Goldman Sachs Exchanges

2024 midyear outlook: building portfolios for a more volatile macroeconomic backdrop

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Allison Nathan: It's been a terrific start to the year for investors. US stocks have surged to all-time highs, outperforming even the most optimistic expectations. Meanwhile, bonds and even cash are offering substantial levels of yield. But are cracks forming under the surface? And how should investors position for the second half of 2024?

Alexandra Wilson-Elizondo: The macro backdrop is supportive. But we don't think it's going to be as easy in the second half as it's been in the first half.

Allison Nathan: I'm Allison Nathan and this is Goldman Sachs Exchanges.

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For today's episode, I'm speaking with Christian Mueller-Glissmann who leads asset allocation research in Goldman Sachs Research and Alexandra Wilson-Elizondo, co-chief investment officer of the multi-asset solutions business in Goldman Sachs Asset Management. We'll discuss their outlooks for asset classes and portfolio strategies heading into the second half of the year, as well as the medium- and longer-term asset allocation shifts they're making to accommodate what looks to be a more dynamic macro economic backdrop. Christian, Alexandra, so great to have you back.

Alexandra Wilson-Elizondo: Thank you so much for having us.

Christian Mueller-Glissmann: Yes, great to be here.

Allison Nathan: So, when the three of us spoke last December, you were both generally pretty bullish on risk

assets. We are now sitting in June with the S&P 500 at all time highs. So, equities have ripped higher. Bond yields have remained elevated. So, you were both pretty right. But if we think about the macro conditions today, Christian, are they just as supportive as they have been the last several months?

Christian Mueller-Glissmann: Yeah, I think so. I think at the margin, growth is pretty solid. Inflation is still coming down, even slower. You have rate cuts on the horizon. I think that's generally a backdrop where we want to be invested. And that was the key message.

Of course, as you said, it's been a very strong rally. So, what we've been recently in the last few weeks a bit worried about is positioning and sentiment. And we can talk about that. But generally, I think the macro conditions are still supportive to take risk.

We shouldn't forget that we're still having a few technology revolutions going on. That also helps. And that's typical when you're late cycle. I think it helps to make, in a late cycle backdrop, equities perform because you run a bit out of earnings growth usually. So, if you still have some

structural help that can support equities.

And I think one important thing we said last time, which I think is still true, is you can take a bit more risk because the bond market is likely to buffer you in case something goes wrong. And I think that was one of the key messages that we want to be invested because we feel that the balanced portfolio is looking a bit less risky in aggregate. So, net net, we stick with that view.

Allison Nathan: But as you said, things have run very far. So, from a valuation perspective, are things more stretched or more concerning at this point?

Christian Mueller-Glissmann: I think, listen, valuations are a difficult story late cycle. What we actually found is often in late cycle backdrops and there are certain elements of the business cycle that look late cycle right now, like unemployment rates are really low. Profit margins are high. Output gaps have been positive. Risk premia are low. And that's a common feature late cycle. And often, you have valuations late cycle being a bit more elevated and at the margin that constrains your long-term return potential. But it is not such a good market timing signal.

And from that perspective, the valuations are high, but we're not really taking it as a reason to be extra bearish compared to the macro conditions.

I think what is important as well is that we've built this new fair value model for the S&P and if you control for profitability, yes, valuations are high. But they're not that high because you have to consider that right now the ROE for the S&P 500 is one of the highest we've seen in 150 years. So, yes, the multiple right now looks high compared to the last 150 years. But so is the ROE. So, I think the valuation discussion is not that clear as a reason to be bearish.

But recently, we've seen sentiment positioning indicators turn quite a bit more bullish. And that has made us just in the last few weeks a bit wary about going into the summer. There are a few catalysts, I'm sure we're going to talk about that, that can potentially drive a bit of volatility. But it's not to the extent that we would change an asset allocation aggressively because of that.

Allison Nathan: And Alexandra, if I recall correctly, you

were also bullish, as I said. But maybe a little bit more concerned about growth risk when we spoke several months ago. Where do you stand now?

Alexandra Wilson-Elizondo: Look, we agree with similarly to what Christian mentioned that the macro backdrop is supportive. But we don't think it's going to be as easy in the second half as it's been in the first half. And by that, we do expect vol to go higher. I mean, look no further than the currency markets recently, which have been an expression of some of the political drama that's starting to play out in the different election cycles to see that we need to continue to expect the unexpected here.

But that said, like, zooming out big picture, we continue to see a benign macro backdrop. And that's going to be driven by softer, not soft, macro data. Christian mentioned some of the components of the labor market, like the unemployment rate, which still remains low at around 4 percent. But you are starting to see things like job openings decline materially. So, we saw something, you know, the lowest print in the last three years. And a lot of the stress intention that's been at the nexus of the growth inflation dynamic has been in the labor market. So, that

does give us some confidence that we're at least moving in the right direction.

And we do expect disinflation to start to reassert itself again, which we recently saw in both CPI and PPI prints. And spot data that starts to roll in a little bit lower than expectations. And recently, the Fed put exceptions back up to a pretty high level will give them the opportunity to do non-recessionary cuts. And that backdrop should be really supportive for risk assets.

Allison Nathan: So, you think about your asset allocation recommendations, Christian is sticking with a risk-on view. What's your view?

Alexandra Wilson-Elizondo: Yeah, we continue to be risk on. And quite simplistically, it's equities over bonds. And that's just based on the thought process that pauses are more supportive for equities than for the rate market. And we continue to expect to see high levels of rate vol just because we are so data dependent. So, with each print that is non-linear, you're going to see the market trade around.

And even recently, we've come back about 50 basis points

from the high. So, our expectation is you're going to start to see a little bit more of that play through through the rest of the year. But that, to what Christian mentioned, bonds are back. And income is a really important buffer to a portfolio. And so, depending on what the client is looking for, we do believe that it provides that strong ballast.

Allison Nathan: So, talking about that AI trade or that AI focus, obviously as both of you have alluded to, there's been tremendous optimism around that theme. Christian, what happens if that enthusiasm fades? How important has that been to this market performance? And do you think it can be sustained?

Christian Mueller-Glissmann: It matters quite a lot from two perspectives. I mean, first of all, you have a large part of the equity market in the US, the Magnificent 7, I think, being very closely associated with that theme. So, as a result of that, you do have a bit of concentration risk, you could say.

But it also matters from a cycle position. When you're late cycle, often there are two residual drivers that you're left with when the economy is running out of runway. One of

them is releveraging, restructuring, the corporate sector becoming more efficient. The other thing is optimism about a structural driver like a tech revolution. And that can become a really important driver late cycle. And can also drive material valuation overshoots. And we've seen that in the tech bubble.

And then, obviously, when the AI optimism fades, you're very vulnerable to the extent that even the tech bubble burst more or less caused the recession. The good news is, as we mentioned, we don't think that's the case right now. We don't think that equities are pricing an excessive AI optimism. But there is some AI optimism priced in. There are different ways to extract that. You can look at the long-term implied growth rate in the S&P 500. Which you can back on by the equity risk premia. That looks a bit elevated. And if you're late cycle and expect earnings growth in perpetuity to be high compared to history, that must mean you're expecting some structural boost.

And I think what we've also done recently, we've published a new report that looks at structural regimes and how they affect portfolios and valuations. And it allows us on the one hand to forecast in case certain structural changes are

happening what will happen to equities, to bonds, and also extract what the market's potentially pricing. And we have an AI scenario in there where we look at, essentially, different changes of productivity growth like similar to what the research from our economists have been. They expect a significant pickup in productivity growth. That means GDP growth goes up without inflation. Profitability might go up. And it allows us to model, like, let's say AI is a super success, how much is left in equities considering where valuations are right now?

And if we go for a soft, Goldilocks AI scenario we call it, we think that's probably priced. So, if you look at the long-term return forecast right now for a soft AI scenario, the long-term returns are in line with the long run average. Which means that if you get paid the long run average returns, it means the market reflects those macro conditions.

But if you go a bit more in the direction of our economists, and you might remember the famous 150 basis points improvement of productivity growth over the next decade, I think that is not reflected yet, we would say. So, I think the market in the next few weeks and month will essentially

look in probabilities. It will put 10 percent probability that this will be the super optimistic one. It will put 30 percent probability that it's more soft. We will learn over time how good it could be. And that narrative is critical for market pricing. So, we'll see that in particular with the results from specific companies. You saw that when Apple announced incorporating AI in Siri. I think these are all very important announcements for the market because they're trying to put together the AI mosaic. So, I think it matters a lot.

Allison Nathan: On top of the AI theme that's been so dominant, of course elections are very much in focus. Alexandra, you already mentioned we have seen surprising election announcements and results in many countries around the world already. And the focus on the US election, of course, continues to grow. If you think about the second half of this year, how are you thinking about election risk around your views?

Alexandra Wilson-Elizondo: Yeah. I think to your point, there have been a lot of surprises in the marketplace that have played through through the different elections. And we're about to go into a UK election and clearly starting in November we're going to see the US election.

I think what's going to be important here is that we can't expect the same policies as we have in the past from two people we've seen before because we're in a much different environment than we were in their terms. And I think that's where we have the opportunity to be a little bit surprised.

Overall, structurally, we don't think that there's going to be a material change in the deficit. But it's going to come from different places and different levers moving around, some of which could be highly inflationary if you think of things like increased levels of trade wars and trade dynamics.

So, from our perspective, it's going to be important to have different hedges and diversification in the portfolios. Some of them we talked about can be bonds, although bonds are exposed to supply risk and some of the rhetoric that could come out of the different policies. But moving towards some of the illiquid - so privates and portfolio diversification in the private sectors. And then equally, you know, if you think vol is going to increase, that's not necessarily a bad thing. There's a lot of opportunity for alpha. So, having active management in the portfolio or even things in the liquid space like hedge funds who can

take advantage of some of these dislocations will be really important.

Allison Nathan: Christian, do you agree with that approach, obviously, as we think about a more volatile period in the months ahead?

Christian Mueller-Glissmann: Yeah, I think we've been very focused on the summer period and hedges and the run up to the US elections. As I mentioned at the beginning, one of our concerns has been the strong rally, how the sentiment has evolved, and where the positioning is right now.

I think a few weeks ago, our risk appetite indicator, which aggregates 27 risk premium attributes across assets, it was at one of the highest levels we've seen since the '90s. It's come down since because you had already a bit of volatility to be clear. But I think we definitely think hedging into the summer makes sense from two perspectives. I think Alexandra already mentioned it. We have a slightly weaker data backdrop in the US right now. We're starting to see macro surprises turn a bit more negative. And they've stayed negative. Yes, we've had the inflation relief recently.

Slightly better inflation data. But if you look underneath the surface, it was driven by consumer-related categories, which kind of shows you what Alexandra already mentioned, we start to see a slightly weaker pattern in labor market data, in selective consumer areas.

And this is not the end of the world for the broad market. The equity market is not the economy. The economy is not just driven by these types of consumers. But I think if anything, it is actually bad news is good news because it might help the Fed cut. But it does increase the vulnerability to shocks because if the macro backdrop is already a bit fragile, and then adding external shocks like from geopolitics and politics, it's just not helping because it might create these vicious cycles between financial conditions and growth where equities take a setback. The market then worries about growth. That further weighs on equities.

So, we've also been focused a bit on hedging. It's been more soft, not to the extent that we would recommend worrying about large equity tails like 10% plus drawdowns, because we just think the economy's too good for that. And I think one important metric we're watching there is the private

sector financial balance.

So, I think one of the unusual things this cycle is you have certain parts of the economy being very late cycle, like the labor market, profit margins, equity risk premia. But the private sector financial health is very early cycle. And it's a lot to do with the fact that you had this huge rise in inflation post the COVID recovery that pushed up rates that actually caused deleveraging. So, normally what you tend to see is as you shift from mid cycle to late cycle, corporates and households are extending themselves. They are leverage up. But because rates have been so high going into the late cycle backdrop, you didn't really see that. You had a bit of fiscal help as well.

So, from that perspective, the private sector is in very good shape. And that actually increases the ultimate resilience of the economy. It's obviously still vulnerable to financial conditions. But it should be a bit more resilient.

So, we're less worried about the big shocks. But we want to diversify, look at selective hedges, private markets can be interesting. So, I think it's softer hedging.

Allison Nathan: A lot of investors seem to not want to hedge because it can be expensive to hedge a risk that may never come to fruition. But is it expensive today?

Christian Mueller-Glissmann: Yeah, I can start. And I'm sure Alexandra has views on this. But it is pretty cheap. And that's the good thing. I think the VIX is low. Like, equity volatility is low. But certain other volatilities are even lower like FX volatilities are particularly low. We see a lot of interest in using FX hedges into the elections. Like, for example, long the dollar because there's a perception that a certain election outcome, especially related to trade tariffs and related to geopolitical uncertainty could be very supportive of the dollar. But also positive drivers around elections like reflation and things like that accelerating. All of that could be positive for the dollar. And FX volatilities, enormously cheap allowing you to protect for that.

And this is a typical late cycle feature. When you're late cycle, usually you're in a stable macro backdrop. Unemployment rate is low. Profit margins are higher. Which means the corporate sector is healthy, as I mentioned. And that often means that you cap the most extreme tails. And that's then when volatility tends to be,

from a macro perspective, lower.

There are a few special factors this time around which we can get into if you want. But there is also a lot of supplier volatility currently, especially in equities from certain ETFs and certain systematic strategies. This is also typical late cycle. Often what happens late cycle is that quantitative strategies and the derivative investors try to squeeze the last carry out of the market. And that often creates opportunities for hedging.

So, we are a bit in that spot. And that creates opportunities. We would be not necessarily buying deep out of the money put options betting on a bear market. But hedging for specific risks, for specific events, I think, makes a lot of sense. And we see a lot of our clients literally use options to hedge specific days these days, specific weeks where they're worried because it's so cheap to protect their portfolio.

Allison Nathan: Alexandra, is that what you're seeing as well?

Alexandra Wilson-Elizondo: Yeah. I think that was

extraordinarily well articulated. In particular, I think that there are two types of hedging, if you will. There's the one where you're using options markets or you could be using currencies to protect your portfolio a little bit. But there's also the opportunity to rotate across assets.

So, for example, if you look at corporate credit, to your point, it's trading to the fact that corporations are doing extraordinarily well. And it's trading very close to post GFC tight levels. So, you can hedge, if you will, your portfolio by underweighting a little bit of that extra carry, which quite honestly is very minimal, and going into the rate market. So, there are multiple ways that you can be adjusting your portfolio right now to protect it should you have any of these left tail type of events come to a fruition.

Allison Nathan: So, there has been so much focus, at least as we sit here in New York, on the S&P 500 and its record highs. But if we look across the pond, even to the UK, but France, we just had some tremendous election volatility in the last week, how have markets performed? And what do we expect ahead?

Christian Mueller-Glissmann: Yeah. Let me start. I think

generally we've been in favor of international diversification in the last two, three years. And it's a feature that is usually quite valuable when you have high inflation and high inflation volatility because it tends to drive more cycle divergence because there's more policy divergence. And that's exactly what we've seen.

You could argue that Europe is, from a macro point of view, in a slightly better backdrop right now. A bit less hot. A bit less late cycle. There are kind of policy cuts. The ECB has actually already cut, which can create certain supports. So, at the margin we were kind of arguing for more international diversification. But it comes with risks, of course. Because the US equity market does have the technology revolution at its core. And, obviously, has been an incredibly strong performer, is a very liquid, large market.

So, we've been a bit more focused on Europe. And as you were saying, that's taken a bit of a hit recently. Coming back to the old problems of Europe where often there is a lot of political volatility that scares off investors. I think we still think that the European equity market is offering good value here because you have a better cycle position. You

have a few more optionalities for the cycle to extend. And there is a lot of value, literally value, like valuations are cheap that can create restructuring, that can create releveraging.

So, now to your questions on the French elections, I think generally we would argue that elections will not materially alter the outlook for Europe and possibly even for France. If anything, there's a potential for gridlock. And the fact that you're now seeing that volatility emerge might actually be an opportunity to look at Europe and, in particular, look at opportunities in Europe that are under pressure even though they shouldn't be.

Never forget that a lot of companies in Europe are very international, they're just listed in Europe, but most of their revenue will be outside of Europe. And if they are coming under pressure just because of elections and elections come and go, we would actually see this as an opportunity to look at those.

Allison Nathan: Alexandra, what are your thoughts about Europe and beyond?

Alexandra Wilson-Elizondo: I think similarly to what Christian was mentioning in terms of, you know, could be an opportunity to buy the dip as people trade on fear rather than actual outcomes. We do think that Europe is a space where you need more active management rather than passive exposure because of some of the things you mentioned. Higher in value. More cyclicality. A lot more banks. Autos, if you will.

And so, it's a place where you can add value to your portfolio. But we need to spend a little bit more time lifting under the individual names in the hood. And when we talk about the expansion of breadth in terms of earnings, we do see potential for that to happen in Europe. And to your point, this is a really unique cycle because Europe cut before the Fed, which is rare. And that typically is supportive for a risk asset. So, cautiously optimistic is how I would characterize our view on European.

Allison Nathan: And what about Japan which has seen a lot of attention lately as well in terms of the equity market there?

Alexandra Wilson-Elizondo: Yeah. So, from our

perspective, we believe in the Japan story. We think this is more of a structural than cyclical storyline that we want to have exposure to in our portfolios. You're seeing two separate dynamics. One is there is a very strong desire from the Japanese government to have real inflation and nominal growth in the economy. And at the same time, you've got a lot of restructural reforms happening within individual companies that would ultimately support better ROEs and better valuations.

So, you're going to see a little bit of volatility, especially with announcements from the BOJ in terms of what they're doing with bond purchasing and rate levels and the currency. But over time, we do believe that this is still a nice valuation story and a way to get diversification into the portfolios.

Allison Nathan: And if we cut through the noise of the volatility that we expect in the coming months and think longer term, has there been any evolution in your thinking about how investors should be thinking about the medium- and longer-term horizon in terms of their portfolio risk?

Christian Mueller-Glissmann: We published this piece,

Strategic Balance Bear, looking at the next five to ten years, trying to understand the corner solutions, the most extreme scenarios you could see from a structural perspective. We discussed one of them already, the ultra bullish AI scenario. But a lot of our clients, they are worried about more unfriendly scenarios like will we have higher inflation with less growth compared to the last 20 years? Will we go to stagnation considering what's going on in China? Structurally, what's going on in Europe?

So, this report goes through all of these scenarios and then creates the optimal portfolios for those scenarios. You can then assign probabilities, what is the likelihood, and try to create something that's robust for all of these different scenarios.

So, to answer your question, short now, what's the optimal portfolio that we've arrived at? It's one-third equity, which is with a tilt towards growth equity to capture the innovation. And I'm not just talking about AI. We have several other innovations currently all going on. Renewable energy innovation, healthcare innovation. And I think that is a problematic part of this portfolio, we can discuss that, because growth equities are already a bit expensive. But

still, if you do have that bullish scenario coming through, even from those valuations you could argue that growth equity can still offer you very attractive returns.

So, one-third equity with a tilt towards growth. One-third bonds. And one-third real assets. And the real assets address the concerns regarding inflation, high inflation volatility, stagflation. But now comes the funny part. If you now take from the one-third real assets 20% or so, put it back into equities, because equities can be real assets if you buy the right equities, you can buy infrastructure, you can buy maybe even real estate at some point again, commodity equity, or you can buy companies with pricing power, that is also a real asset. So, you put that back into equity. You're back at 55 - 60. And then you take the rest from the real assets into TIPs, indexing bonds that are also having inflation protection, put it back into bonds. So, you're back at 60/40, which we often end up at and which has been the right asset mix for the last 150 years. But certainly not the last few years. But you have a 60/40 portfolio which is actually robust to a lot of the worries we hear from investors right now.

Allison Nathan: I was just about to say, I mean, did you

just do a lot of work, Christian, to kind of get back to what we kind of already know?

Christian Mueller-Glissmann: Well, I mean, the headline is the same. But what you do within the 60 and within the 40, that's important and that's new.

Allison Nathan: Interesting.

Alexandra Wilson-Elizondo: Yeah, we would agree with that analysis. And in fact, I think one of the things that's causing the reevaluation is because bond yields are so much higher than they have been over the last decade or so. Which makes risk premium in equities look less appealing. That said, I think one of the things we're spending a lot of time on is just the shape of the bond curve.

So, we expect more demand for term premia or plainly stated, that the more you extend out in lending, that you should be compensated more. And right now we know the curve is inverted. And that should just be a reflection of what Christian mentioned, higher inflation risks, higher supply risk. And so, over time, we do think that, yes, we

will have that ballast and that 60/40 concept is very important. But we continue to see the value actually in the front of the curve until we see that shape take more of a steepness in the back end.

Allison Nathan: So, what I'm taking away from this conversation is still risk on, lots of volatility ahead, cheap ways to hedge it, but stick with 60/40 over the longer term with some nuances to make sure that you're covering yourself for the specific risks that we're facing.

Christian Mueller-Glissmann: I think that's fair. I think we need to be clear that one wants to stay agile late cycle. And one wants to watch the data. I think generally late cycle backdrops on their own are not that scary. Late cycle periods can last a long time. You can have the unemployment rate down at low levels for a very long time, profit margins can stay high. But we need to watch momentum.

And I think we are not worried, like both our economists and based on our cycle framework, we're not worried about an unfavorable late cycle scenario. But I think we need to be a bit agile. I think that we're doing the best we can with

building this, you could say, advanced 60/40 approach. But I think we need to recognize that we're late cycle.

Alexandra Wilson-Elizondo: Yeah. I think the one other thing to highlight is that there are certain themes that are persistent in the market narrative. But there is a lot more happening out there. And so, to your point on being agile, sometimes it seems just paying attention where nobody else is in certain corners. And there are spaces that are going to really benefit from some of the larger themes that we're seeing.

So, we talked a little bit about commodities. But there is a lot of value of adding commodities to your portfolio right now. And in particular, we're looking at things like copper, which are going to be big players in the EV revolution. Supply we're expecting to be down over the next couple of years. So, I think the message we would add onto how well you articulated and concisely you articulated our conversation is just keep your eyes open. Look in the corners. There's a lot of stuff to be done right now.

Allison Nathan: Christian, Alexandra, thanks so much for joining us.

Alexandra Wilson-Elizondo: Thanks for having us.

Christian Mueller-Glissmann: Thanks.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Friday, June 14th, 2024. I'm your host, Allison Nathan.

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