AllianceBernstein®

JULY 2024

3Q 2024 Strategic Investment Outlook:

Cyclical versus Structural Inflation...and TINA Again?

Our latest quarterly note considers the interaction of tactical and strategic views. One complication for investors is that there has been a significant muddying of the waters between cyclical and structural inflation, even though the forces at work have been very different.

We think it is easier to form a strategic market outlook than a tactical one at this stage, but one has to have an explicit view—our tactical view is that the equity market will be higher at year end, albeit with more volatility than we have seen of late. It should be noted though that the US election now appears less close with the probability of a Trump win now distinctly higher.

It is simply too painful for investors to stand in the way of the growth-momentum trade, but even within that context, investors also need to have value-like positions as part of a prudential allocation. We highlight the Energy sector and post-election UK as two examples of this positioning.

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So far, 2024 has witnessed very significant shifts in investor expectations. The point of this note is to consider what this means for portfolio allocations—especially where tactical views impact longer-term strategic positioning.

The lack of concern about equity valuation that we encounter is concerning. However, despite strong inflows, other metrics of sentiment are not, perhaps surprisingly, indicating an overextension. We acknowledge that doubts about such sentiment metrics will be legion when performance is so concentrated. It is probably easier to express a medium- to long-term view than a tactical one at this stage. That longer-term view is positive for global equities and we are strategically overweight. We see equities as a key allocation to a "real asset" in the context of a higher equilibrium level of inflation. This comes with the major caveat that we expect those returns to be muted compared with recent and long-run history. Valuations, strong inflows and the observation that a high proportion of market weight is accounted for by the momentum factor mean that volatility over the next six to12 months should be higher than we have seen recently. The tactical view is much harder to form, but **our view is that the equity market will be up, not down, from now until the end of the year—albeit with a lower return and significantly higher realized volatility.**

The latest events around the US election including the attempted assassination of Trump have had a perhaps surprisingly muted impact on markets, but we think there is a logic to it. As far as betting markets are concerned at least, the US election is no longer a close race. Trump was already priced as the most likely candidate to win and over last weekend the odds moved even more in his favor. Given Trump is seen at the margin as being more friendly for equities (potential for cutting of regulation and marginally looser fiscal policy) this has been reflected in slightly higher equity expectations. We have made the point before that European risk assets probably lose out in a Trump presidency (increased trade tension while defense spending needs to rise more quickly).

We have gone from an expectation of six Federal Reserve rate cuts at the beginning of the year to one now, which has been offset by the avoidance of a recession. The equity market has seemingly not cared about the nuances of this dynamic, rallying through it. It is not totally obvious that the extra earnings make up for the discount rate not being as low as was expected, yet investors seem sanguine about this. In our client conversations, they seem less concerned about equity market valuations now than they were six months ago. The concentration of market leadership makes this situation even more challenging: Are historical metrics of sentiment even valid in a market where a handful of stocks are what has really mattered? What are investors to make of all this?

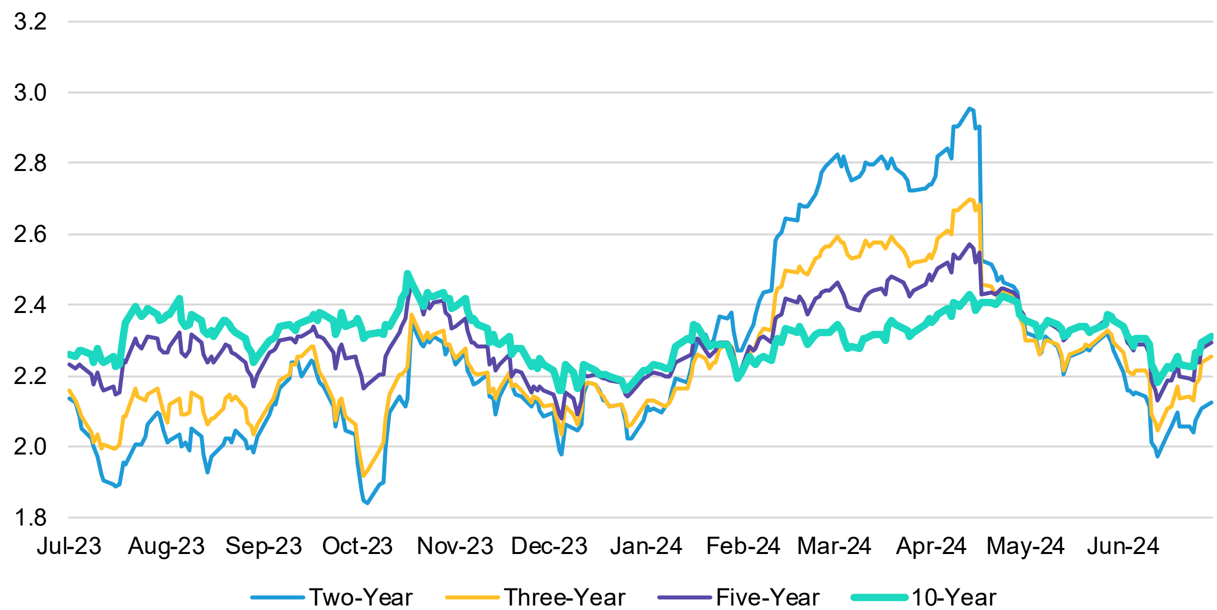
We suggest a few angles that are important for portfolio allocation:

- The interplay of cyclical and structural inflation is now even more muddied.
- What is the case for equities now? How does the tailwind of a "no-landing" scenario stack up against the loss of support from potential rate cuts?
- Large buying of US equities (by both investors and corporations) implies that we are back to the "TINA" (There Is No Alternative) narrative again.
- We think the recent evolution (higher valuations and inflation), further embeds the view that investors should expect lower strategic returns, especially in real terms (the only terms that count!), as well as higher realized volatility.
- Stock-bond correlation has remained positive, highlighting the need to seek diversification elsewhere.
- The US, UK and French elections all have very different implications for markets. The US faces possibly the most consequential election in years. The surprise French election result, while likely a relief for investors, points to a period of uncertainty. The UK, meanwhile, has moved from a period of somewhat chaotic politics to a potentially more stable state.
- Tactically it is too hard to stand against the growth-momentum trade. Even if it looks extended, taking an opposing tactical position is too painful. Having said that, investors also need value trades in place in the interest of prudence. We suggest two such value examples in this note. One is the UK, by some degree the most-hated equity market. The recent UK election is almost the opposite of the upcoming one in the US, given the closeness of the policy positions laid out before the vote. But it might possibly be a catalyst. The other value trade we highlight is the energy sector. We show that the sector is buying back more than 2% of its stock per year, has been the most out of favor and offers an attractive free-cash-flow (FCF) yield in a market that is short of valuation opportunities. We discuss potential catalysts.

Cyclical vs. Structural Inflation

One of the core metrics that has driven recent investment decisions but also defines longer-term strategic positioning is inflation. The point of this note is not to comment on the near-term inflation data; instead, if we stand back, the main point is that there has now been a significant muddying of the waters between cyclical inflation and structural inflation. One sees this, for example, in the recent rebound of two-, three- and five-year inflation break-evens upward toward the level of the 10-year breakeven, at least in the US—the dynamic is not the same in Europe (*Display 1*).

DISPLAY 1: MEDIUM TERM BREAKEVENS HAVE RISEN TOWARD LONGER-TERM BREAKEVENS



Historical analysis does not guarantee future results.

Through July 1, 2024

Source: Bloomberg and Alliance Bernstein (AB)

This shift in inflation expectations began even before the betting odds on the outcome of the US election moved more decisively in favor of Trump. We think this shift could increase medium-term inflation expectations. While fiscal largesse will be a feature of whichever candidate wins the election, a Trump win would, on balance, likely be more inflationary, given the stated policy preferences of clamping down on immigration, which had created significant extra capacity in the labor market, and the possibility of some form of trade war.

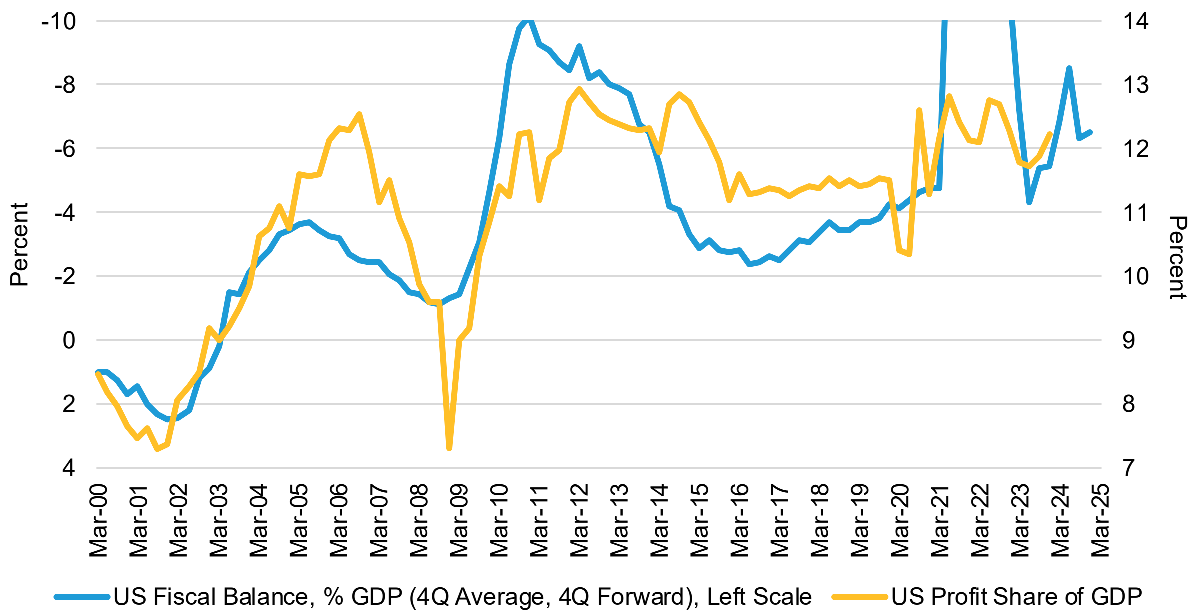
We continue to expect that medium to long-term inflation will be above the level suggested by 10-year break-even rates. In our conversations with European and US clients in recent months, we find that a clear majority also expects the equilibrium level of inflation to be definitively higher than before Covid. What has changed is that the path to that higher longer-term outlook now looks more like a case of higher nearer-term inflation blending with longer-term inflation. The two are distinct, though. Higher nearer-term inflation is a function of strong growth, while our case for higher equilibrium inflation rests on the more exogenous forces of deglobalization, paying for an energy transition and the possibility of an increase in labor bargaining power driven by demographics.

Equity Market Dynamics

Market expectations have faded from six assumed policy-rate cuts to one for 2024, and yet the US equity market is up by nearly 15% year to date. The hope for both risk assets and bonds at the beginning of the year was the predicted rate cuts. Instead, the support has come from the US avoiding a recession and from the strength of mega-cap growth stocks. It is not totally obvious that the extra near-term growth has been sufficient to offset the hope of a decline in the discount rate, but that point does not seem to have mattered in the face of projections for AI-driven growth. Aside from AI growth and cyclical strength, two other important sources of support for risk assets need to be considered.

As for the first source, the US stands out in the degree of fiscal largesse that supports profitability (*Display 2*). Whomever wins the election, we think a high degree of fiscal support will remain in the near term, because it is too hard politically to roll this back. The election outcome would impact the form that this fiscal support takes, whether through tax cuts or spending. This support is likely to remain in place, and should not be underestimated as a near-term support for risk assets. It does prompt longer-term questions about debt sustainability, which has been a frequent topic in recent client meetings—we discussed this in a recent note. [1]

DISPLAY 2: US CORPORATE PROFITABILITY SUPPORTED BY FISCAL STIMULUS



Historical analysis does not guarantee future results.

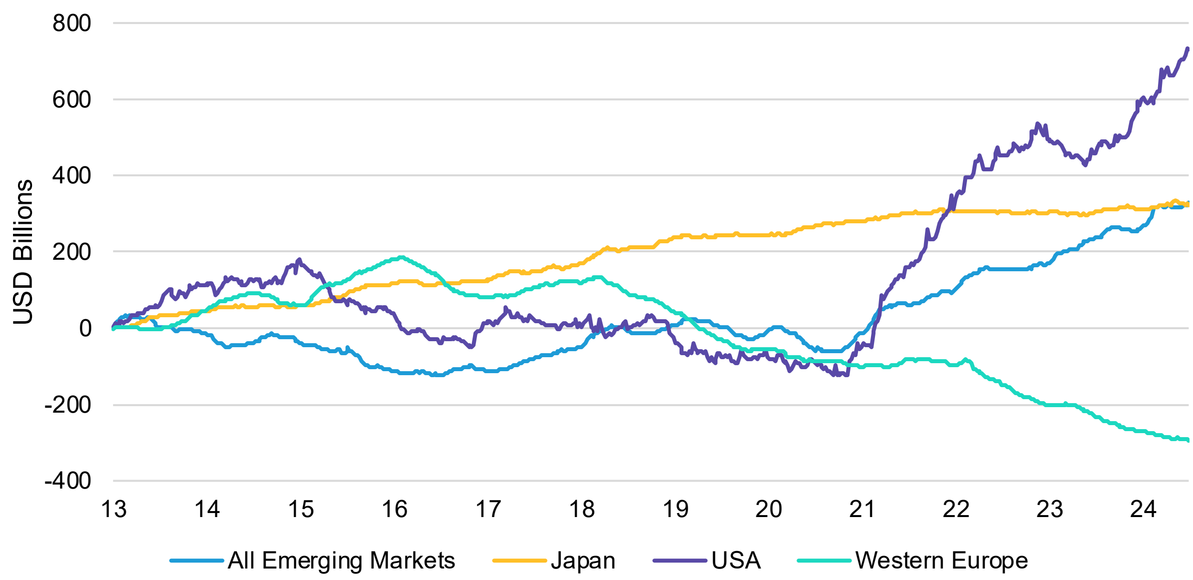
Through May 8, 2024

Source: Thomson Reuters Datastream and AB

Flows have been the second critical support for risk assets (*Display 3*), with material net buying of US (and Asian emerging market) equities this year. Year to date, the net inflow into global equities has been more than $230 billion, the lion's share into the US. This equity inflow had been partly matched by outflows from money market funds, but have now returned to net inflows as rate cuts have been pushed further out yet inflows to equities have continued.

[1] Inigo Fraser Jenkins and Alla Harmsworth *Notes from the Road: Summer 2024*, AllianceBernstein, June 26, 2024

DISPLAY 3: CUMULATIVE REGIONAL EQUITY FUND FLOWS



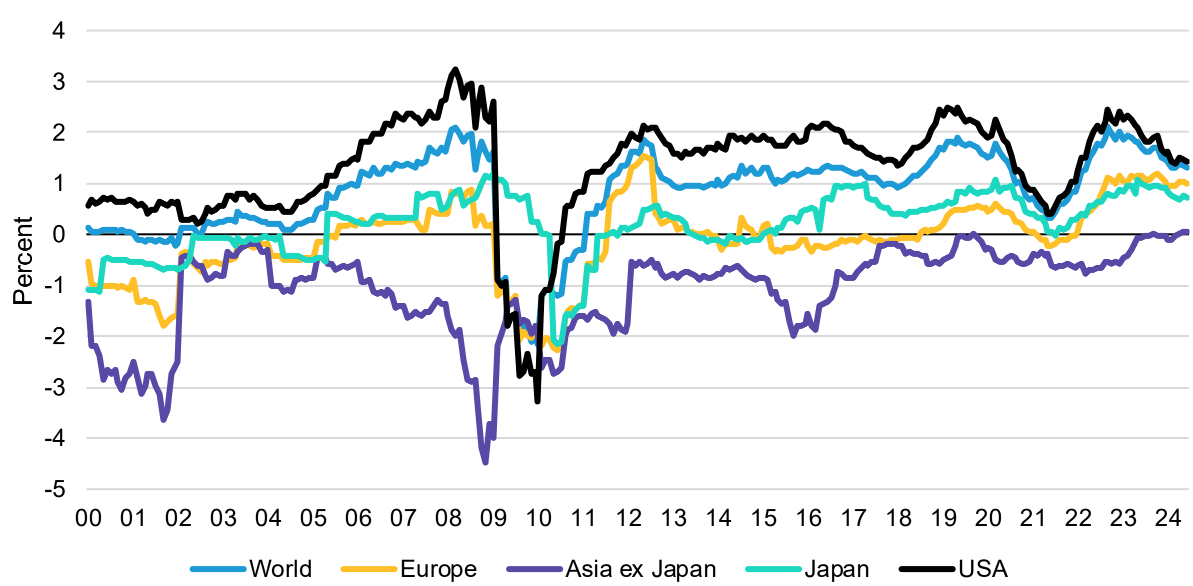
Historical analysis does not guarantee future results.

Through June 26, 2024

Source: EPFR and AB

One category of demand has beaten even investor flows, though—corporate net buybacks. Unlike investor flows, this dynamic is the same across all regions (*Display 4*).

DISPLAY 4: NET BUYBACK YIELD BY REGION



Historical analysis does not guarantee future results.

The display shows developed market regions. Asia ex Japan excludes China

Through June 27, 2024

Source: Factset, IBES and AB

Based on market trends and investors' observations, it seems that we are back to "there is no alternative", or TINA, investing mode again. Investors are wary of credit, with tight spreads a frequent comment made to us in client meetings. A flat yield curve and concerns about debt sustainability don't point to an obvious trade in duration, so investors are left buying US equities.

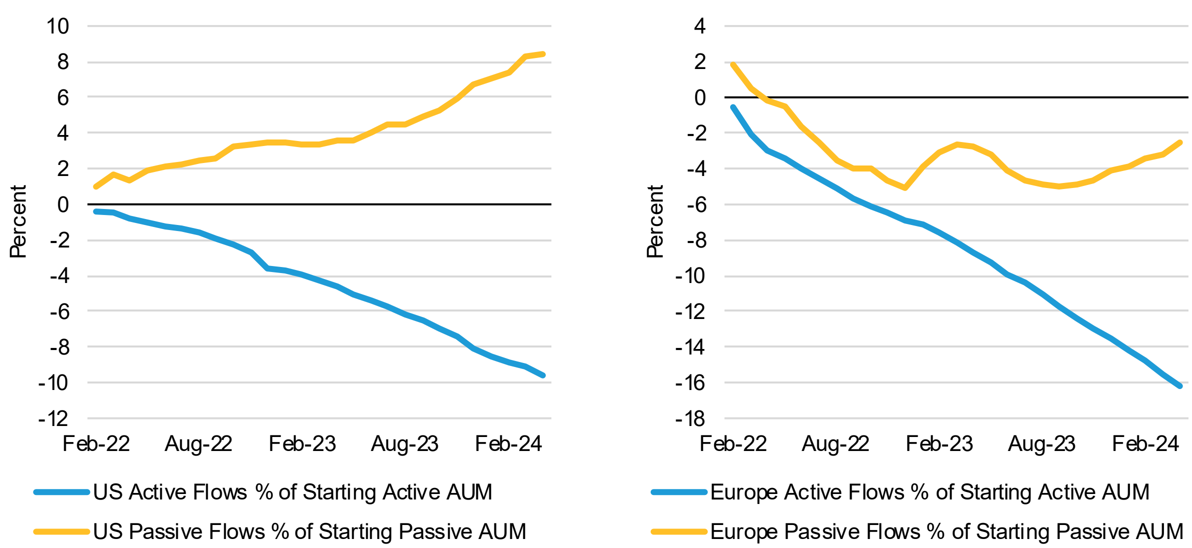
We do encounter a remarkable lack of concern in client meetings about market valuation. This appears to be reflected in a capitulation of bears, for example a decline in the volume of puts to calls for US equity indices. At face value, this is worrying, but how extended is sentiment exactly? Flow-based metrics, such as buying demand of funds and exchange-traded funds (ETFs) or slower-moving central bank data of overall demand for overseas equity, if added up for every region, implies that sentiment is extended.

However, other tactical metrics of sentiment remain better-contained and hence supportive. There has been a decline in speculative positioning in NASDAQ futures, and while the VIX is low, it has remained stable even as realized volatility has fallen faster. So, while investors might puzzle why the VIX is low, the spread over realized volatility is actually wide in the context of recent history. One problem is that, with the market so concentrated, do these sentiment metrics have the same efficacy?

Our read on this: It is easier to spell out the medium-to-long term strategic outlook for equities benefitting from being a real asset that is a key part of portfolios if inflation is elevated but not unanchored. Over a tactical horizon, we think that high valuations and a very elevated valuation of the momentum factor, with the absence of a definitive signal that sentiment is overextended, imply that the equity market should rise from now until year end but with a high degree of volatility.

One interesting point to note on the mechanics of flows is that, despite a very different overall flow picture for the US versus Europe, (with one loved and the other hated), outflows from active funds in the two regions are at nearly identical rates (*Display 5*). The huge difference in net flows is expressed only via passive vehicles, and we are often asked whether this dynamic will change anytime soon. The passive market has become "riskier" in the sense of its concentration and valuation, but we don't encounter any willingness to let that fact alter these dynamics. The key thing that would change this state is the realization by investors that in a new regime, the prospect of lower returns, higher inflation and less diversification implies that simple passive positions are less likely to outperform inflation, calling for a new approach to asset allocation. However, we realize that this process takes time.

DISPLAY 5: OUTFLOWS FOR ACTIVE SIMILAR ACROSS REGIONS—BUT NOT FOR PASSIVE (ACTIVE VS. PASSIVE CUMULATIVE FLOW, % OF STARTING AUM)



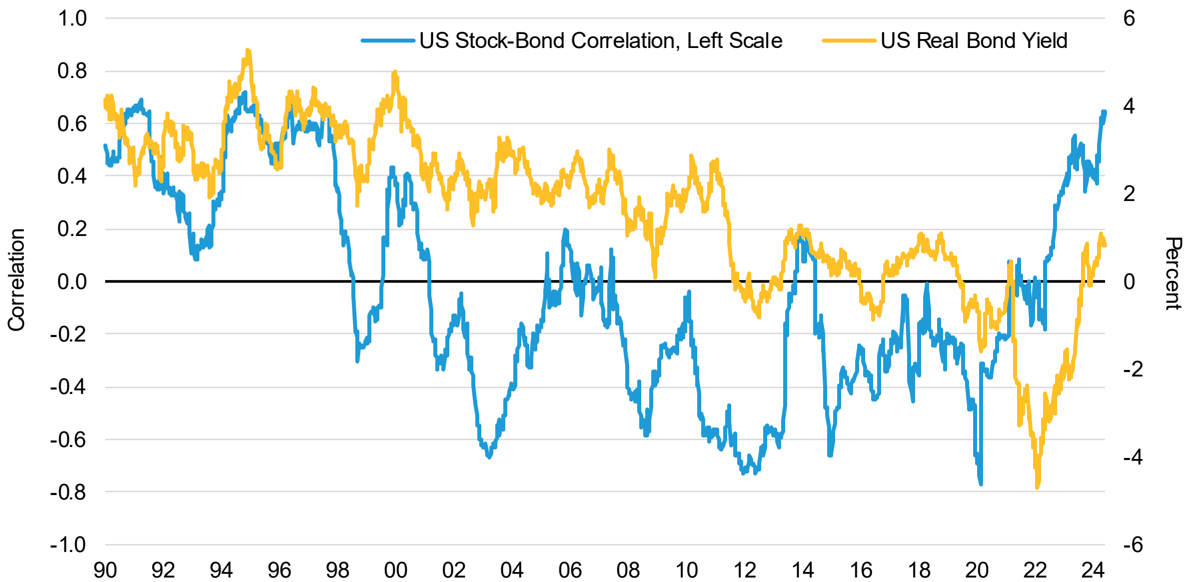
Historical analysis does not guarantee future results.

Through April 30, 2024

Source: EPFR and AB

We also note that stock-bond correlation has remained elevated, keeping up pressure on those who rely on it as a source of diversification in portfolios. This behavior has maintained its historical relationship with the level of yields (*Display 6*), so this is not just an issue for strategic asset allocation—there is a nearer-term need for diversification as well.

DISPLAY 6: US STOCK-BOND CORRELATION VS. US REAL BOND YIELD



Historical analysis does not guarantee future results.

Through June 25, 2024

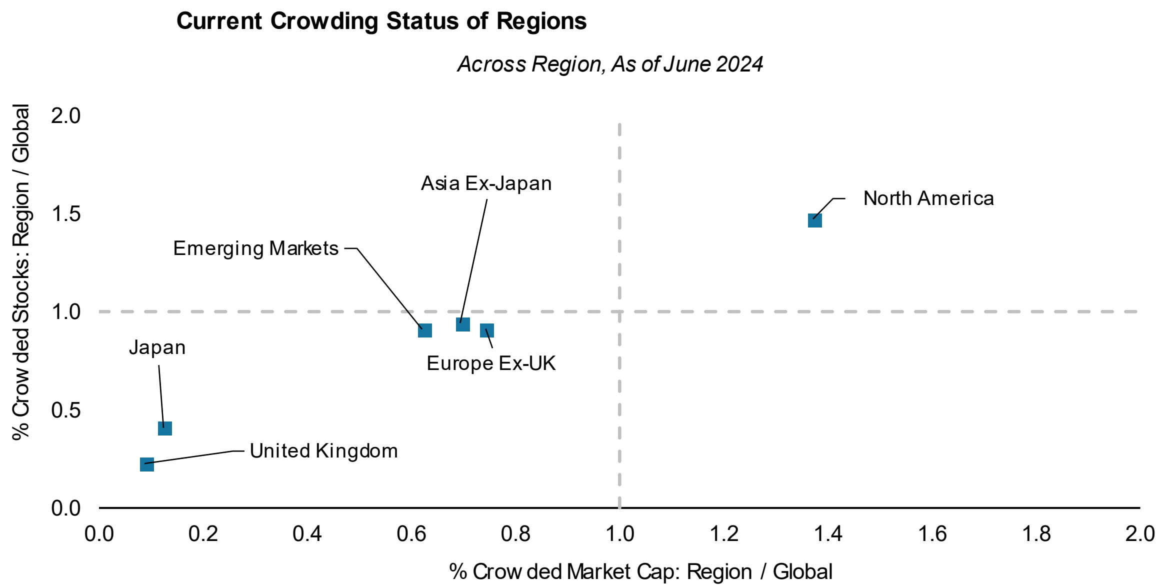
Source: Datastream and AB

Finally, we note that tactically, it is too hard to position against the momentum-growth trade. Nevertheless, to be prudent and guard against valuation-driven drawdowns given the very extended state of the growth-momentum trade, investors also need to hold value positions. We propose two possible elements of this below.

Post-Election UK

It might seem almost irrelevant to mention equities listed in Europe as a contender to hold in portfolios at present, such is the degree of investor ennui with such assets. However, the most hated market globally is the UK, in our view, which now screens as the most uncrowded market globally (*Display 7*). Its market composition with a solid pro-value sector tilt and the absence of a tech sector means that its composition is firmly against that of the pro-momentum zeitgeist.

DISPLAY 7: THE MOST HATED MARKET: UK CROWDING LEVELS ARE TINY



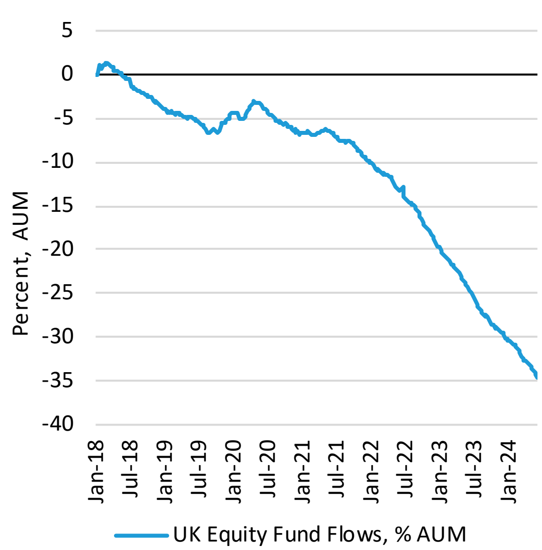
Historical analysis does not guarantee future results.

Through June 13, 2024

Source: Bernstein Quantitative Research team and AB

In addition to the lack of crowding, we would point to the remarkable monotonic nature of the outflows from UK equity funds, which have now lost 35% of their starting assets since January 2018 (*Display 8*). Moreover, the FCF yield of the market is significantly above the global average (*Display 9*).

DISPLAY 8: UK CUMULATIVE EQUITY FUND FLOW

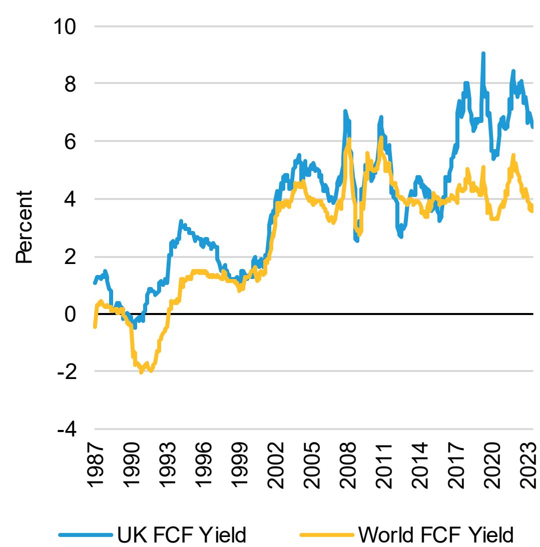


Historical analysis does not guarantee future results.

As of June 12, 2024

Source: EPFR and AB

DISPLAY 9: UK FREE-CASH-FLOW YIELD VS. WORLD



Historical analysis does not guarantee future results.

As of June 12, 2024

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

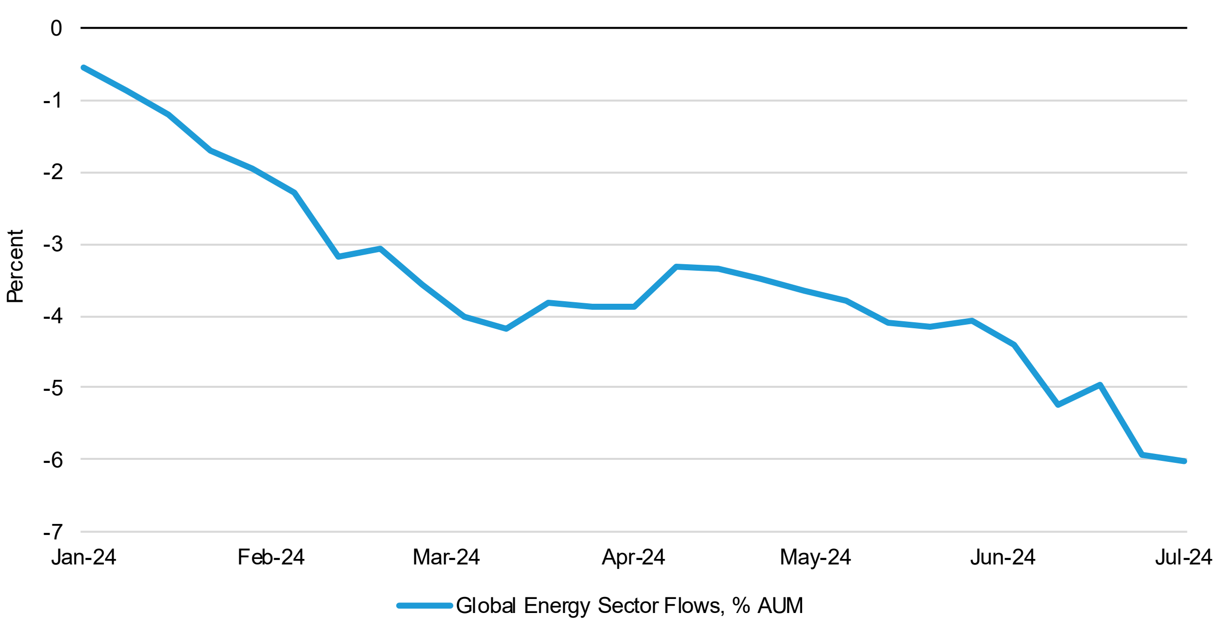
Yes, we get it. This is a value trade and, for equities listed outside of the US, hardly a confluence of attributes that has been popular. Also, the entire FTSE100 Index has a market capitalization smaller than each of the largest five listed US companies. However, we would argue that investors need some value exposure to guard against any volatility in the momentum trade. With elections on the radar of many investors this year, the UK and US elections could not be more different. The race in the US is highly consequential. The UK election, by contrast, potentially draws a line under a somewhat chaotic period in British politics and points to a possibly more stable, centrist period in which it is different from the likely paths in Europe and the US. The fiscal plans outlined by the main parties going into the election were very similar, so in that sense, the result might almost be deemed "boring." For investors, we would argue that boring is probably a good thing. Having the election out of the way could be a catalyst to trigger some inflows. We are happy to overweight the hated UK market.

Tactically More Positive on Energy

The other interesting trade within value would be the energy sector. For one thing, it offers attractive valuation in a market of few valuation opportunities. One can view the valuation in several ways, but we would particularly highlight its attractive global FCF yield of 5.8% versus 3.5% for the global market ex financials. A second aspect of energy's attractiveness is net buybacks, with the global energy sector buying back more than 2% of its stock per annum. This is in the context of an overall developed public equity market that is shrinking and will continue to do so over any realistic forecast horizon (we are very happy to get into debates with people about how far this trend can go). Energy is buying back its stock at the fastest rate among the large sectors

We have been struck by the growing number of questions from pension and insurance clients in recent months about commodities. They can have a role in inflation-proofing portfolios (more for investors with short horizons), but there is an important debate to be had about what a commodity allocation means over long horizons. Presumably, the weight of such allocation switches toward favoring copper and away from energy commodities over time. Having said that, the energy transition is taking much longer than was previously expected—governments are finding that they may have to extend time frames given a much broader step-up in the cost of living combined with fiscal constraints. The stretching out of these forecast time frames could be a medium-term catalyst for the energy sector. Also, from a sector flow perspective, energy has been deeply out of favor, with 6% of the AUM of energy-dedicated equity funds being net sold over the past 12 months (*Display 10*).

DISPLAY 10: GLOBAL ENERGY SECTOR EQUITY FLOWS



Historical analysis does not guarantee future results.

Through July 3, 2024

Source: EPFR and AB

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