Dynamic Allocation Strategy

JULY 2023

Macro/Market Update

Global economic growth continued to accelerate in May, based on the S&P Global Purchasing Managers' Index (PMI) readings. The combined services and manufacturing global PMI rose to its highest level since November 2021. It was the sixth straight monthly increase, the longest winning streak since October 2009, when the global economy was just getting out of the Global Financial Crisis recession.

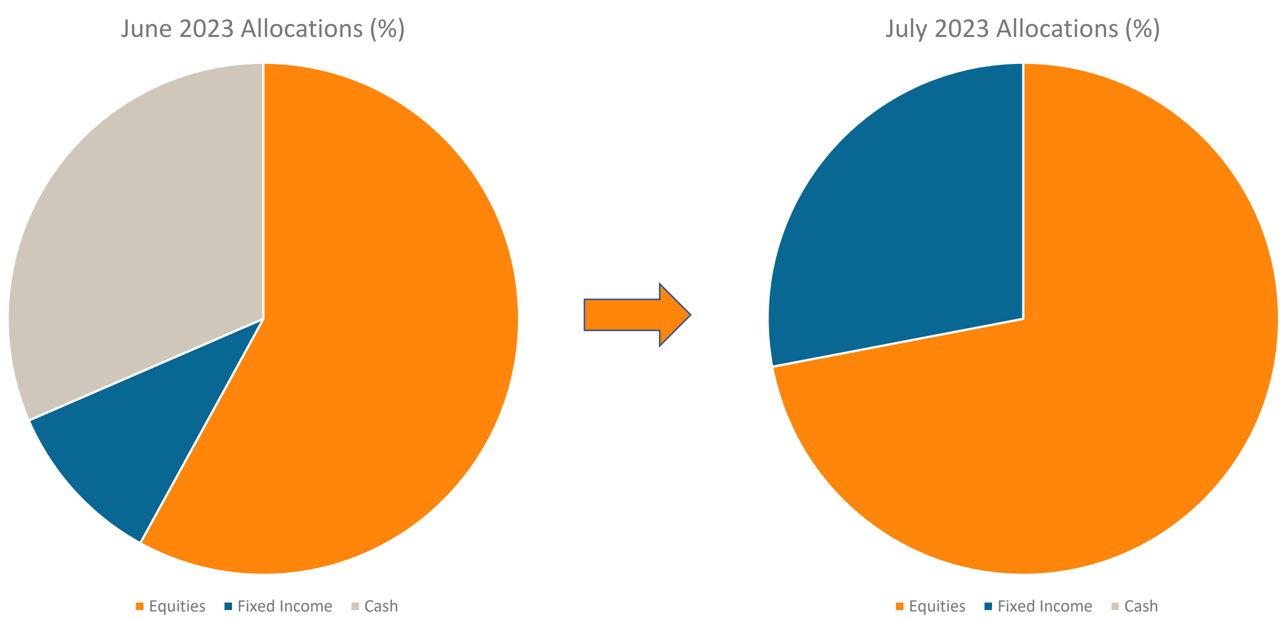
On an aggregate basis, the global economy appears to be in excellent shape, but it masks narrow leadership and sector-level divergences. Services continue to be the only growth driver, as manufacturing shrank for a third-straight month. The last such divergence between the services and manufacturing PMIs occurred in early 2009. Such gaps typically have not been indicative of an ominous economic future. Rather, they tend to happen either well into, or towards the end of global slowdowns/recessions. This is because the more stable services sector often gains traction faster after economic bottoms.

Even so, the ability to maintain accelerating momentum will be more challenging in late 2023/early 2024. Businesses and households will continue to face tighter credit conditions in the U.S. and Europe as the impact of the past year's tight monetary policy continues to slowly work its way into the global economy.

Stubbornly high inflation, particularly in the developed world, indicates that central banks will remain hawkish for longer. Meanwhile, China's growth will likely ease as pent-up demand is satisfied.

During June, the MSCI All Country World Index (ACWI) outperformed the Bloomberg Barclays Global Aggregate Bond Index by more than 585 basis points (bps), the largest spread since October. Global stocks have outpaced bonds for nine of the last 12 months. Global slowdown lead times suggest that a renewed global slowdown may still be at least six months away. History indicates that global equities can still rally during short expansions, but such rallies tend to be shorter-lived.

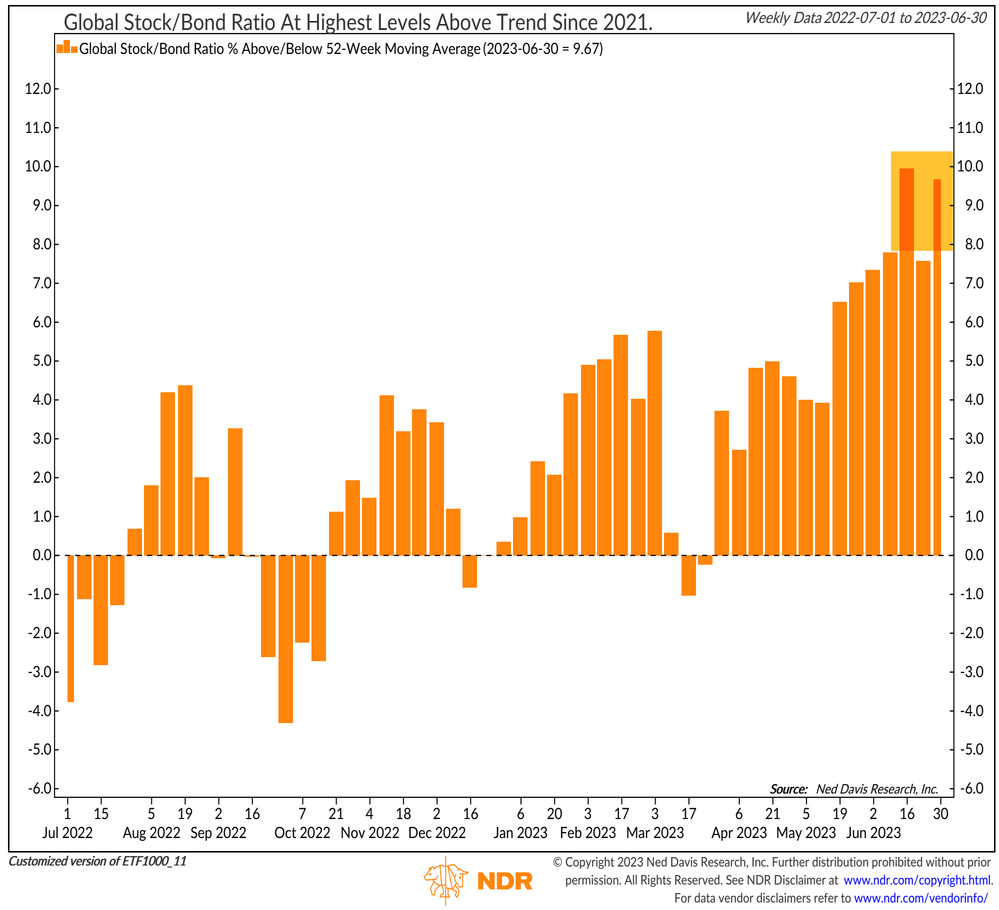
Asset Allocation Summary

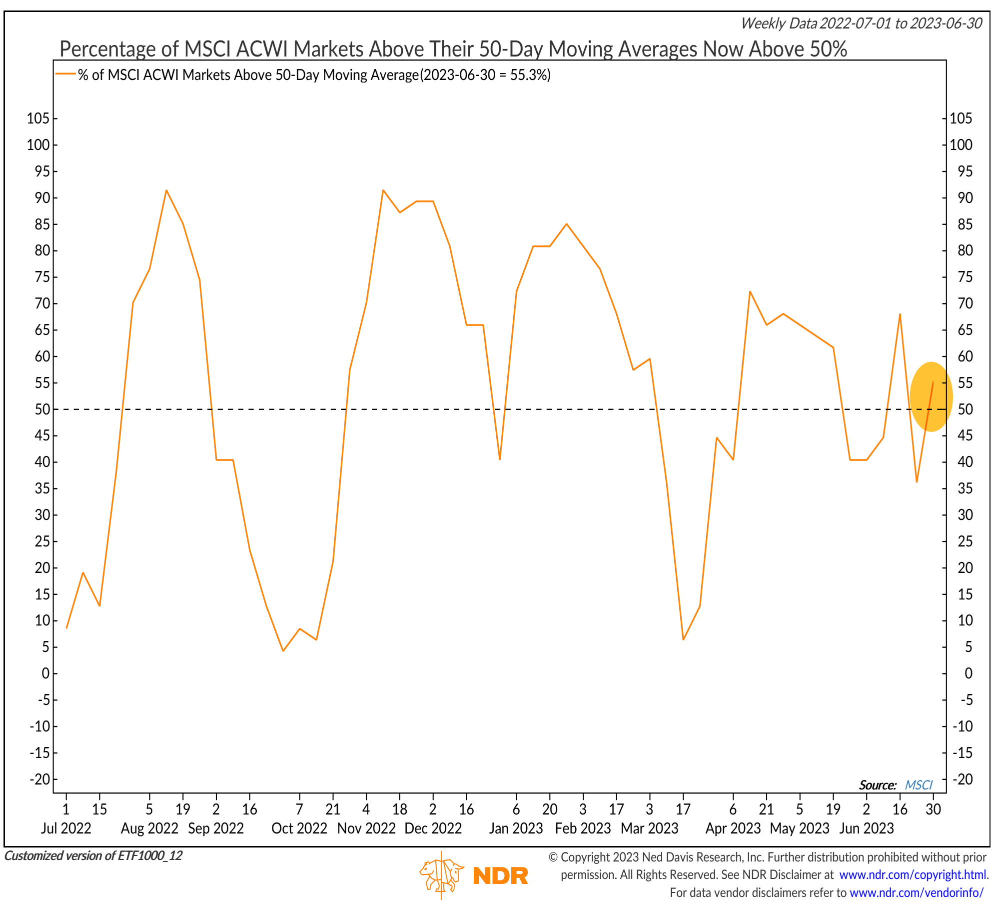


* See Equity Allocation Summary for how the equity allocation is distributed
** See Fixed Income Allocation Summary for how the fixed income allocation is distributed

The equity allocation rose to above benchmark weighting. 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 9% above its one-year moving average (chart at right), its highest spread since 2021. Currently, the trend is equity's friend relative to fixed income.

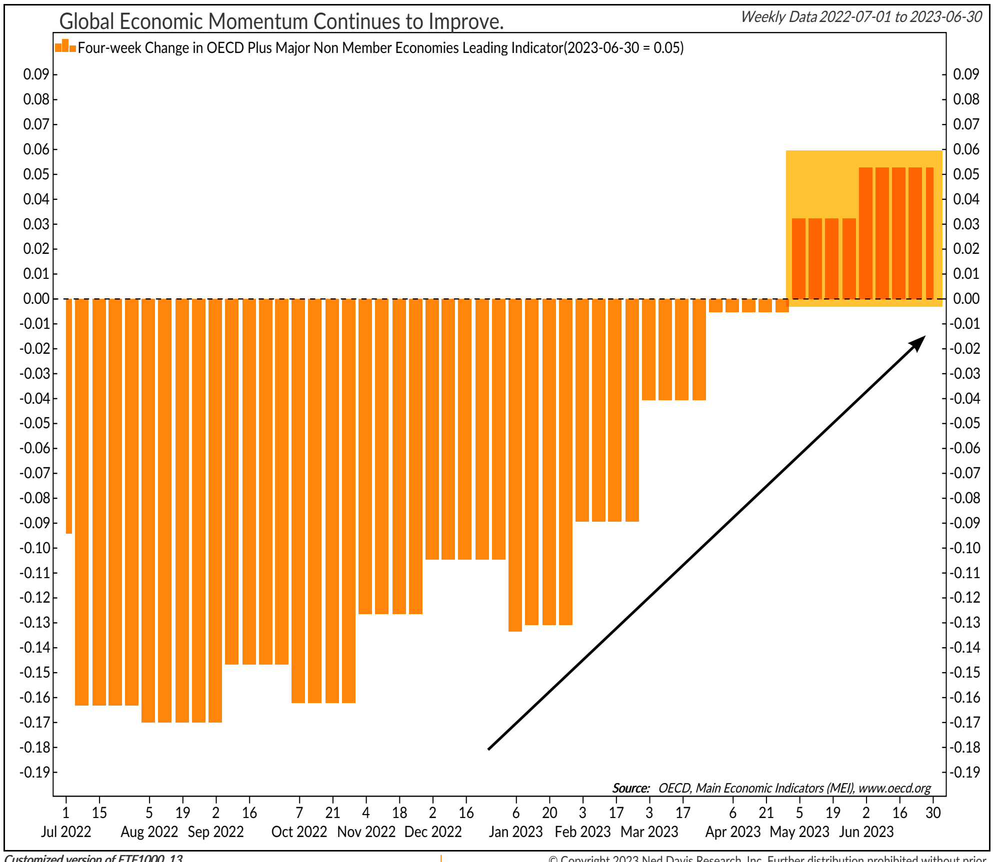
The only indicator to change its signal this month was the global equity breadth indicator, which calculates the percentage of global equity markets trading above their 50-day moving average. It describes the underlying health of global equities, since it tracks the number of markets participating on 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.

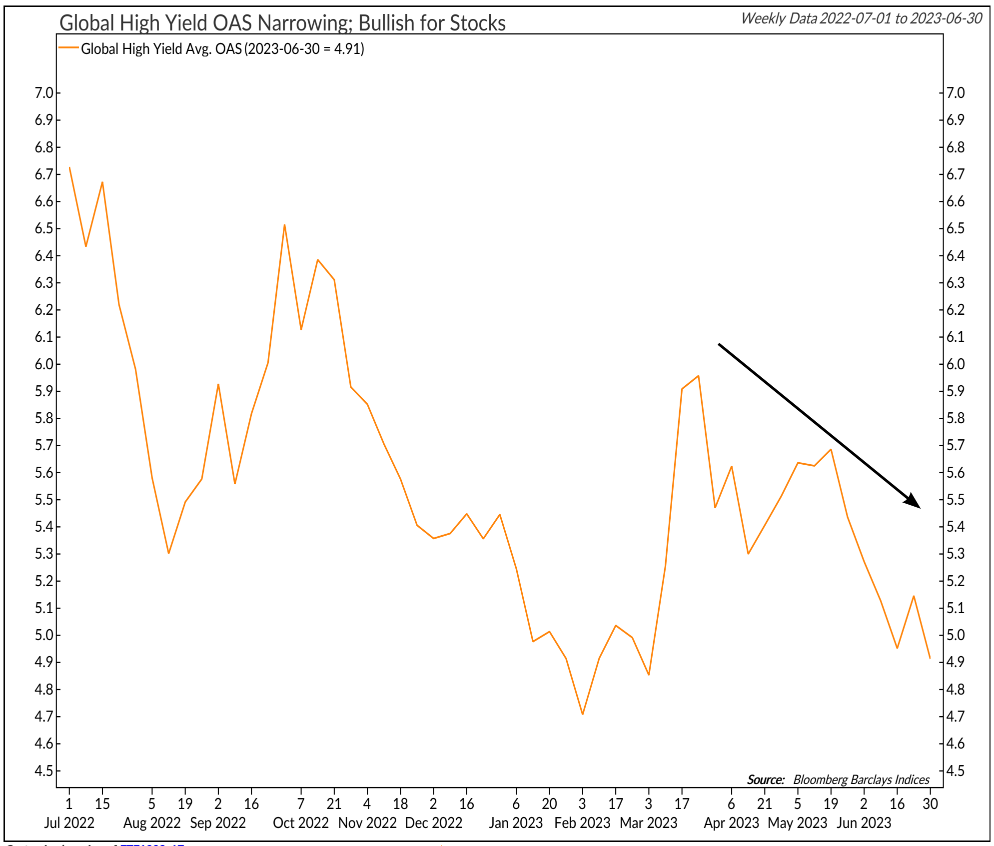




The global equity market breadth indicator has produced bullish and bearish extremes this year. At the end of January more than 85% of global equity markets traded above their 50-day moving average, but by mid-March only 6% of equity markets met that criterion. The indicator improved to 68% at the end of April, but it declined to 40% by the end of May. At the beginning of July, 55% of markets resided above their trends (chart at left).

The one-month change in the Composite Leading Indicator (CLI) has increased for the past two months after declining for 18-consecutive months (chart at right). The Organization for Economic Cooperation and Development (OECD) creates monthly CLIs for 35 economies to capture turning points in the growth cycle. Each CLI contains a wide range of indicators such as money supply, yield curve, building permits, consumer and business sentiment, share prices, and manufacturing production. Improvement in global economic momentum supports the equity trend.

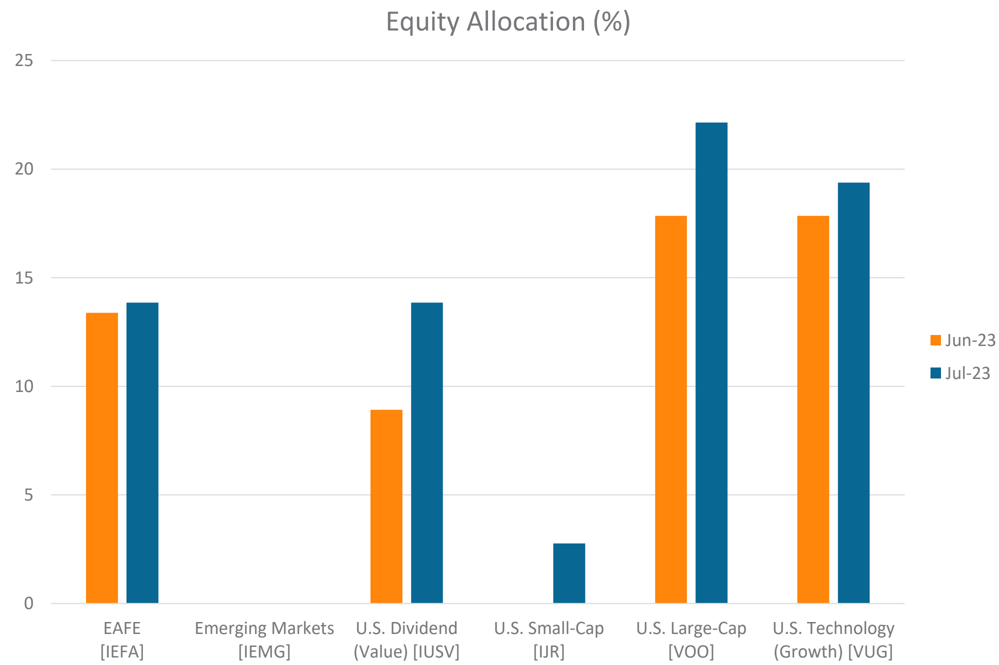


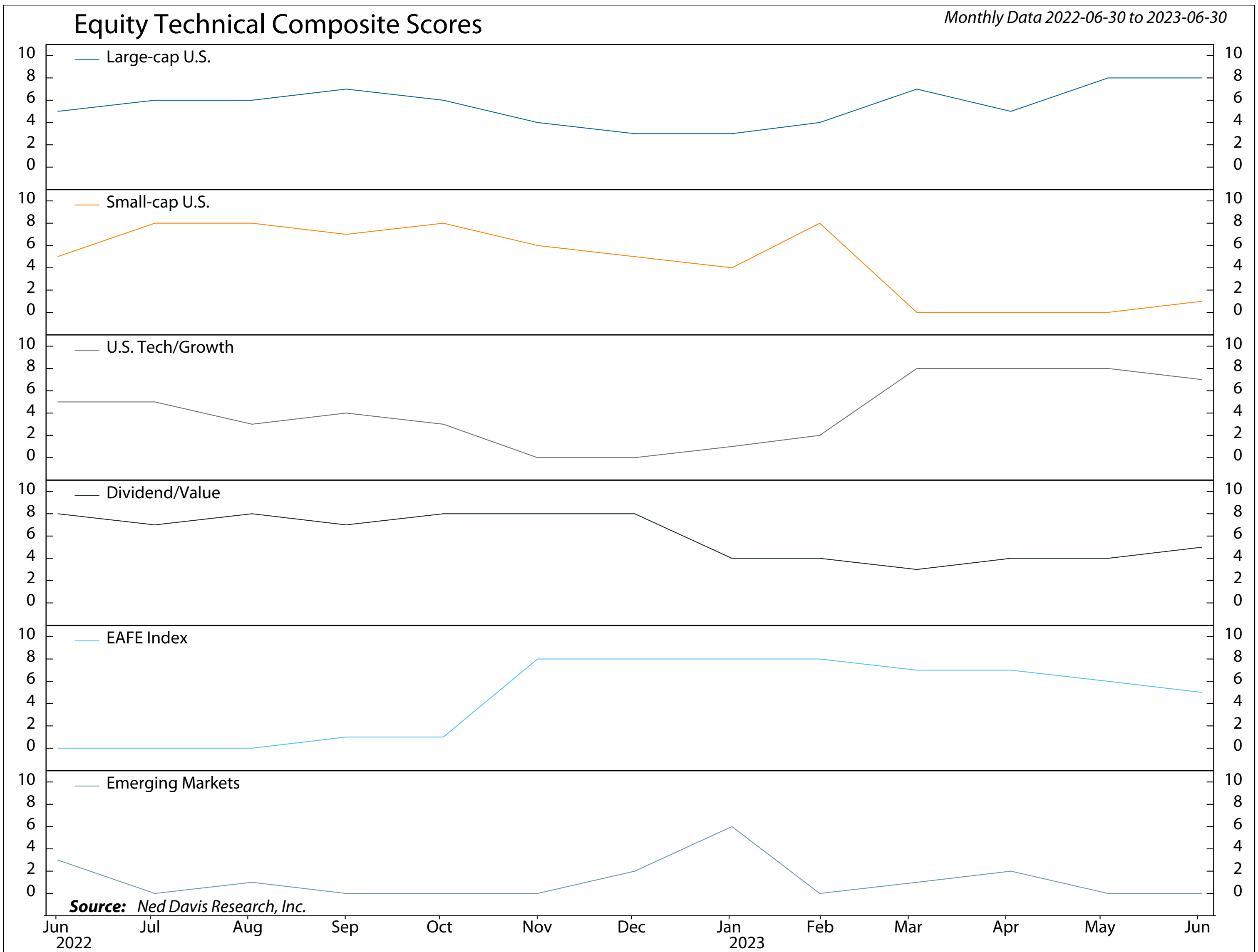


Global high yield option-adjusted spreads (OAS) widened by 125 basis points (bps) from early February until mid-March during the banking sector weakness. With global high yield OAS widening, bond investors demanded higher yields for taking on more risk. However, since mid-March spreads have narrowed more than 100 bps (chart at left). This indicates growing risk appetite, which favors equities over fixed income.

Equity Allocation Summary

For the first time since January, all six equity areas jumped more than 400 basis points (bps). U.S. Value (IUSV) and U.S. Small-Caps (IJR) gained more than 700 bps in June. It was only the second monthly increase for IJR this year. U.S. Growth (VUG) and U.S. Large-Caps (VOO) rose more than 600 bps. VUG and VOO have been higher for five of the last six months. VUG, IUSV, IEFA, and VOO each received more than 10% allocation for July due to their technical composite scores.





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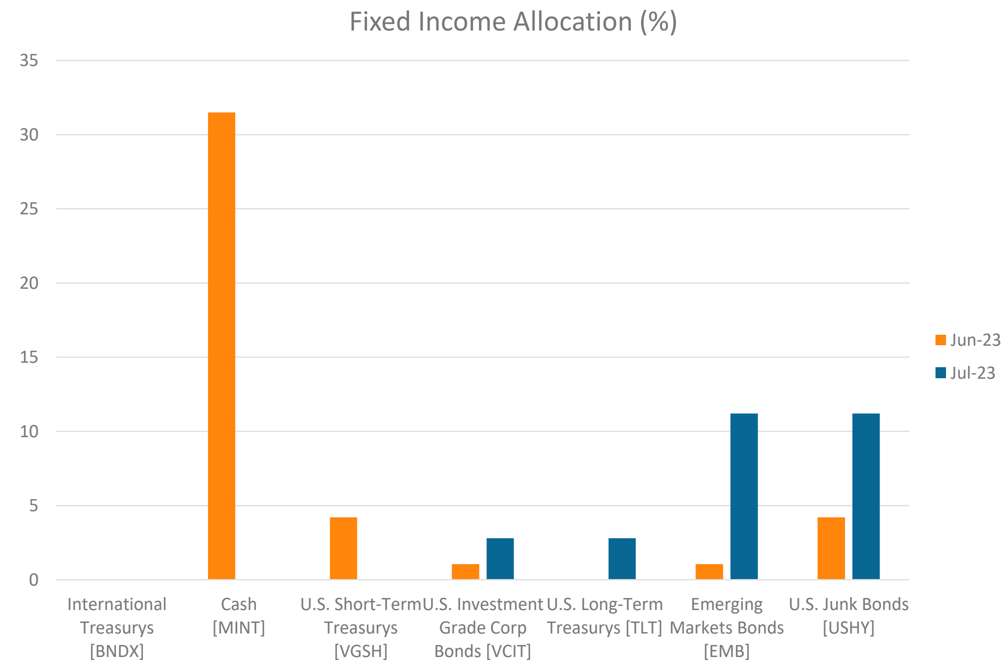
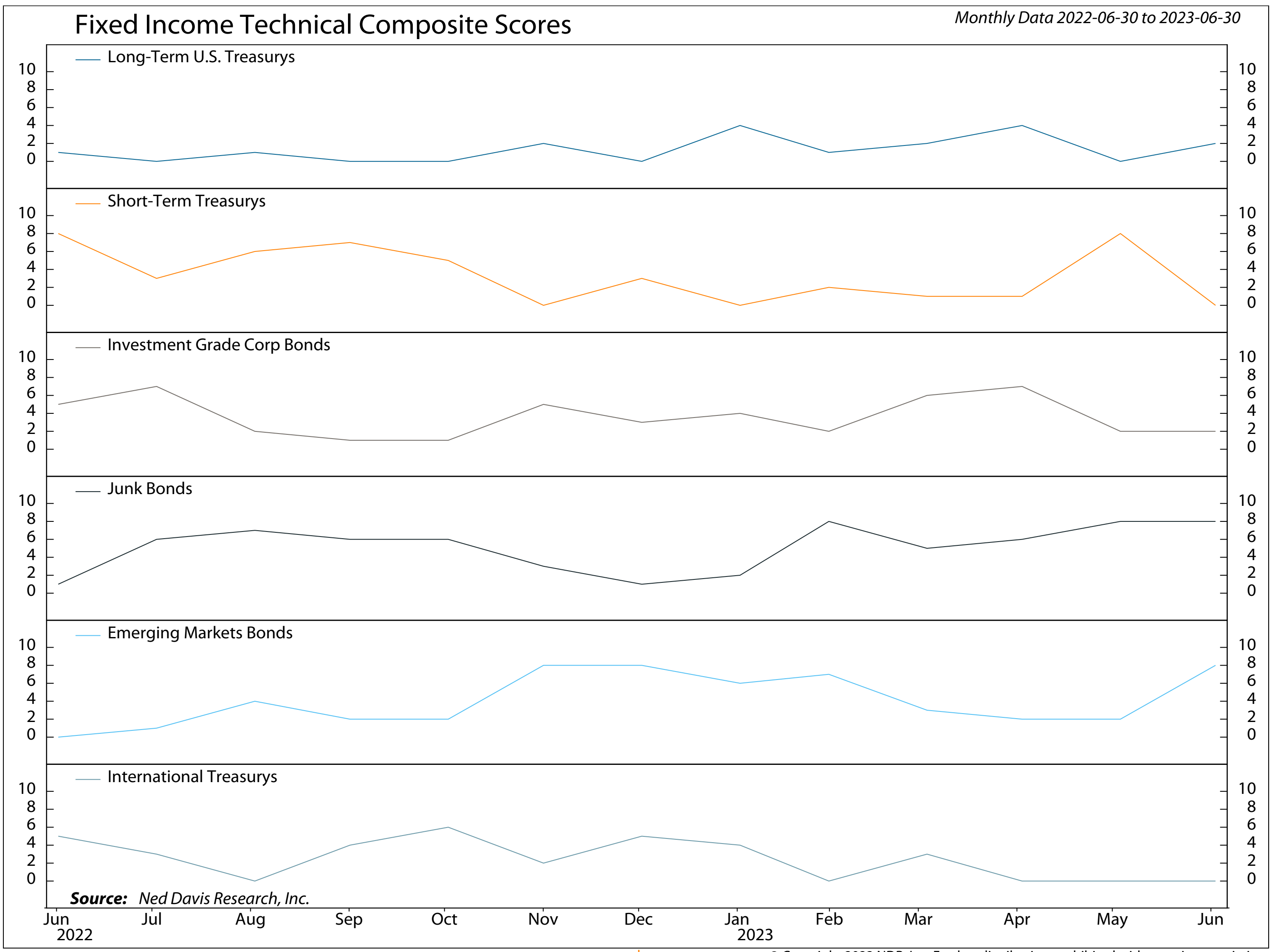
Fixed Income Allocation Summary

Only U.S. High Yield (USHY) and Emerging Markets (EMB) increased by more than 150 bps during July. It was EMB's best month since January. U.S. Long-Term Treasurys (TLT), U.S. Investment Grade Corporates (VCIT), and International Investment Grade (BNDX) gained less than 30 bps. BNDX has risen for four consecutive months. EMB and USHY both have over 10% allocation for July due to their technical composite scores.





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