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NED DAVIS RESEARCH

Dynamic Allocation Strategy

JANUARY 2023

Macro/Market Update

The global economy contracted for a fourth-straight month in November, according to the S&P Global Purchasing Managers' Index (PMI). The global composite (services and manufacturing) PMI reflects the deepest contraction since June 2020. At its current level, the composite PMI is historically consistent with a 0.9% decrease in global annual real Gross Domestic Product (GDP) growth.

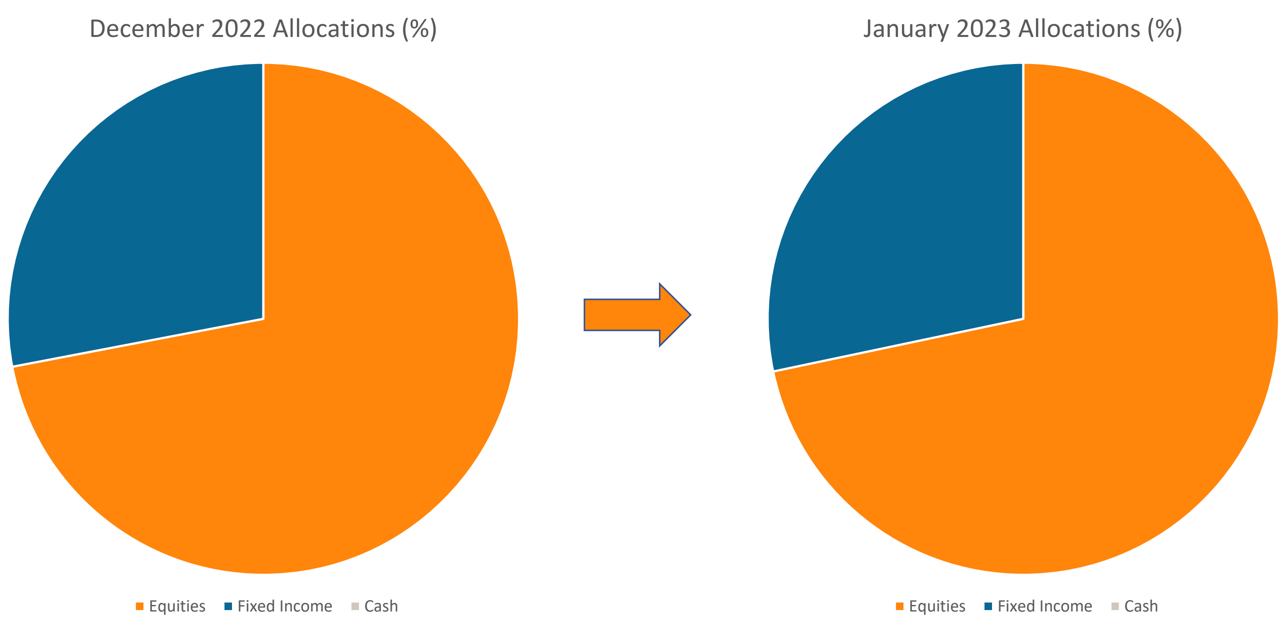
Both the manufacturing and services sectors contributed to the composite's decline, as they indicated contraction for a second-straight month. The last time that happened was also in June 2020. The economic weakness continued to broaden among countries and regions, as both the emerging and developed economy composite PMIs indicated contraction.

Most of the downside risks that plagued the global economy in 2022 will likely continue in 2023, but from a much lower starting point. Global savings have been depleted, while labor markets are starting to show signs of slowing. Moreover, given the lagged impact of monetary policy on the economy, the indicators, many of which are already on the cusp of levels associated with global recession, are likely to worsen in the coming months.

However, one major positive is that price pressures continue to deteriorate. Both the global composite input and outprice indexes fell to their lowest since February 2021. Even so, the indexes (especially input prices) remain well above their pre-COVID levels.

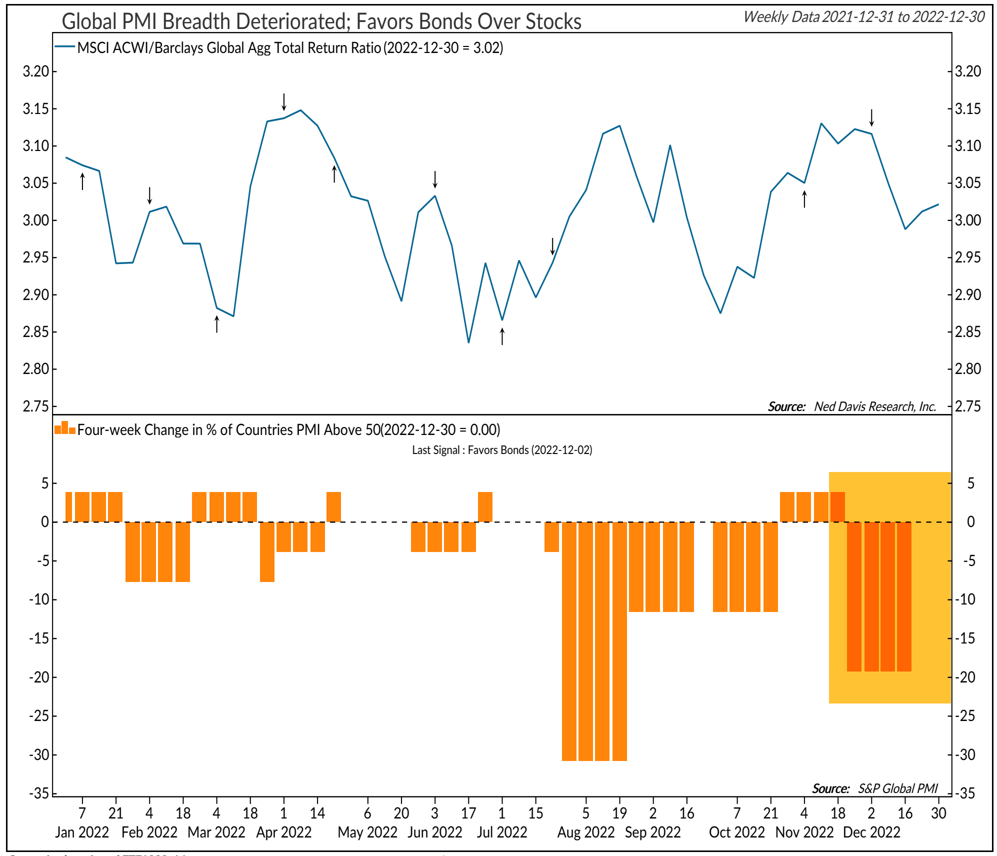
During December, the MSCI All Country World Index (ACWI) underperformed the Bloomberg Barclays Global Aggregate Bond Index by over 400 basis points (bps). It was the fear of inflation and its influence on central bank policy that drove the stock and bond downtrends in 2022, culminating in a sentiment extreme. Stocks and bonds could trend higher in 2023 on the increasing evidence that inflation is receding, which means that central banks will be able to slow and eventually stop their rate hiking initiatives.

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 allocation for January as the model's turnover reduction mechanism prevented new trades. There was significant indicator volatility entering this month. 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). A change greater than zero favors stocks, while a change less than zero supports bonds. This economic momentum breadth indicator (chart at right) weakened this month as Brazil's, Ireland's, and Japan's readings all fell below 50.



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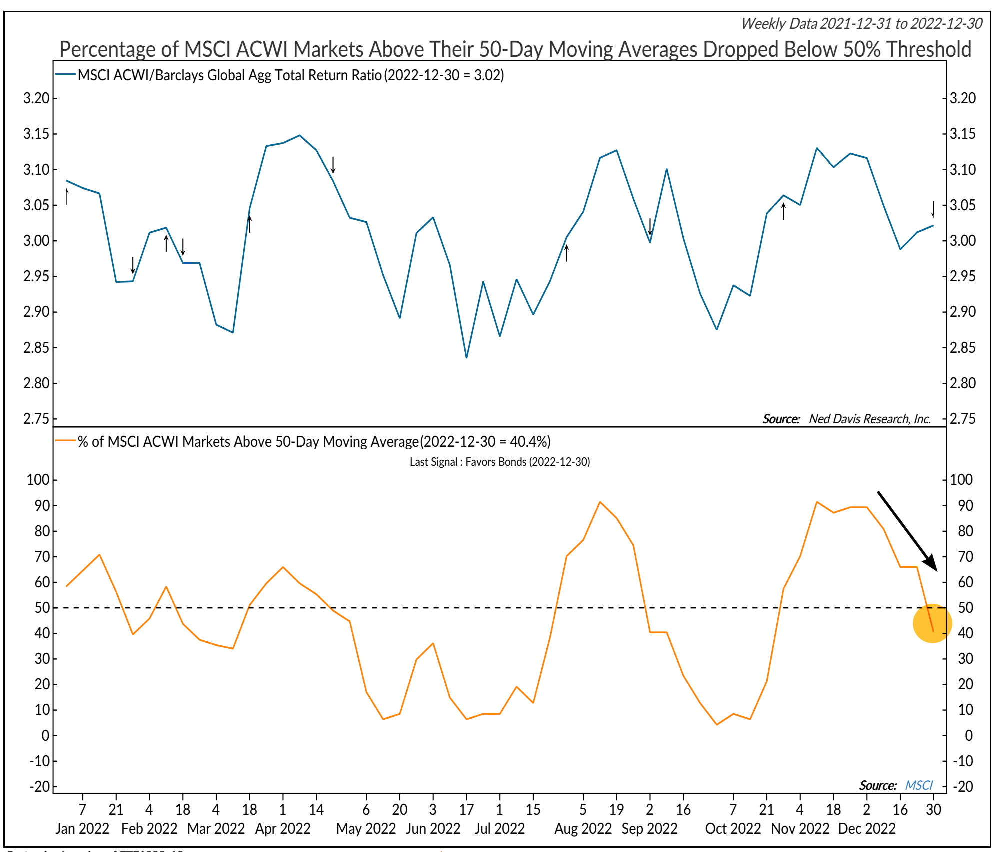
Global equity market breadth also rolled over during December. Early last month, almost 90% of global equity markets traded above their 50-day moving averages. During December that number plummeted to slightly more than 40% (chart at left). When less markets are in uptrends, the global equity market is more susceptible to larger declines. Historically, weaker equity market upside participation has favored bonds relative to stocks.



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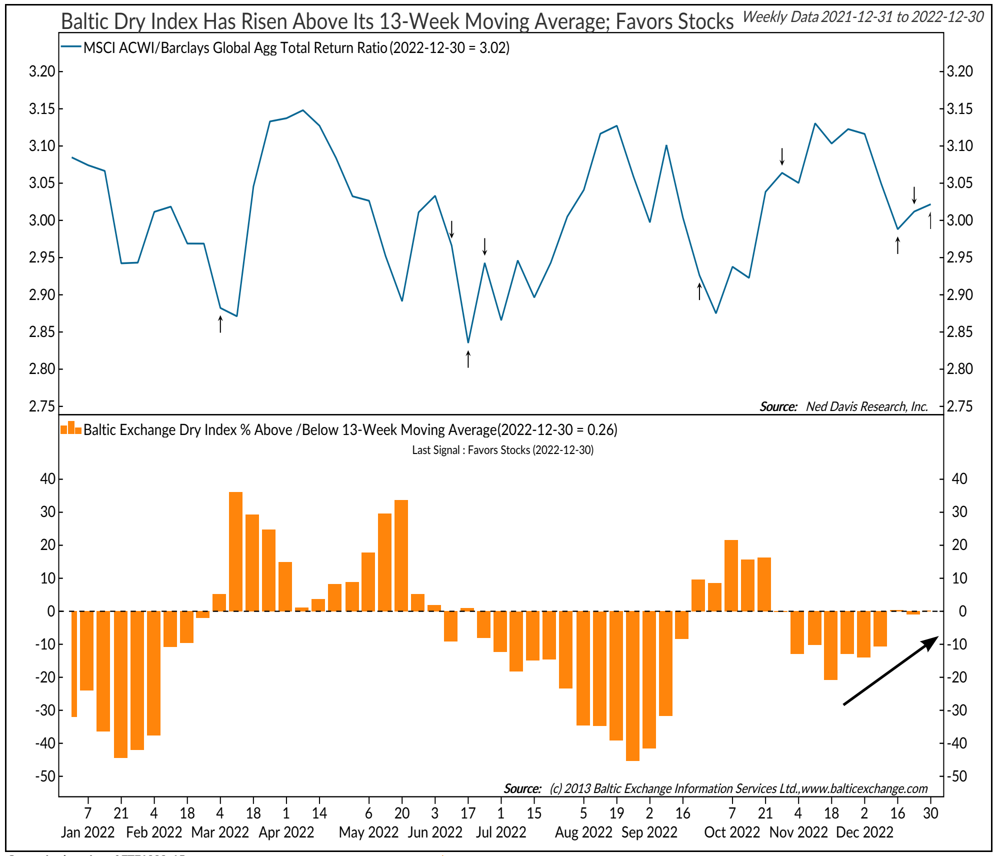
Not all indicator changes were negative for stocks. The Baltic Dry Index (BDI) indicator compares global shipping rates relative to their 13-week moving average. Entering this week, the Baltic Dry index (BDI) improved to less than 0.5% above its 13-week moving average (chart at right). In mid-November the BDI was more than 20% below its intermediate-term trend.



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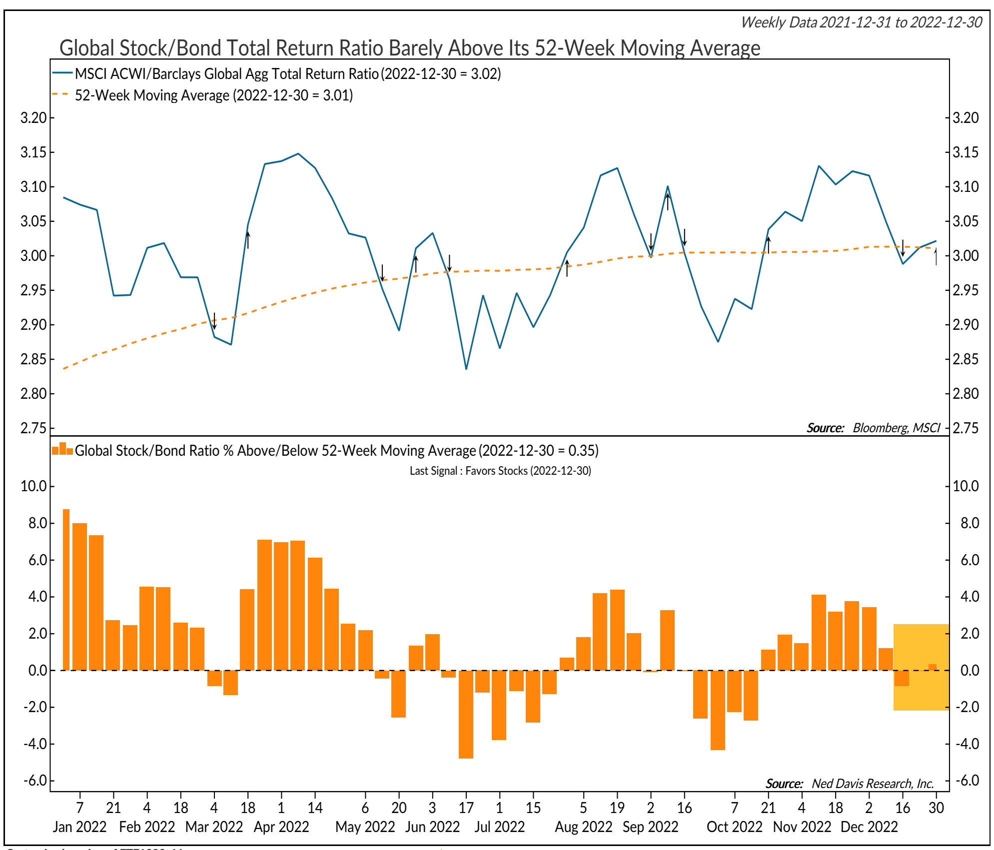

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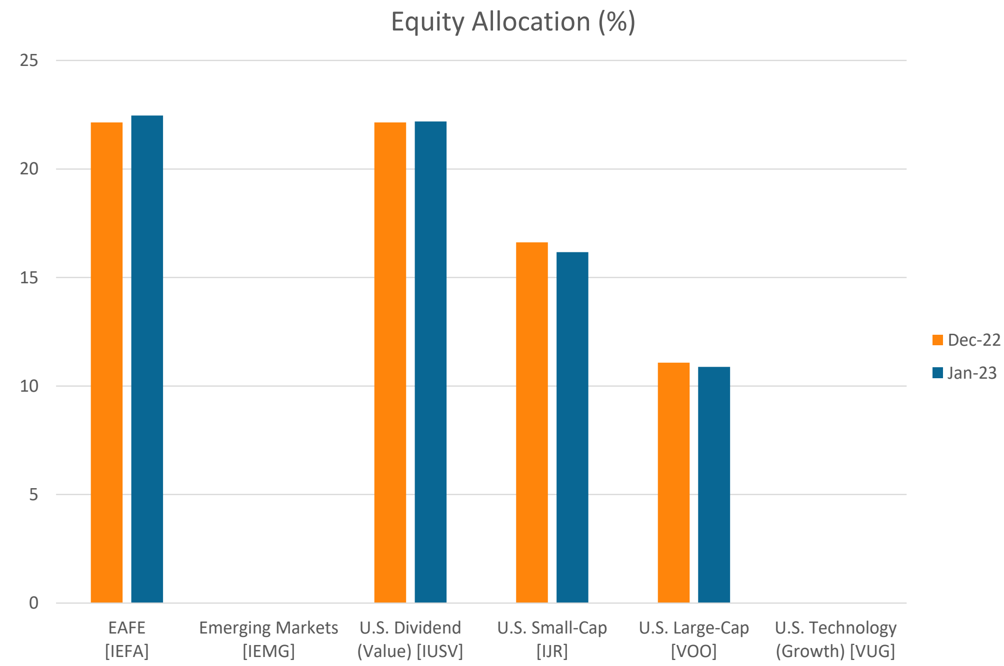
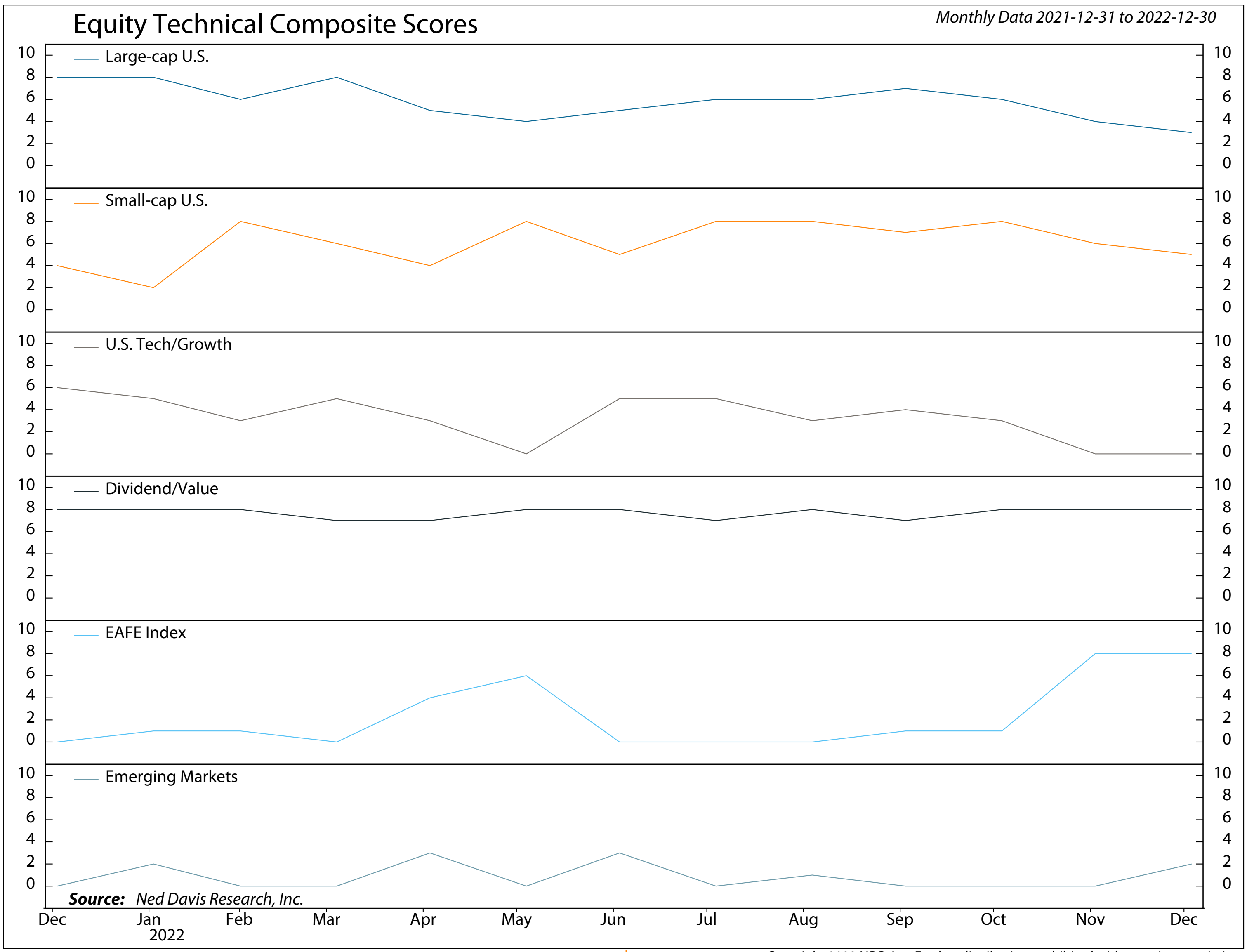
Although it did not change signals this month, the global stock/bonds relative strength indicator is tenuously holding its bullish reading. The ratio is less than 1% above its 52-week moving average. Equity weakness relative to fixed income during January could cause this indicator to flip, which would significantly shift allocation from stocks to bonds.

Equity Allocation Summary

During December, all equity areas declined. International Developed (IEFA) and Emerging Markets (IEMG) fell by less than 300 basis points (bps). For a second-consecutive month, Value (IUSV) has been the best (relative) performer within the U.S. IUSV, IEFA, and U.S. Small-Caps (IJR) each received more than 15% allocation for January due to their technical composite scores (chart below).





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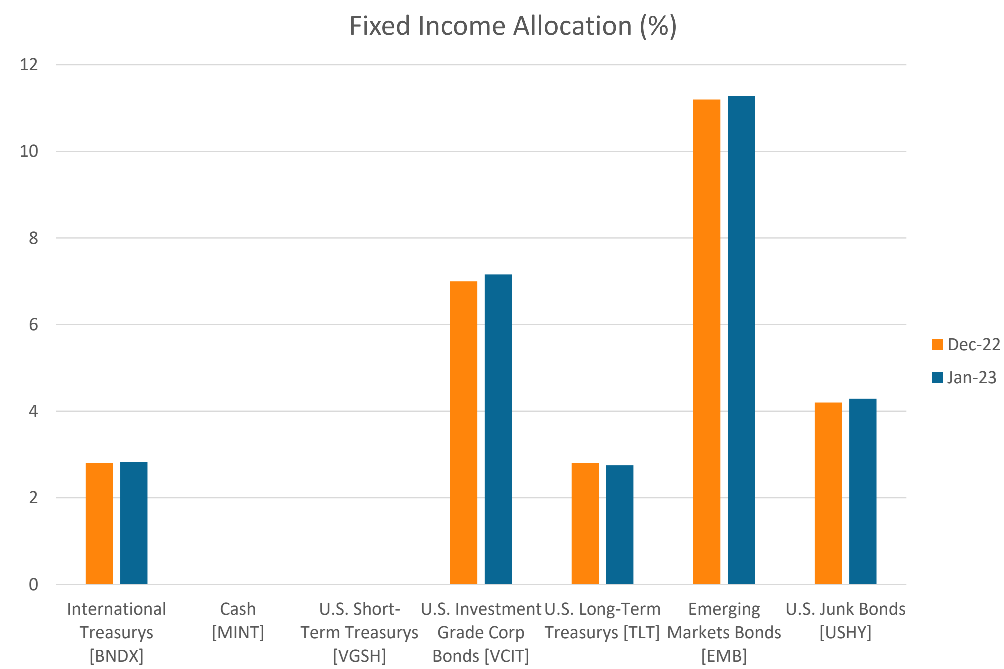
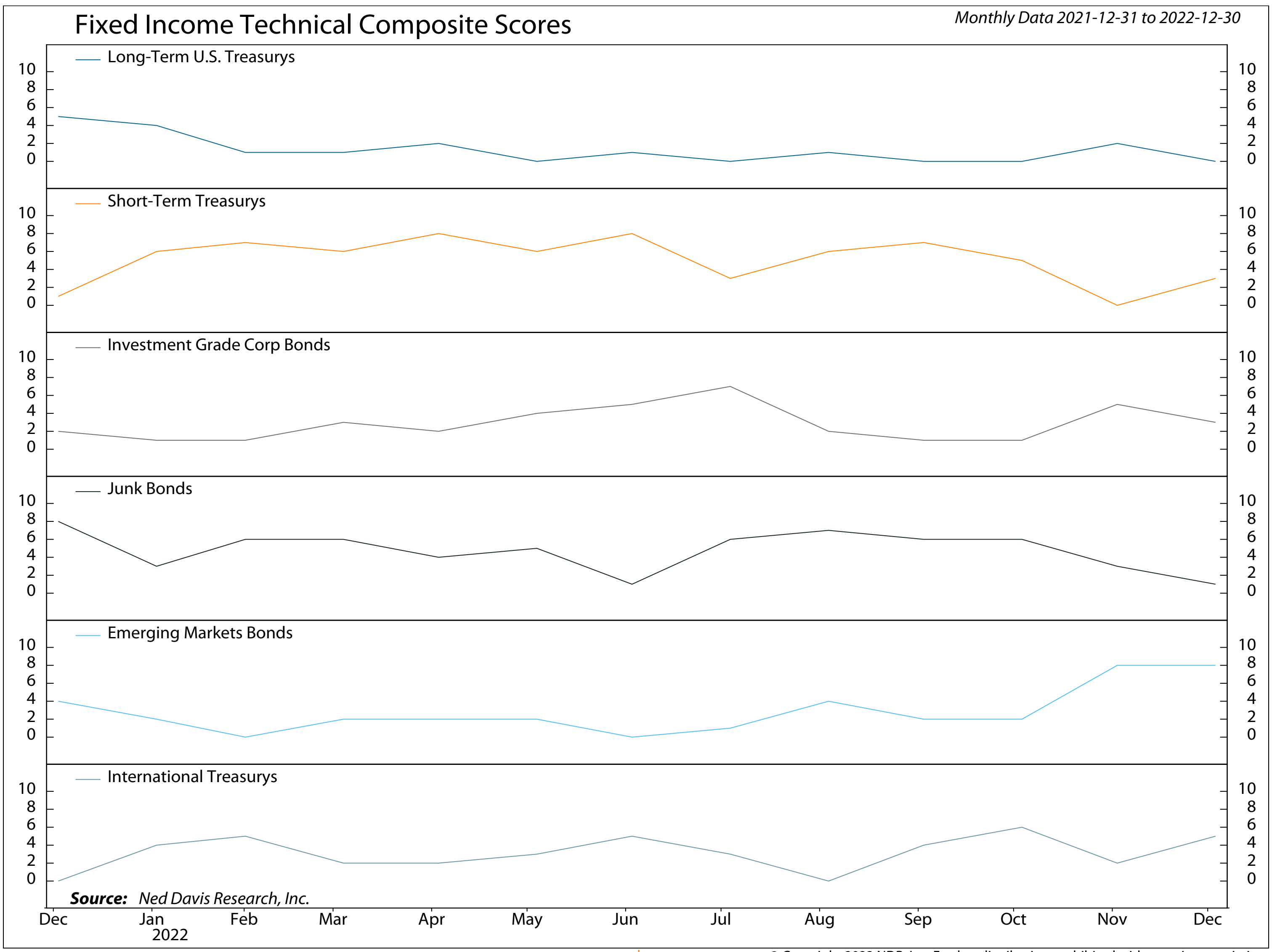
Fixed Income Allocation Summary

Except for U.S. Short-Term Treasurys (VGSH), all fixed income areas declined last month. U.S. Long-Term Treasurys (TLT) and International Investment Grade (BNDX), the worst-performing areas, declined more than 200 bps. Emerging Market bonds (EMB) and U.S. Investment Grade (VCIT) each received at least 5% allocation for January due to their technical composite scores (chart below).





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