

EXECUTIVE SUMMARY

- The global economic landscape reflects moderate growth, lower inflation, and falling interest rates. This environment typically bodes well for corporate earnings and equity returns. Yet the outlook is notably fragile and uncertain.
- During the third quarter the consensus mood of investors fluctuated and drove market volatility as confidence in an ‘economic goldilocks’ gave way to fears of an imminent recession. Faith in the resilience of the US economy has been at least partly restored, but such volatile sentiment is likely to repeat.
- Whilst forecasting any single outcome with accuracy is close to impossible, we assess US economic scenarios over the coming 12 months through a consistent framework, outlining the most convincing evidence for a continued moderate rate of expansion. This supports our selective participation in global equity and credit assets with broad portfolio diversification.
- Recent disappointment from a range of Chinese indicators of activity underscores the challenges facing the world’s second largest economy. A sizable stimulus package, announced by the authorities in recent days, may boost investor sentiment in the near term. However, it is unlikely to ignite consumer and private business confidence and drive the real economy to higher growth rates.
- The Artificial Intelligence investment theme has evolved significantly this year. As the year has progressed the initial wave of excitement has cooled. Investors have become more discerning around which businesses stand to benefit from AI, and how quickly.
- Our equity strategy captures the AI theme through a sizable allocation to the US market as the core growth engine of multi-asset portfolios, and by investing in a diversified range of specialist active managers.
- Insurance Linked Securities, specifically the Catastrophe Bonds (CAT) segment, represent an attractive allocation in our alternative component. Beyond the high-income generation, underlying risks are independent from the economic cycle and are therefore highly diversifying for equity and fixed income portfolios.
- The global cycle has matured, and a range of geopolitical and economic risks create a fragile backdrop for portfolio allocation. We remain constructive on continued opportunities for risk adjusted returns over the coming 12 months and beyond, but are deeply aware of the potential for a period of heightened market volatility.

INTRODUCTION

Following a strong upswing in global growth during the first half of the year, economic momentum has cooled in recent months (figure 1¹). The US economy, strengthened by resilient consumer spending since the pandemic, is now experiencing a ‘soft landing’ as growth moderates. Europe has stabilised and is gradually recovering, having stagnated over recent years, yet persistent manufacturing weakness weighs on confidence and activity, particularly in Germany.

In China, recent disappointment in industrial profits, retail sales, real estate investment and youth unemployment underscores the challenges facing the world’s second largest economy. A sizable fiscal and monetary stimulus package, announced by the authorities in recent days, may boost investor sentiment in the near term. However, it is unlikely to ignite consumer and private business confidence and drive the real economy to higher growth rates.

Now that the labour and commodity market imbalances of recent years are largely normalised, prices are rising at a healthier pace. Lower inflation and softer growth mean that high interest rates are no longer required. Major central banks are almost coordinated in a gradual loosening of financial conditions, which can cushion the global economy over the coming months.

The global economic landscape is therefore one of moderate growth, lower inflation, and falling interest rates. This environment typically bodes well for corporate earnings and equity returns. Yet the outlook is notably fragile and uncertain. Over the summer the consensus mood of investors fluctuated and drove market volatility (figure 2¹), with confidence in an ‘economic goldilocks’ giving way to fears of an imminent recession.

Since then, faith in the resilience of the US economy has been at least partly restored, with the global equity market recovering to reach a return of 18.7%² for 2024 so far. But such volatile sentiment is likely to repeat. The risk of further geopolitical escalation with financial market impact remains high, and the US presidential election is just weeks away, promising a close outcome and potential calls of foul play.

Figure 1: Economic softening led by manufacturing

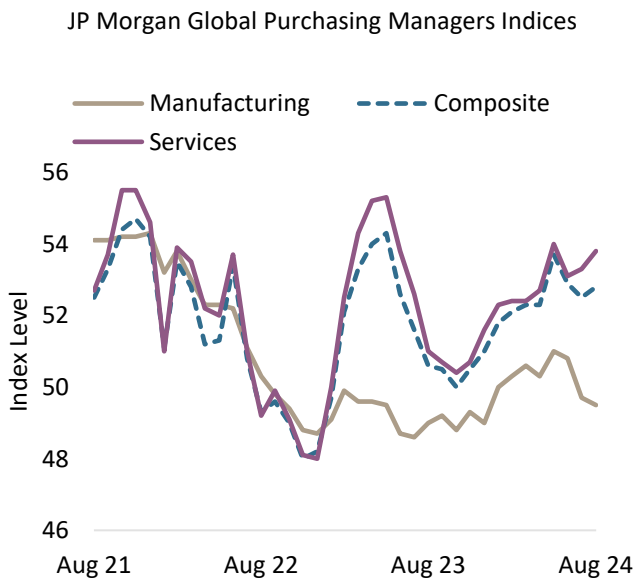
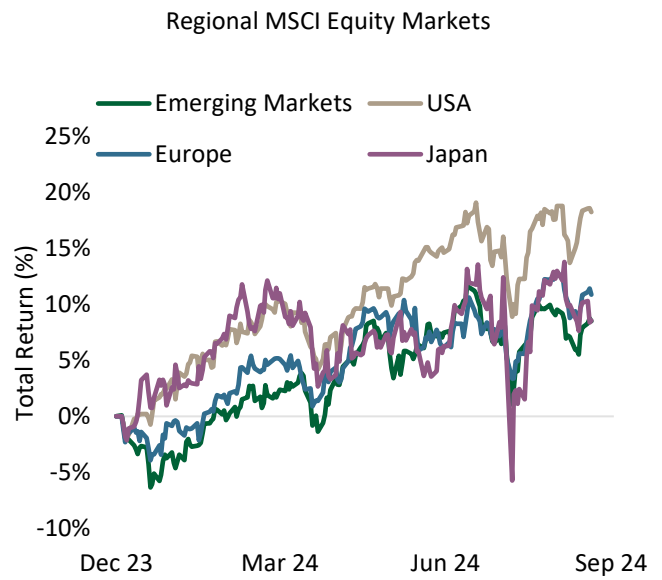


Figure 2: Equities recover as volatility picks up



As we look forward to 2025, the risk of an unforeseen external shock, or a more meaningful economic deterioration, requires a well-diversified spread of assets and flexible portfolio approach.

¹ Source: Bloomberg, August 2024.

² Source: Bloomberg, USD, September 2024.



In section 1 of this quarterly Investment Outlook we review the key US economic scenarios that are critical in the setting of our overall investment strategy, and provide an update on developments in China. In section 2 we outline how we are positioned to capture the evolving Artificial Intelligence (AI) theme within our equity strategy, and the appeal of a key diversifying alternative asset – Insurance-Linked Securities (Catastrophe Bonds).

Having focused on the potential consequences of a second Trump US administration, and considerations around US fiscal debt, earlier in the year, we will cover the broad investment ramifications of the forthcoming US presidential election in a mid-quarter update following the result.

Section 1. Assessing the Global Economy

1.1 US growth has shifted to a lower gear – will it falter or reaccelerate?

After a strong post-pandemic recovery, the US economy is no longer firing on all cylinders. Critically, the labour market, which is the lynchpin for the consumer-centric US economy, has weakened over the course of this year. As inflation pressures have receded, Jerome Powell, the Chair of the Federal Reserve, has highlighted how they “do not seek or welcome further cooling in labour market conditions³”. Unemployment has risen, partly because new entrants to the labour market (either through immigration or returning after the pandemic) are not finding employment as quickly. Other timely indicators, such as initial jobless claims, are not sounding alarm bells.

For now, the economic growth is softening but remains positive. The combination of declining gasoline prices, lower mortgage rates, a Federal Reserve interest rate cut and a strong stock market is keeping consumer spirits high and underpinning spending.

What comes next? To answer this, we assess economic developments through the lens of possible scenarios over rolling 12-month periods (figure 3). This table summarises four scenarios with estimated probabilities.

Whilst forecasting any single outcome with accuracy is close to impossible, this framework offers a consistent reference for reviewing the evolution of the economic cycle, judging emerging risks and setting investment strategy.

Figure 3: Scenario analysis for the US economy

Scenario (next 12m)	Severe Recession	Mild Recession	Growth Moderation	Growth Acceleration
Probability	10%	30%	50%	10%
GDP growth	-10% to -2%	-2% to 0%	0% to 2%	>2.0%
Inflation	<1.0%	<2.0%	1.5% to 2.5%	>2.0%
Unemployment	> 8.0%	6.0% to 8.0%	4.0% to 6.0%	3.5% to 4.0%
Interest rates	Near zero	1.0% to 3.0%	3.5% to 4.0%	>4.5%
Precedent	2008, 2020	1991, 2001	1995	2023

³ Source: Speech by Jerome Powell, Federal Reserve Chair, 23 August 2024.

1.1.1 Why growth is more likely to slow than reaccelerate

Whilst US growth has faded in recent months, perhaps it could reaccelerate into 2025, as businesses hire at a faster pace and consumers spend at a consistently elevated clip? This is possible, particularly if interest rate cuts are rapid and fiscal expansion is delivered by a potential second Trump presidency. Unemployment would return to historically low levels, and inflation would likely remain above target.

However, the evidence suggests this ‘growth acceleration’ scenario is relatively unlikely in the next year, with a much higher probability of a continued moderation in economic momentum. The reason for this is that the insulation around the US consumer, which has supported our constructive stance in recent years, has diminished.

Firstly, the magnitude of government support during the pandemic left consumers with approximately \$2trillion of accumulated savings in aggregate (figure 4⁴). This meant spending remained strong even as high inflation eroded real income levels.

Secondly, job vacancies reached historical highs in 2021 as consumer demand rebounded following the end to pandemic lockdowns (figure 5⁵). Businesses sought to re-employ staff, who were able to negotiate higher wages and replace lost work very quickly. Thirdly, with interest rates extremely low, mortgages were re-financed securing very favourable long-term rates in many cases. These factors created a potent recipe for resilient spending, even as inflation and interest rates rose aggressively.

Figure 4: Pandemic savings have been spent

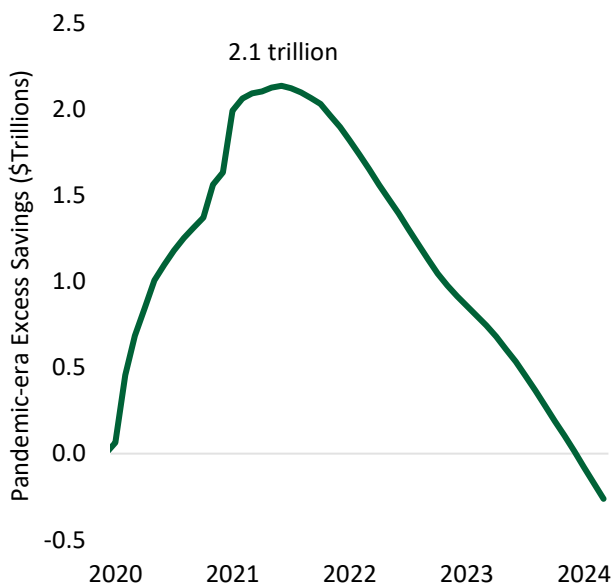
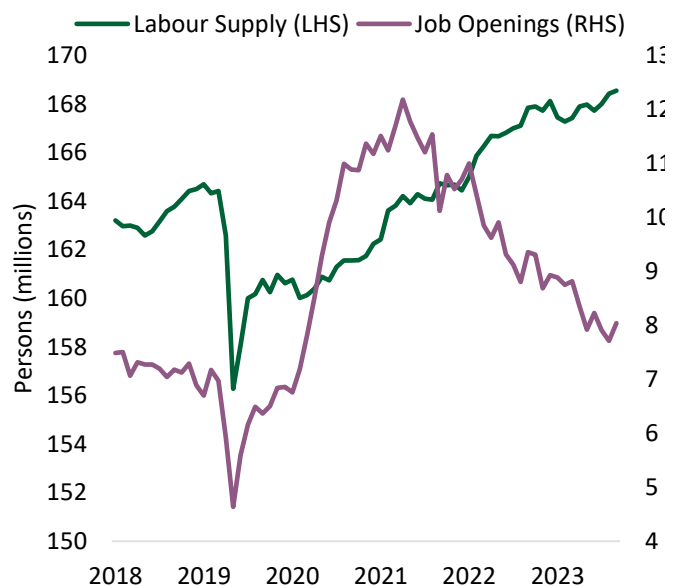


Figure 5: Fewer vacancies reduce consumer insulation



As 2025 approaches, these spending buffers have worn thin. Measures of excess savings from the pandemic suggest they are virtually gone, particularly for lower income households. Job vacancies have fallen consistently, and are now close to pre-pandemic levels.

In turn, workers who enter the labour force or lose their jobs are finding it harder to find employment, pushing up the unemployment rate. Meanwhile, the lagged impact of higher interest rates is starting to bite. New homeowners, or those resetting their mortgage out of necessity, are being squeezed by elevated mortgage rates.

⁴ Source: BCA Research, Federal Bank of San Francisco, September 2024

⁵ Source: Federal Reserve of St Louis, August 2024



1.1.2 On the cusp of recession?

Some economists are convinced this slowdown will inevitably push the economy into recession by early 2025. This could certainly happen should signs of weakness in the labour market gather momentum, leading to a relatively short and shallow contraction in activity. We ascribe a 30% likelihood to such a ‘mild recession’ over the next year in our scenario analysis (figure 3).

However, that the economy is moderating from a position of strength implies the current expansion can persist for longer than widely expected. Early indications of business activity during September from the S&P US Purchasing Managers Index (PMI), a survey of c. 800 companies, highlight continued stable growth. Whilst manufacturing remains under pressure, the (much larger) services sector indicator registered a reading of 55.4, comfortably above the 50.0 marker for positive growth (figure 6⁶). US economic growth (measured by GDP⁷) is likely to remain in moderate expansion in the near term as a consequence (figure 7⁸).

Figure 6: No signs of weakness in the US services sector

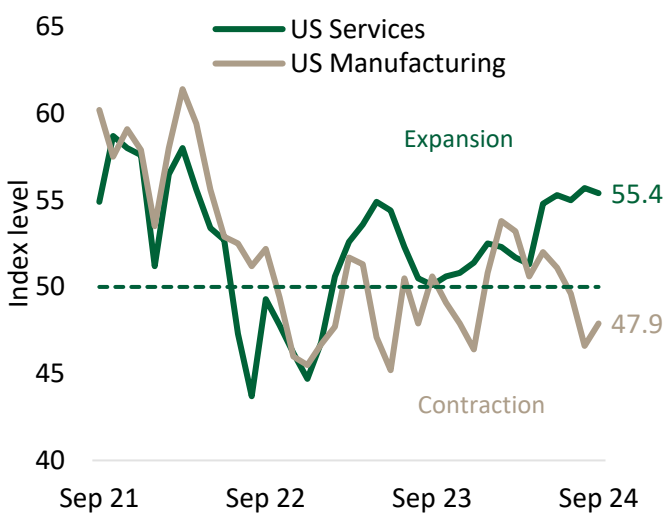


Figure 7: Slower but stable US GDP growth



Our conviction that a recession can be postponed has been further supported by coordinated monetary loosening by major central banks, with the Federal Reserve cutting rates by a hefty 0.5% to begin their easing cycle.

As the first quarter of 2020 reminded us all, exogenous shocks can trigger severe recessions which are virtually impossible to foresee. This means there will always be a small likelihood of such an event repeating, and motivates appropriate diversification in our investment strategy.

The probability is higher when there is widespread excess or structural imbalance in the economy. For example, in the lead up to the Global Financial Crisis in 2007-08, a glut of single-family homes and unsustainable household leverage amplified the economic shock when the slowdown arrived and credit subsequently seized up. The good news is that these excesses are not pervasive today, limiting the probability of a ‘severe recession’ in our scenario analysis to just 10%.

⁶ Source: Bloomberg, September 2024.

⁷ Gross Domestic Product.

⁸ Source: Bloomberg, September 2024. End September reading is a forecast from the Federal Reserve Bank of Atlanta for Q3 only.



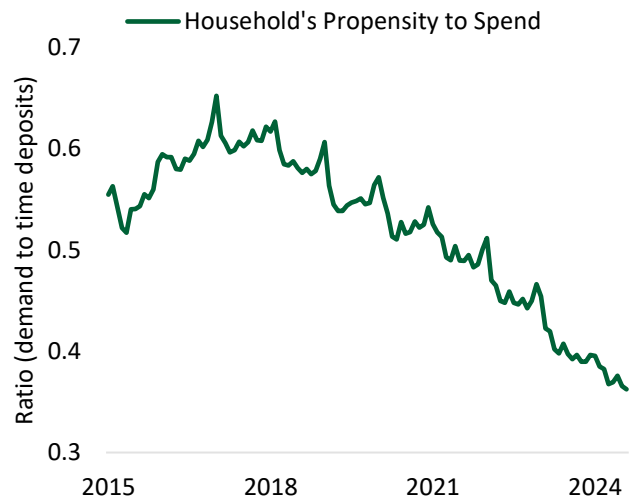
1.2 China – a turning point?

The Chinese economy is also slowing. After being a large driver of global growth in recent decades, real estate deleveraging and bankruptcies have driven a broad decline in confidence and activity. Having shown signs of stabilisation earlier in the year, most economic indicators are moving in the wrong direction, raising concerns that the historically modest 5% GDP growth target this year will be missed (figure 8⁹).

Figure 8: Chinese growth continues to slow



Figure 9: Spending remains low despite easing measures



Towards the end of September, a sizable package of stimulus measures to aid the ailing economy and boost investor sentiment through cheap liquidity was announced by the authorities. This could trigger a short-lived rebound in depressed Chinese equities, but it is unlikely to drive a meaningful turnaround for the real economy.

China's underlying economic issue is one of over-production across industries relative to domestic consumption. This creates "the risk of a doom loop of falling prices, insolvency, factory closures and, ultimately, job losses¹⁰". Whilst the PBOC¹¹ have cut reserve requirements and interest rates in this latest effort to reinvigorate growth, it is likely that the economy is already in a 'liquidity trap'. This term was coined in the 1990s as Japan entered a prolonged period of decline, and refers to how lower rates can fail to stimulate demand due to a very low propensity to spend (figure 9¹²) and preference for saving.

China's economic future is highly uncertain, with considerable challenges to overcome for a sustainable growth trajectory to be restored. The latest round of stimulus measures implies the authorities are taking these challenges seriously, but more is needed to support a notably positive stance towards Emerging Asia equity markets.

⁹ Source: Bloomberg, BCA, June 2024. Ratio of demand deposits to time deposit accounts used as a proxy.

¹⁰ Source: Foreign Affairs, "China's Real Economic Crisis", Zongyuan Zoe Liu, August 2024.

¹¹ The Peoples Bank of China.

¹² Source: Bloomberg, June 2024.



Section 2. Multi Asset Investment Strategy

2.1 Investing in the next phase of Artificial Intelligence (AI)

The AI investment theme has evolved significantly this year. At the start of 2024, AI was at the centre of investor enthusiasm, which led to significant capital inflows into AI-related technology stocks, particularly semiconductors and software companies. However, as the year has progressed, this initial wave of excitement has cooled. Investors have become more discerning about which businesses stand to benefit from AI, and how quickly.

Our equity strategy captures the AI theme primarily in two ways. Firstly, through a sizable allocation to the US market as the core growth engine, we access mega-cap technology leaders that reside at the top of conventional indices such as the S&P 500.

Amazon and Microsoft, which are also active positions in the Stonehage Fleming Global Best Ideas portfolio, are key examples of companies expected to deliver strong earnings growth through AI investments. Amazon recently announced that their internal AI tool, Amazon Q, is saving them \$260m annually and reclaiming 4,500 developer years. Microsoft is also expected to see further growth within its Azure Cloud business as it rolls out its AI Co-pilot tool. Secondly, by investing in a diversified range of specialist active managers, we participate in the returns from 'hidden AI beneficiaries' further down the company size spectrum and across industries.

One example is in insurance, which we actively allocate to. Insurers have a lot of scope to use AI tools to enhance claims processes, improve risk pricing and reduce expenses by automating repetitive tasks. For instance, Travelers currently have 40 unique AI claims models running in real time, producing 750,000 recommendations annually.

We also capture AI opportunities in the small cap sector, through lesser known companies involved in the design and manufacture of computing architecture. As perceptions shifted over the past year, one of our favoured managers in this space, Driehaus, benefited from the rise in the data centre hardware company, Super Micro Computer, before exiting due to extended valuations.

We are now in a phase when investors are questioning whether companies will be able to realise large enough returns to justify the high level of AI capex. Investors are looking for real monetisation of these technologies or meaningful cost savings. So far, whilst a key AI application has not yet emerged, we have seen some good evidence of how companies are using AI to their benefit.

Over the next 2-3 years we expect this trend to be very important, with continued differentiation between winners and losers in the AI space, but also for the benefits to broaden out to other industries. We aim to capture a range of opportunities through our equity strategy.

2.2 Catastrophe Bonds – uncorrelated returns for uncertain times

The objective of our allocation to alternative assets is to access investments with differentiated risk and return profiles compared to traditional equities and bonds. One example that meets this requirement well is the Insurance Linked Securities market, specifically the Catastrophe Bonds (CAT) segment.

Catastrophe bonds form an important role in the insurance industry, providing a means for insurers to diversify their exposure in line with regulatory guidelines. As an investor in CAT bonds, we participate in the aggregate underwriting of a diversified range of high impact and infrequent events, such as earthquakes and hurricanes, on a global basis. In turn, we are compensated through premium income, in the form of an income yield, which has been particularly high following years of rising claims.

Beyond the high-income generation, the CAT bond market is also attractive because the underlying risks are independent from the economic cycle and are therefore highly diversifying for equity and fixed income portfolios.

We are mindful that the changing climate may impact the frequency of certain events, and to date this has been most clearly observed in the frequency of wildfire linked to drought. CAT bonds are relatively short duration with a life of 3-5 years, which means that changes in event probability can be dynamically modelled and reflected in the pricing of risk. In essence, the market price for insurance can adapt very quickly with any long-term changes associated with Climate Change.

2023 was a relatively benign year for global events, with no events impacting the CAT Bond market. As such it was an exceptional year for the market with 15-20% returns achieved. This year has been more active for storm activity, however higher 'attachment points', which reflect the level at which bonds are triggered, have shielded investors.

Hurricane Helene, a sizeable event for South Eastern US in recent days, is not expected to impact our CAT bond investment due to the very specific set of conditions needed before losses can attach to underlying bonds.

Looking forward, certain secular trends underpin the growth of the CAT Bond market including migration, rising property values and insurance companies' need for diversification. We anticipate a continued demand and supply imbalance which should support very attractive yields. We continue to monitor spreads and coverage terms, and will be sensitive to any erosion of the favourable returns which underpin our thesis.

2.3 A diversified portfolio for a moderate economic expansion

The global cycle has matured, and a range of geopolitical and economic risks create a fragile backdrop for portfolio allocation. In particular, the impact of the upcoming US presidential election, and efficacy of recent China stimulus in jump starting growth, are highly uncertain.

Our strategy therefore emphasises long term and selective participation in global risk assets with a preference for broad diversification of return drivers. Portfolios are characterised by the following:

- **American leadership** – the US remains our largest equity allocation, with consumer sector resilience, structural growth outperformance, AI opportunities and stable earnings the key supporting factors. Historically the US market has performed well relative to other regions during periods of economic slowdown
- **Style and sector diversification** – Increased divergence across sectors is providing scope to emphasise those areas of the market that offer enhanced risk adjusted returns, such as healthcare, insurance and smaller companies
- **Fixed income opportunities in multiple scenarios** – Should growth and inflation continue to moderate, bonds will offer investors positive real yields and the potential for capital growth over time. In the event of a mild or severe recession, we could see much lower bond yields as central banks respond with accelerated interest rate cuts. Our increased allocation to US Treasuries has performed well in the past quarter as bond yields have fallen on rate cut expectations
- **Diversifying alternative investments** – These key allocations create a balance to our moderate weighting in traditional risk assets, such as equities and credit, with vital sources of uncorrelated returns in the event of higher equity market volatility. Physical gold, catastrophe bonds and carefully risk managed long / short equity strategies remain favoured investments

Multi-asset returns have been firm in 2024 so far, and we remain constructive on continued opportunities for risk adjusted returns over the coming 12 months and beyond. We are deeply aware of the potential for a more meaningful economic deterioration or period of heightened market volatility. As we reference in section 1, we keep indicators of such scenarios under close watch.

Stonehage Fleming Investment Management
Chief Investment Officer Group
03 October 2024



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