



TAKING STOCK: NEPC ASSET ALLOCATION ROUNDTABLE, THE 2024 EDITION

October 2024

Asset allocation is integral to the success of any investment portfolio, and it is among the most important decisions an investor will make. In this discussion, we pull back the curtain to offer you a behind-the-scenes glimpse of the issues and themes at the forefront of the meetings of the NEPC Asset Allocation Team.

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What are your thoughts on the current economy and the likelihood of a recession in the next 12 months?

Jennifer: We talk a lot about aggregate economic data looking resilient, whether it's inflation slowing or robust consumer spending or GDP growth. But I do think some of the cracks—maybe they're more hairline fractures—in the economy are there.

One of the things that I've been thinking about is the consumer side and the K-shaped recovery. I still think that the lower-income section of the economy is stressed, and you can see it in some credit-card data and auto loans delinquencies. That's maybe the one crack that I'm most concerned with at this point. Still, everything seems fine for the Federal Reserve to continue to gradually ease rates.

Phillip: If I had to put odds on a recession, I would say there's a 25% chance in the next 12 months. There are some issues that come into play, but I think at this point you need some sort of exogenous event—maybe related to geopolitics or significant changes in economic policy—that tips the economy into recession.

It's hard to see what those triggers could be because you have a steady state of wage gains, job growth and consumer spending, and that's been the hallmark of success for the U.S. economy for the last 50 years. I think what's more interesting in the next 12 months is the manufacturing and industrial side of the U.S. economy, which is very much showing signs of a recession. We are curious to see the extent to which areas of the economy that are more sensitive to interest rates start to rebound if we see looser monetary policy and lower interest rates.

When you couple that with decent levels of consumer spending, you could say the U.S. economy could be entering a period of fairly high nominal growth over the next 24 months.

What are your views on inflation? Will we see inflation move down to the Fed's 2% target level (and does it even matter if it doesn't)?

James: No, I don't think we get to the 2% level for inflation, not in 2025. If we get a strong U.S. economy that we just talked about, it might not come down to 2% in the medium term. The higher numbers we saw in the last few years are also unlikely to return. I would say that we start to settle into a 2.5% to 2.75% range, maybe even upwards of 3%, when you think about the headline number.

Certainly, the Fed will be looking at some of the core PCE components of inflation that appear stickier. I don't expect we really get down to 2% and that will ultimately result in the Fed keeping rates a little bit higher for a little bit longer than what had been priced in. It also might influence the central bank's views on what the neutral rate of interest is. So, as we see inflation level off at a higher than 2.5% level in 2025, you'll hear more dialogue around higher neutral interest rates.

Robert: I agree with James. I think we've established maybe not a permanent but a semi-permanent floor to inflation. I doubt you would hear that from the Fed and policy makers, but I think with deficits at 6% to 8% of GDP and a more dovish Fed pacifying the economy, it seems like the Fed dot plot—long-term expectations for rates—have crept up for the last 9-12 months. I think we've established a new normal. But I doubt you'll see that change in the headlines, but under the hood I feel like it's changed, and you've seen markets realize some of this dynamic with longer-term interest rates moving higher after the Fed cut in September.

Jennifer: The market seems to be quite reactive to every data point that's come out. I think it's possible that with some of the base effects and nuances in the CPI calculation, we could see higher prints through the end of the year that could spook the market.

Phillip: Do you think there is a chance we could see inflation levels get back to 4% level sometime in the next year at any point?

James: Of course, geopolitical risk.

Jennifer: Like energy prices?

Robert: Yes, energy plus tariffs and a combination of those could certainly cause a spike. But I don't see trend inflation sticking at 4% for an extended time.

James: Services have been a big driver of inflation over the course of the last six-to-eight months. If we do see tariffs, even if it's not a huge number, it will be an added tailwind to inflation. But I don't think that drives you from 2.5% to 4%. In my view, it's the geopolitical risk related to energy that could potentially take CPI to 4% or more.

Jennifer: I would add that we partially saw inflation in prior years because of supply chain problems. If we see disruptions to supply chains from geopolitics, that's a big risk too for the prices of goods.

Phillip: I think this is one of the big worries we have: you look back to the late 1970s when the Fed thought it had inflation under control and started easing and then realized, over a period of a couple of years, that

that wasn't the case, and inflation roared back. Some of that was related to geopolitical risks and some to the economic policies of the time. History rhymes and there are some parallels you can draw to today.

What are your views on the Fed and monetary policy?

James: I'll start with what's priced into the market because I think that's a useful starting point when we think about our discussions. So right now, fed funds futures for the end of next year are priced at 3.4%. That would imply that we're going to see five-and-a-half cuts or so over the course of the next 12 plus months, with the bulk of those being front loaded in the next three or four months.

Market expectations have priced in four cuts between now and May, which feels like a fair adjustment to a restrictive monetary policy in the face of inflation coming down. Even if you believe in a higher natural rate of interest, I would say what's priced in looks almost reasonable. Over the course of the last month, the market was probably overly aggressive with its rate cut outlook, but recent data such as retail sales have forced investors to realize that the Fed probably wasn't going to cut quite as quickly.

Phillip: Trailing inflation is slightly below 2.5%. The fed funds rate is at 5%, with a real fed funds rate more than 2.5%. That's a tighter monetary policy, especially compared to the last 25 years. Fed funds should be coming down. The challenge is to what extent the Fed cuts rates, knowing the economy is in fairly decent shape. The pace of rates coming down will probably be a little slower than what the market thinks it'll be, and the Fed most likely is going to be more patient than many expect.

Robert: It's easy to be critical of the Fed, but post-COVID, we have to give Jerome Powell, the Fed Chair, and other members of the Federal Open Market Committee credit. It's easy to say the Fed should have cut rates here or raised rates there, but it has the challenge of its dual mandate of stable prices and full employment. In terms of the economy, we have settled into a healthy spot, and I think the Fed deserves credit for a lot of that.

Phillip: One thing we haven't mentioned is the steady shrinking of the Fed balance sheet and its impact is clearly getting overlooked. At what point does the Fed decide to hold off on interest rate cuts and also pause on shrinking the balance sheet? That's maybe something we see in 2025. There's so much liquidity in the market, you don't really see an impact today. But when you compare the Fed's outsized impact on the market over the last 15 years, its balance sheet has been the most potent monetary policy tool that we've maybe ever seen. This is not being talked about a lot today.

What are our expectations for the 2024 elections?

Robert: Betting markets have become more widely referenced this election season when forecasting potential results. Some are more liquid than others; but it is important to remember these are probabilities and not predictions.

Phillip: It's largely a tossup. Next question.

James: I think there's a couple of things I want to add. Being days away from the election, you're going to have a number of states that have already been voting for more than a week or two and it is fair to say the usefulness of polls has declined.

Also, when you look at some Senate races, you see one candidate significantly ahead of the other. But

that's not necessarily reflected in the presidential polls of those same locales. Today we live in such a polarized political environment that voting a split ticket seems less likely and adds only more uncertainty to the polling numbers. Election betting markets might be all we've got left but hopefully our country is not at the whim of the betting markets.

Does the outcome of the election matter for capital markets?

Phillip: If we see some form of divided government, it's hard to see much material change come through from a policy standpoint—with the exception of potential tariffs—under a Trump administration. For the most part, I think the market is prepared and hoping for a divided government.

I think what's interesting is if we see a more significant Republican wave through the House coinciding with a win for Trump. I think markets would be surprised and start to discount more significant shifts in tax policy and tariffs.

Jennifer: I always come back to this idea that if you try to make a bet on certain sectors that you think would do well under a certain administration, it often doesn't work out.

Phillip: History would say that in the short term, we tend to over-anchor to election outcomes in terms of their impact on capital markets. Depending on the outcome, I think there are a couple of unique pieces that are going to come into focus. One is tariffs and U.S. relations with China.

What do you think the likelihood is under a Harris or Trump administration of a new trade agreement negotiated between China and the United States?

James: I expect either administration would be willing to negotiate with China during the next four years. At some point in these next four years, China will get out of the economic slump it's in and we've got a lot to deal with on the semiconductor side, artificial intelligence and defense. I would expect either candidate to be open to negotiate trade with China, but I don't believe they see it as an imperative.

Phillip: It's fair to say that's not priced into the markets at all.

Robert: The chances of a trade agreement with China are higher under Trump because he's declared the intent to use tariffs. That's a potential bargaining chip in some type of agreement with China.

Phillip: Just politically, it would seem much easier for a Trump administration to pivot to a more conciliatory tone with China than it would be for a Harris administration. The question is to what extent does either administration look to maybe replicate some of Nixon's outreach to China over 50 years ago in line with some kind of legacy building?

Robert: Between China and the U.S., who would you say is more willing to reach out for an agreement?

Phillip: I think that's the challenge. The status quo could last much longer than people think. Some of it ties back to domestic politics in each country, the voting base and political opinion in United States, and the key institutions and areas of power in China.

The question is who blinks first in terms of feeling the pain from a restrictive U.S.-China trade policy.

James: I don't see a need for the United States to blink in any material way, with the exception of the

artificial intelligence race. There is a risk that China could accelerate its development ahead of U.S. I think that's a very small risk, but anything can happen in this world where change can be very rapid. I don't think there's anything that we know today that would warrant either side to come to the negotiating table. But I do think that if we see the current status quo persist for the next couple of years, AI and defense are going to be the major drivers of trade negotiations.

What is your stance on China from an investment viewpoint?

Robert: Show me, don't tell me. We have all this stimulus talk and I need to see it benefit the economy and asset prices. I would be willing to wait it out rather than invest in expectations because China set all these high expectations over the past 10 years, and they haven't come through in terms of equity returns.

Jennifer: I think that stimulus gap is what's most concerning to me...that the market reacted so strongly on hopes, but we don't have all the details on a more forceful economic stimulus push. There's plenty of structural issues that we could talk about, but the key to reigniting the economy comes back to rebuilding confidence of households, consumers and the private sector.

I don't think we have a whole lot that suggests that's going to change by the end of the year, but I'm a little more excited than last month, which is maybe counter to some of the things I just said. But this is at least a sign that there is some willingness from the government to change things.

James: There does seem to be an increased willingness. We have heard more announcements of stimulus, but they lack adequate details and follow-up. If I put myself in the position of one of the largest economies in the world with a growth problem, I'm going to wait until I know the outcome of the U.S. election to figure out where I need to fight, and maybe not provide too many details until then.

So, part of me thinks all the willingness that we've seen could result in actual details sometime in the next three or four weeks as the Chinese get a better sense of the political landscape in the United States.

Phillip: If you could change one aspect of China's economic policy, how would you fix its economy?

Jennifer: It's difficult to answer that question because there are so many critical issues. The real estate sector remains a significant drag on the economy. The savings rate is very high on a relative basis in China, and if you want to spur the economy, you need to reduce savings to fuel greater consumption. China also needs policies that are going to be friendly to businesses and entrepreneurs and that really hasn't been the case the last couple of years.

Phillip: I think we're judging consumers in China at their low point, and that speaks to what it needs to do next. What the economy needs is real stimulus, money going directly into consumers' pockets, lower interest rates, a quantitative easing program and balance sheet expansion...all the things that Japan was too slow to do in the 1990s when it allowed deflation to take hold. China needs to act, and indications show that it knows it needs to act. But I think it's a fair point to say they are likely waiting for the U.S. elections to decide to what extent and the speed with which they hit the gas pedal on stimulus.

What are your views on private markets?

James: Private equity offers investors an opportunity with top general partners to get access to some of

the technologies that might shape future growth. That's a hard thing to do through public markets in a meaningful way. Obviously, the Amazons and Googles of the world invest in advanced technologies, but you don't get direct access until you get into the venture space within private equity.

So, for investors with an appropriate risk tolerance, having private equity exposure certainly can be beneficial. Also, in a declining interest rate environment, you could see the potential for buyouts to take advantage of companies that might have struggled over the last couple of years with higher rates. In addition to their access to financing, there could also be opportunities for buyout companies to use their abilities to bring about operational change. I think there's opportunities with high-quality GPs in private equity even though you do see high valuations in public markets.

Phillip: In recent years real estate has also got a lot of negative airtime with office space being the most pronounced. But you're starting to see more transactions clear the market, capitalization rates resetting to more favorable levels...there's something to be said about being a liquidity provider in the institutional real estate space.

What is our most important recommendation to investors?

Jennifer: I say this most years when this question comes up, but in the current environment, having liquidity/safe-haven exposure is critical. I say that not only because it's a long-term foundational belief for us, but with the elections coming up and with some of the geopolitical flashpoints, there could be more volatility and quick selloffs in markets. Against this backdrop, it's vital to have liquidity to be able to rebalance into equities.

James: I echo the liquidity comments and am playing off that a little bit: balance your risk exposures. I think the best example of that is within fixed income. You could have a core bond manager that might have more credit than you expected and might not have the daily liquidity. Having Treasuries as a standalone mandate with daily liquidity really helps afford that structural benefit. So, balancing your risk exposures with liquidity in mind is important.

Phillip: For me, it's more of a focus on governance. The most important piece that we can reinforce to our clients and investors is just investment discipline and not being swayed by the news flow and the headlines that we are likely to see in coming months. Given some of the volatility that might get pushed through the markets, it is vital to maintain discipline and keep to your policy targets. If markets overreact in times of fear, be willing to put money to work and be a liquidity provider to the markets.

Looking at 2025, what is the one asset class that you think could do well?

Robert: For me, it's gold. It's up 30%-40% this year. I still like the asset class and with the U.S. running large fiscal deficits, and central bank and retail demand, I think it is not all fully priced in. Plus, there's the safe-haven aspect of gold. All those factors still look great for that asset class going into 2025.

Jennifer: The last few years I have said China equities and, while it has not been a smooth ride, it has delivered so far this year. But I think even with the rally at the end of the third quarter, there's still a compelling valuation argument. The return for next year is going to hinge on if we start to see all the stimulus that we've been talking about. So, I'm willing to take that bet for 2025.

Phillip: Jenn, you might be winning that bet in 2024.

Jennifer: Wait until the end of the year before you call anything!

Phillip: For next year, I'm really looking to U.S. small caps and similar-sized companies in the private equity buyout space. I don't want to sound overly tactical, especially in private markets, but I think the potential for lower interest rates, strong nominal growth in the U.S. can benefit many companies.

James: There's a lot of potential catalysts for U.S. small caps, but since Phill took it, I'll say something a little bit more provocative: long Treasuries.

By the end of this year, you could see the 10-year at 4.5% and by the end of next year, it could be nearing 3% depending on economic conditions.

IMPORTANT DISCLOSURES

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