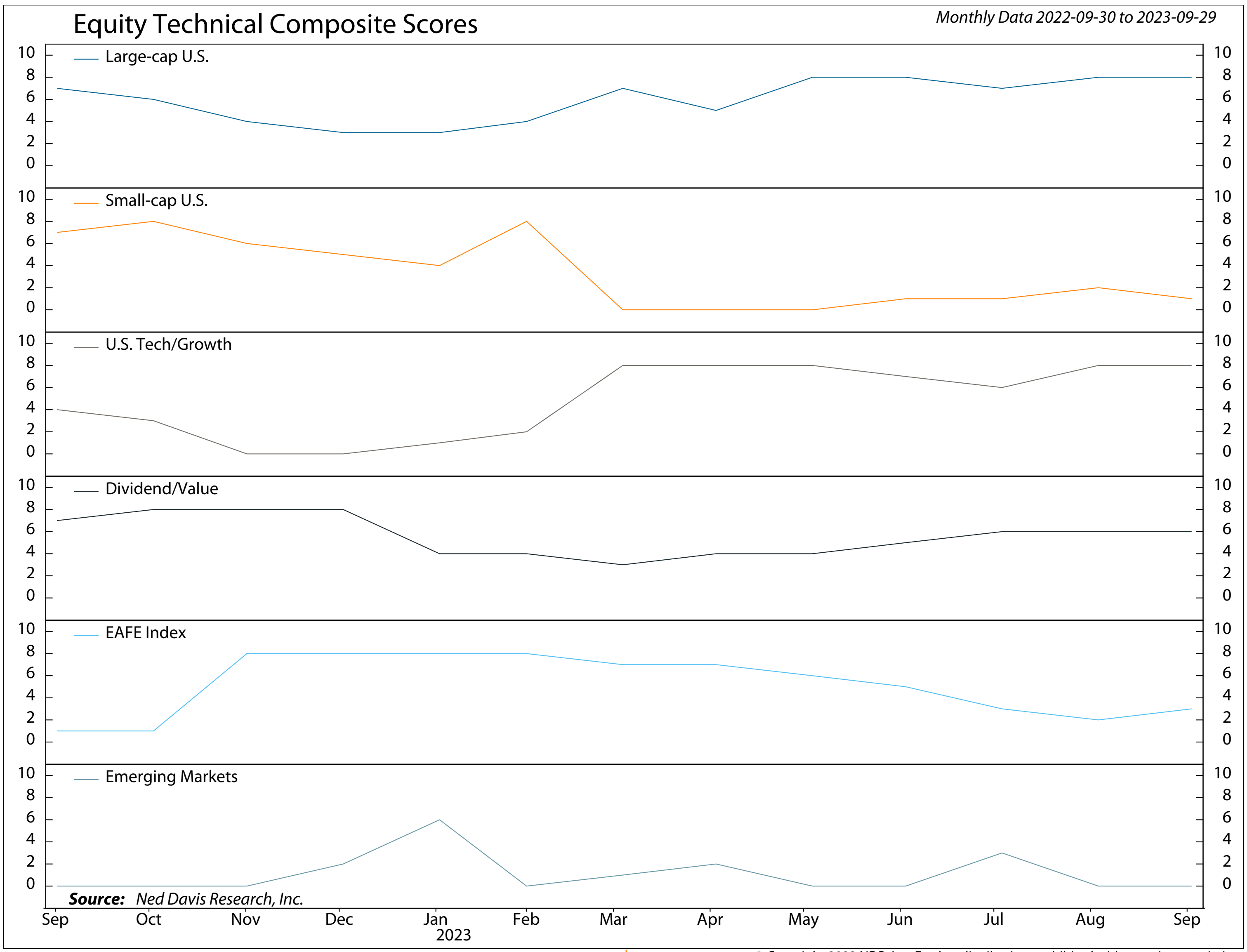
The Baltic Dry Index (BDI) indicator turned bullish on stocks as it crossed above its 13-week moving average. The BDI is a proxy for the cost to transport items such as grain, metal, and energy materials. Rising trends in the BDI can signal improving economic activity, since growing levels may indicate greater demand for raw materials.

Global shipping rates' deviation from trend resided more than 49% below its 13-week moving average during February. Now, the BDI is more than 40% above its intermediate trend (chart left). This indicator has improved over recent weeks to a level that typically favors stocks over bonds.

Equity Allocation Summary

During September, all six equity areas declined more than 299 basis points (bps). It was the second consecutive month where all equity areas declined, which last occurred in August and September of 2022. The U.S. suffered the largest declines, as large-caps, small-caps, Growth, and Value all dropped more than 450 bps. However, VUG and VOO each received more than 15% allocation for October (chart right).





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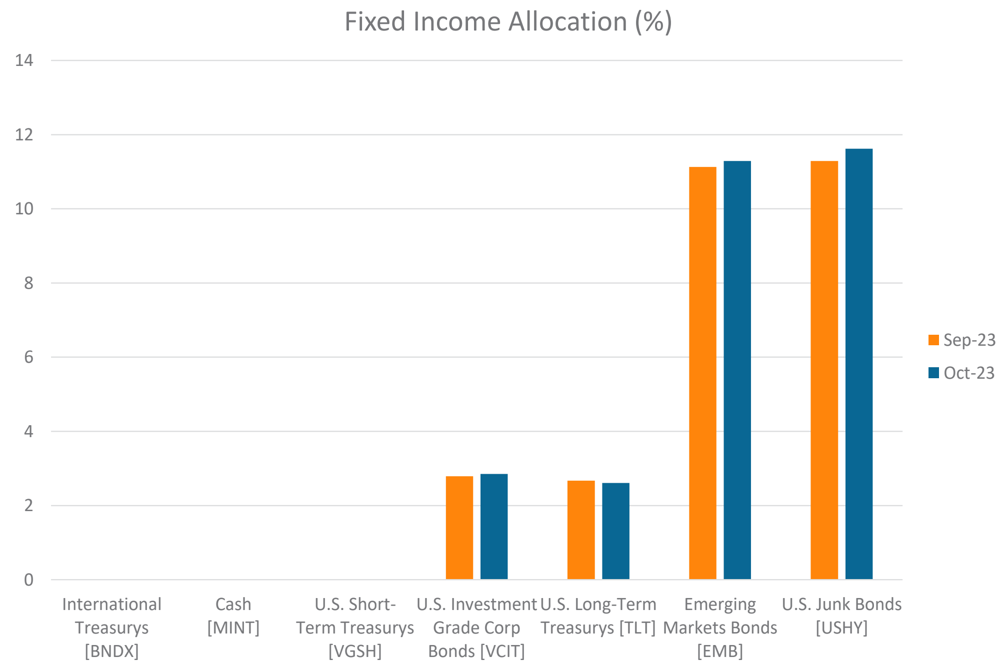
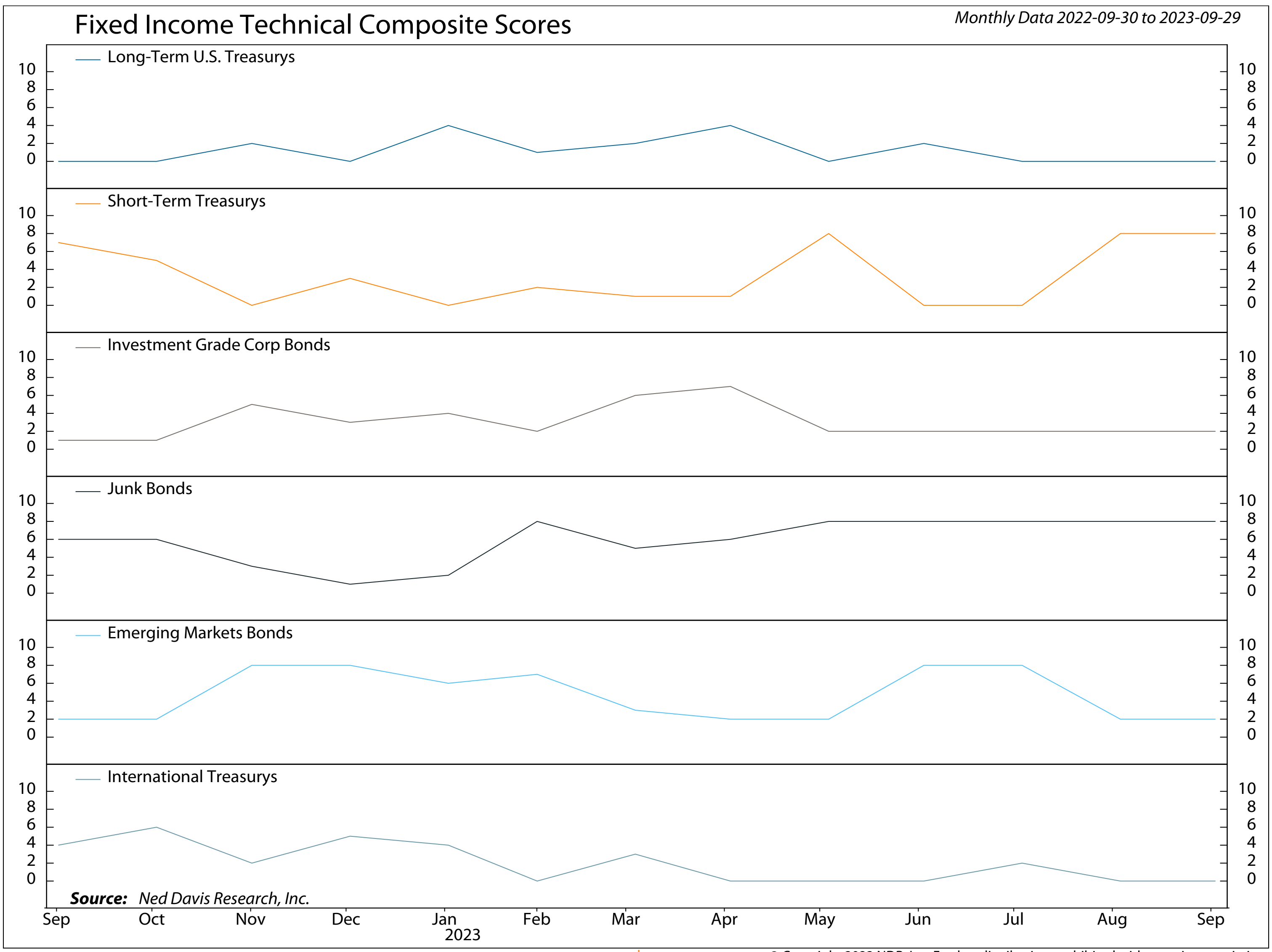
Fixed Income Allocation Summary

All six fixed income areas declined last month. Only short-term Treasurys (VGSH) fell by less than 100 bps. Emerging Market (EM) bonds and U.S. Long-Term Treasurys suffered their largest monthly declines since September 2022. EM fell over 330 bps, while long-term Treasurys plummeted more than 790 bps. TLT has declined more than 250 bps during nine of the last 14 months! EMB and USHY both have over 10% allocation for October (chart right).





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