BNY MELLON
iFlow
MACRO MORNING BRIEFING

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Asset Allocation And The Four Ds

The world in the first quarter of 2024 has struggled to differentiate itself from 2023. The level of uncertainty has forced investors into cash equivalents and stocks. Low-volatility and high-carry trades have been winning, passive strategies beating active ones, and tighter ranges trumping trends as no one seemingly wants to be over-positioned for good or bad outcomes. The strip for a so-called soft landing is narrow. There is also a larger thematic focus on a world divided, which leads to the four Ds:

De-globalization, De-carbonization, Digitalization, Demographics

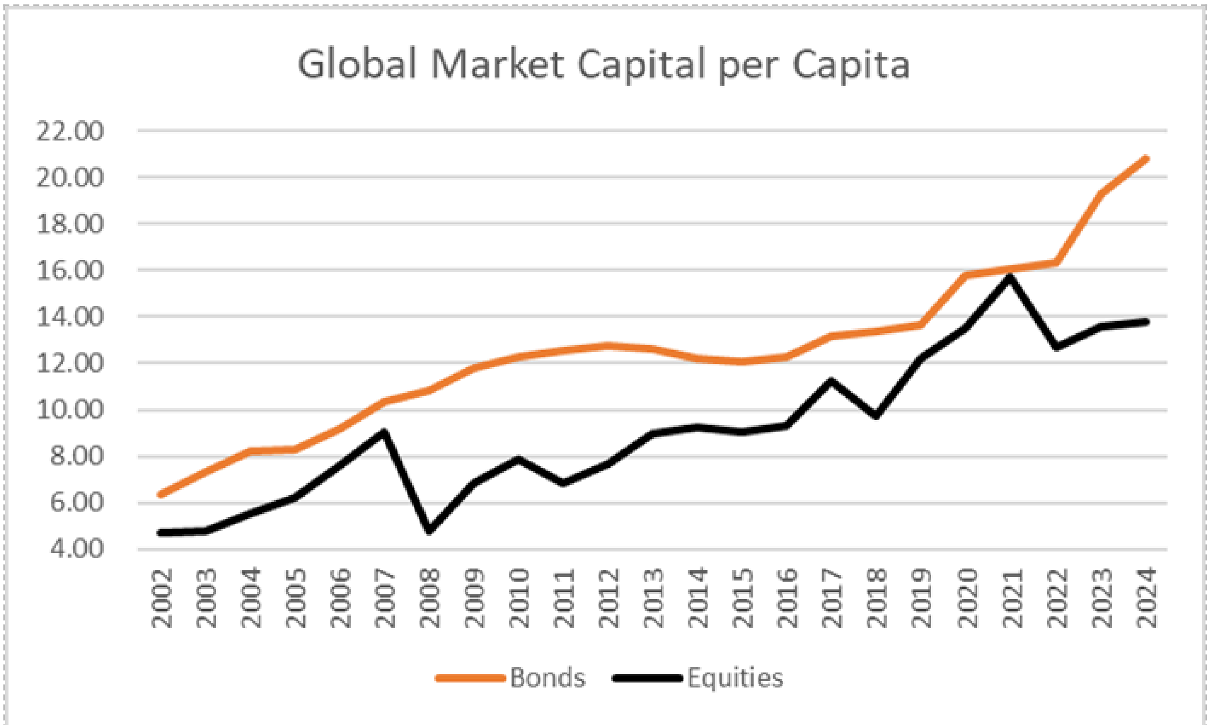
The big-picture themes of 2024 are caught in the technicals of 2023. The first problem for investors is getting bonds back into a portfolio and moving away from cash. The second is considering risk outside of the 'home bias'.

- Global bonds outstanding total $133trn across maturities, growing 7-fold in the last 40 years, fueled by government and corporate issuance across both G10 and emerging market countries. The convergence of flows in 2024 into any bond chasing yield over ratings stands out – narrowing spreads across credit and nations usually leads to issuers.
- In contrast, global equity markets have risen 5-fold in market capitalization, but the number of listed companies has risen by just 1.9 times. By definition, then, the risk in shares is more concentrated. What's more, this rise in listed equities falls short of the rise in the global middle class from 15% to over 50%. This suggests an inherent need for more equities as the world’s savings increases faster than does the supply of stocks.
- Approximately 55,214 companies were traded publicly throughout the world as of December 2023 (latest data), a 1.9% y/y decrease – some of which reflects the rise of private credit and private equity, along with stalled growth in China and APAC, where new company creation in the previous decade dominated.

Diversity no longer attracts money as risk-mitigation – only a few shares globally have led the markets. The question investors face: when will this concentration risk end?

- Even more concerning is that actual coverage by analysts of those names has shrunk. For example, 19% of the NASDAQ has no coverage and 14% has just one analyst covering. Trading volume and market capitalization are the presumptive drivers for analyst coverage, and yet the world requires AI to solve for this gap. New diversification pressures will likely feed more AI investments. This begets more concentration risk, as well as concerns globally about US exceptionalism remaining dominant.

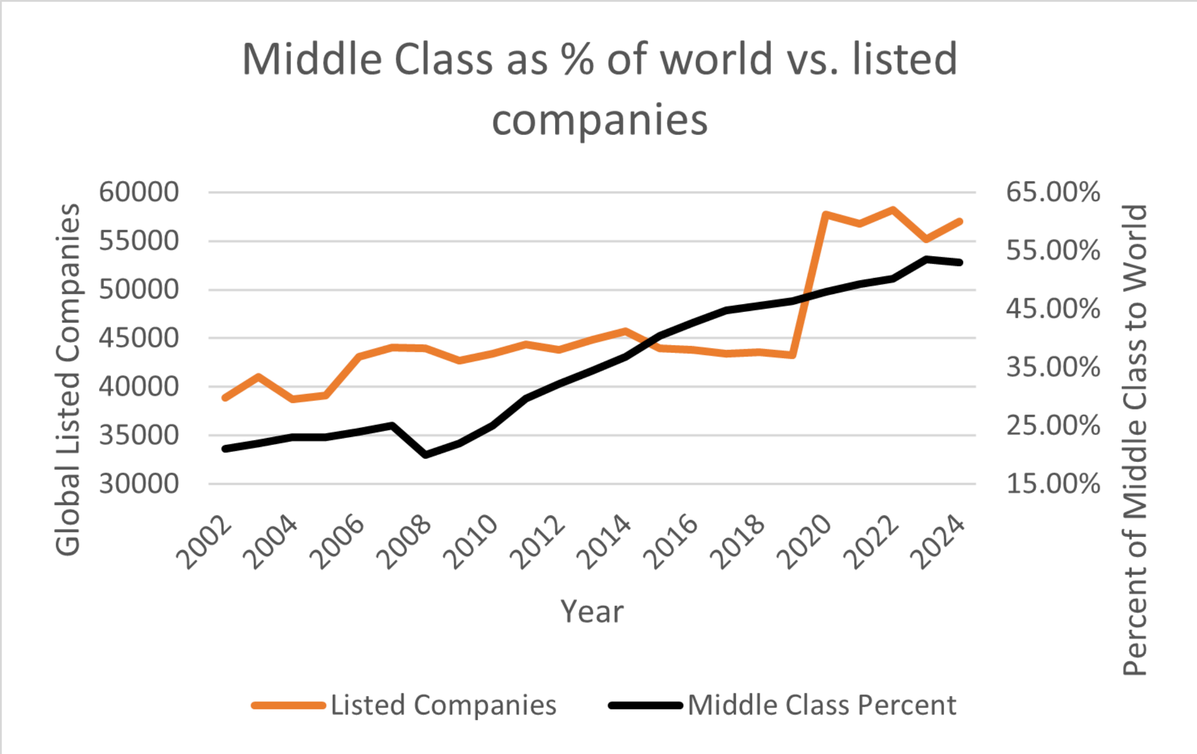
Bond Supply Outstrips That Of Stocks In A Growing World



Source: SIFMA, World Bank, BNY Mellon

What we find more interesting than the rise in bond supply over that in equities is the rise in the global middle class during the last 20 years. Defining 'middle class' in a world context is quite different than in a developed-markets context. The World Bank definition is $10-$100 a day in PPP terms set to a 2005 index base. Most of the cohort is in India and China, and they invest more in stocks than bonds. Our point is twofold: in the last 20 years, the supply of shares has not caught up to rising demand, and capital markets developments in these economies have been inconsistent. The rise of the middle class everywhere drives domestic equity growth more than borrowing across the world. The role of government borrowing has clearly shown up in the ratio of GDP to government debt, with both the US and China across all administrative levels (States/Provinces) suffering from an oversaturation of debt. There is a tipping point for debt capping growth globally. Post-pandemic debt issuance has surged globally as the OECD noted this week.

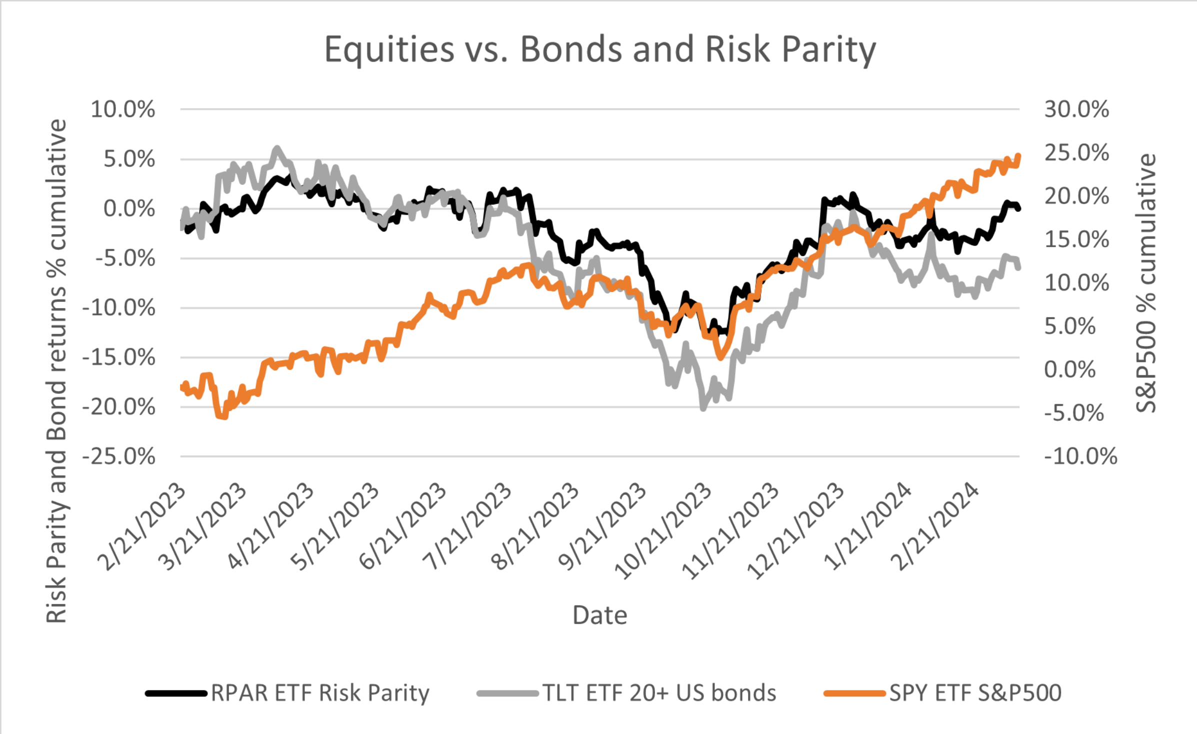
Global Middle Class Key To Asset Allocation



Source: World Bank, OECD BNY Mellon

From 2005 to 2015, middle-class expenditures grew by 8% y/y in developing countries, compared to growth of 0.4% y/y in developed countries. In some of the fastest-growing emerging and developing countries, the annual growth of middle-class expenditures exceeded 10% in the 1990s and 12.5% between 2005 and 2015. The great convergence has stalled both developed and emerging market middle-class spending and growth. But that convergence shows in our flows: the difference between EM and G10 markets against the US is almost indistinguishable. Risk parity worked during the painful US regional bank crisis in March 2023, but not since. Owning US bonds and duration hasn't worked since then, either. The 60/40 portfolio usually outperforms in an election year. Risk-parity programs work from April to August in a 50-year seasonal backtest, but this might be different in 2024.

Risk Premia Out Of Sync



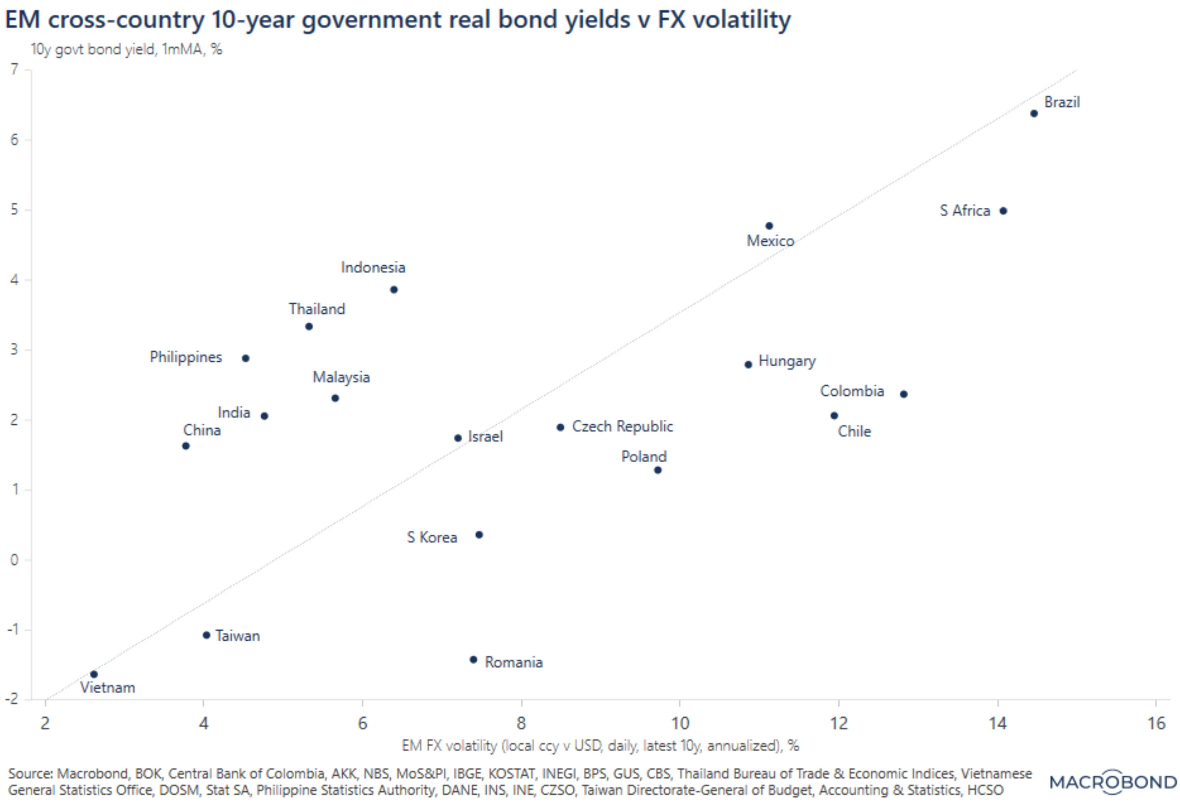
Source: Bloomberg, BNY Mellon

1. **Diversification -** What will drive investors out of cash or money markets and into longer duration holdings? Thematic pressures of diversification globally haven't worked yet, so US exceptionalism dominates much of the focus. The need for easing by the Federal Reserve dominates global investor themes. Risks this year stem from refinancing: 40% of sovereign debt and 37% corporate debt need to be rolled over the next three years. Global growth risks rise without easing in Europe and some emerging markets – given China's recent NPC targets were viewed as somewhat underwhelming. The pressure to meet Green goals for 2030 requires more money-raising in a market that has pushed back against ESG. According to FactSet, the lowest number of S&P 500 companies cited "ESG" on Q4 earnings calls since Q2 2019. As per our iFlow Green index, ESG factors are not showing positive alignment on a consistent basis with equity flows, possibly indicating a decline in importance among global investors. The de-carbonization theme for 2024 puts China EV production and demand into question – and adds to recovery doubts.
2. **De-Globalization** - This theme matters to investors in 2024 but wraps around supply chains and the focus on the two wars – those conflicts are driving wedges across emerging and frontier markets. iFlow shows clear investment doubts in Europe linked to war. But some investors are beginning to shift to what happens in a peace deal, for either or both conflicts, and which sectors and nations could win. The primary concern for investors when discussing

"globalization" is in the tail risks of an extended conflict pairing Russia and increasingly China against the US and EU in a cold-war scenario.

3. **Digitalization.** The digitalization push dominating markets at present flips between the role of AI in enhancing productivity to "Defi" where Bitcoin (BTC) and financial disintermediation of banks accelerates, particularly in EM where fiat currency and national financial institutions like a treasury or central bank aren't viewed as strong. Record highs in BTC have been taken as another signal of liquidity being too "easy" globally, and of distrust of USD in a deglobalized world. Both feed back to the diversification problem. The BTC rally vs. the NVDA rally are different and merit deeper analysis.
4. **Demographics**. This theme clearly shows in our iFlow data, e.g., the rush into Egypt fixed income after the IMF deal and shift in EGP FX policy to a quasi-free-float regime. Investors are focused on the potential growth of Indonesia, India, the Middle East – particularly Saudi Arabia and the United Arab Emirates – and Africa, where Nigeria, Egypt and Kenya all register as key frontier opportunities for the next five years.

EM FX Volatility & EM Real Yields Key For Risk:Reward



Source: MacroBond, BNY Mellon

Bottom Line: The current environment of low FX volatility, trend-chasing in equities and tight credit spreads in fixed income has investors implicitly using carry/volatility comparisons. The ability to predict when this changes rests on economic data to come, overlayed by central bank decisions in Japan, the US and elsewhere in the week ahead. The convergence trade of EM to G10 markets was the story of 2005-2015. The new re-convergence risk is central to 2024. Real yields in liquid emerging markets can help to gauge flow risks in the wait for the FOMC and more data, and while investors struggle to believe that bonds can provide some hedge to an equity downturn. What we find interesting using this analysis is how much it matches the lack of positioning in EM bonds in APAC vs. other regions. The risk:reward of the next few weeks and months will hinge on whether a sense of urgency to trade the four Ds develops over the 2023 hangovers of US exceptionalism and AI dominance.

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