New Global Reserve LLC Address: 3721 Rawlings St, #1420, Dallas, 7521, Texas, USA Website: https://thenewglobalreserve.com
Date: 02/25/2024

Corporate/literature/whitepaper

New Global Reserve LLC

-

2024 Global Outlook

Grabbing the wheel: putting money to work

The new regime of greater macro and market volatility has resulted in greater uncertainty and dispersion of returns. We believe an active approach to managing investment portfolios will carry greater rewards as a result. This is a sea change from relying on the one-and-done asset allocations that worked so well during the Great Moderation, the long period of stable growth and inflation. That period is over. We believe this is a time to grab the investing wheel – and seize the opportunities the new regime has on offer.

Higher rates and greater volatility define the new regime. It's a big change from the decade following the global financial crisis. Ever expanding production capacity allowed central banks to stabilize economies and shore up growth through loose monetary policy. That helped suppress macro and market volatility, and stoked bull markets in both stocks and bonds. Investors could rely on static, broad asset class allocations for returns – and gained little advantage from differentiated insights on the macro outlook. Today, we think the flipside is true. Production constraints abound. Central banks face tougher trade-offs in fighting inflation – and can't respond to faltering growth like they used to. This leads to a wider set of outcomes, creating greater uncertainty for central banks and investors. There's a temptation to interpret the new regime by taking a classic business cycle view of the current environment, we believe. Markets are swinging between hopes for a soft landing and recession fears as a result. This misses the point: the economy is normalizing from the pandemic and being shaped by structural drivers: shrinking workforces, geopolitical fragmentation and the low-carbon transition. The resulting disconnect between the cyclical narrative and structural reality is further stoking volatility, we believe.

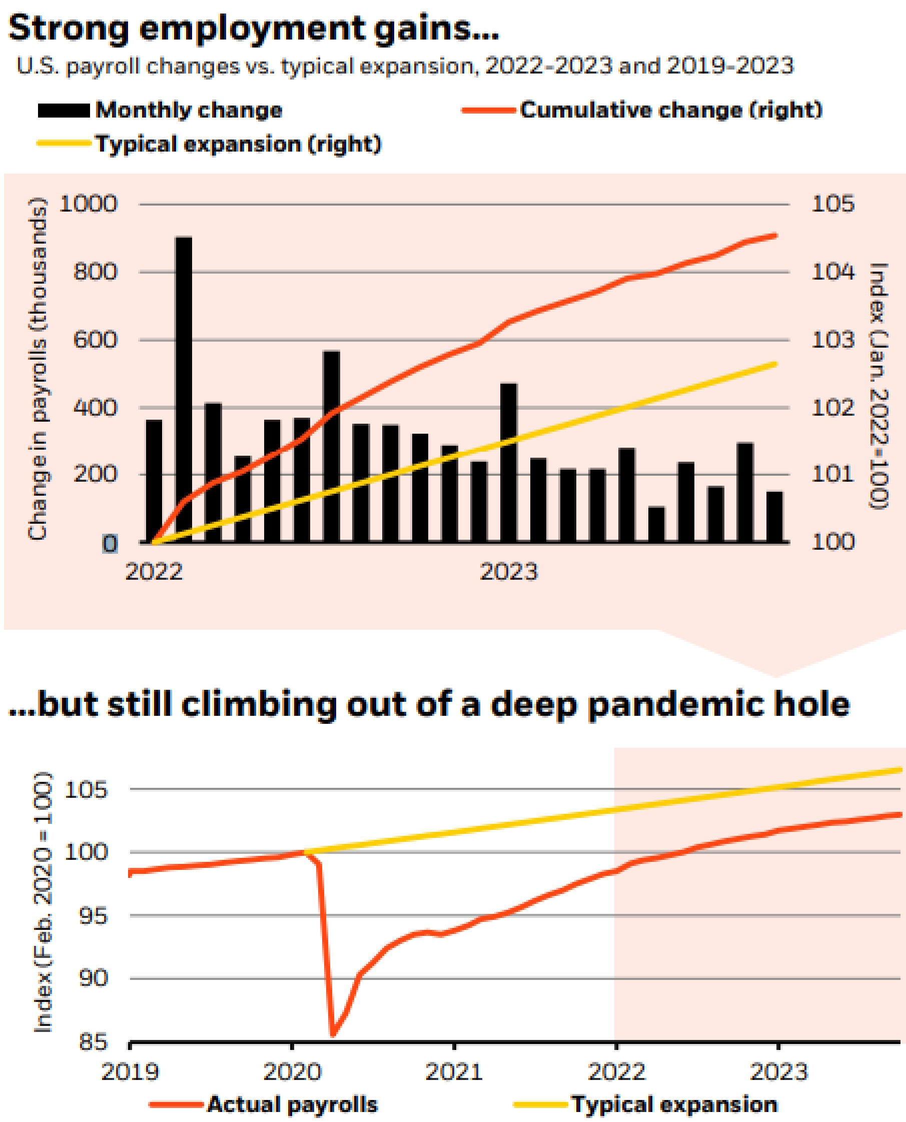
Seemingly strong U.S. growth actually reflects an economy that's still climbing out of a deep hole created by the pandemic shock – and tracking a weak growth path. What matters most, in our view, is that the environment implies persistently higher interest rates and tighter financial conditions. Financial markets are still adjusting to this new regime, and that's why context is key for managing macro risk, our first theme. We think macro insights will be rewarded in the new regime. Greater volatility and dispersion of returns create space for investment expertise to shine, as detailed in our second theme – steering portfolio outcomes. This involves being dynamic with indexing and alpha-seeking strategies, while staying selective and seeking out mispricings. One way to drive portfolio outcomes is by harnessing mega forces – our third theme. These are five structural forces we see driving returns now and into the future. They have become important portfolio building blocks, in our view. Our bottom line for 2024: Investors need to take a more active approach to their portfolios. This is not a time to switch on the investing auto pilot; it's a time to take the controls. It's important to be deliberate in taking portfolio risk, in our view, and we expect to deploy more risk over the next year.

Context is everything

Multiple times in 2023, market hopes have been revived that the U.S. economy can achieve a soft landing – or inflation getting back to the Fed's 2% target without a recession. What's fueling those hopes? In contrast to other major economies, the U.S. grew at a robust clip in the third quarter of 2023. Core inflation has fallen sharply. And nearly 7 million new jobs have been created since January 2022 – a phenomenal pace of jobs growth compared with a typical economic expansion. See the chart below. The economy has just been climbing out of the pandemic hole.

Some 22 million jobs were lost when the pandemic struck. Strong job gains since then largely reflect the recouping of those lost. The level of employment is well below the track we would have expected to be on before the pandemic.

Looking at broader economic activity, the U.S. economy has grown by less than 1.8% a year, on average, since the pandemic. That's well below the trend we would have expected pre-pandemic – and well below where the consensus and Federal Reserve had expected. That's nothing to be excited about. This resulted in, even with more muted growth, historically low unemployment and higher inflation. Our bottom line: Something has changed – and it's structural in nature. We are on a weaker growth path and got here with more inflation, higher interest rates and much higher debt levels. The upshot for investors? We think the key is to focus on how the economy and markets are adjusting to the new regime. Adopting the typical cyclical playbook may be misguided.



Structural shift

Markets have been flip-flopping between hopes for a soft economic landing and fears of yet higher rates that ultimately result in recession. This has created volatility, as the chart shows. The U.S. economy has been navigating two large shocks, in our view. The first was the pandemic. Over the past two years, most new jobs created have been due to the restart of activity after shutdowns. A shift in consumer spending drove up inflation by creating a mismatch between what people wanted to buy and what the economy was set up to produce. That mismatch is now resolving, and inflation has been falling as a result. As the effects of the pandemic shock recede, the effects of the second, more structural one are becoming clearer: A worker shortage has emerged, as a growing share of the U.S. population ages into retirement. That's why unemployment is at historic lows – even though U.S. growth has averaged well below its pre-Covid rate.

The workforce is growing more slowly in Europe and China, too, and it's one of several long-term production constraints we think will prevent many economies from growing at their pre-pandemic pace without sparking renewed inflation. Rising production costs in a fragmenting world will also push up inflation across major economies over the longer term, in our view. And the transition to a low-carbon economy is creating price pressures as the energy system is being rewired. This means central banks face a tough trade-off. If they want to stop inflation resurging, they will need to keep policy tight. We think policy rates are poised to settle well above pre-pandemic norms. Ultimately, we see central banks living with higher inflation amid hefty government spending and debt loads. Our bottom line: This is a regime of slower growth, higher inflation, higher interest rates – and greater volatility.

Yield swings on short-term surprises

Sensitivity of U.S. 10-year yield to economic surprises, 2003-2023

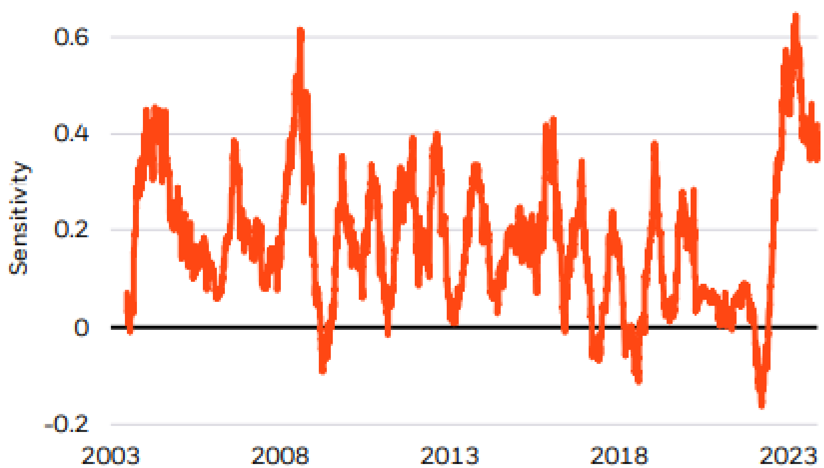


Chart takeaway: *Data surprises are driving the sharpest, sustained swings in U.S. 10-year Treasury yields of the past two decades. We believe this reflects greater uncertainty from investors still trying to view the economy through the lens of a typical business cycle.*

If central banks want to stop inflation from resurging, we think they will need to keep holding back economic activity with higher policy rates.

Managing macro risk

This is a regime shift, not about whether a recession happens. So it doesn't make sense for investors to wait for the macro environment to improve, in our view. We think investors should seek to neutralize macro exposures or – if they have high conviction – be deliberate about which exposures they take. We see more scope to outperform the market now than in the less volatile Great Moderation. Production constraints abound. Central banks face tougher tradeoffs in fighting inflation and can't respond to faltering growth like before. We think this leads to a wider dispersion of views. For example, analyst estimates of future S&P 500 equity earnings are more dispersed now than before the pandemic, according to LSEG data. See the chart. They are having a harder time reading the earnings outlook. So macro insight is likely to be more rewarded. Still, we think investors need to be alert to risks around macro exposures in the new regime. First, markets are slowly adjusting to structurally higher inflation and policy rates, but it is uneven. U.S. 10-year yields surged to 16-year highs around 5%, for example. But most DM equity earnings yields haven't risen much. This adjustment matters more than if a technical recession occurs, in our view, and keeps us cautious on broad exposures. Second, structurally lower growth and higher rates pose a problem for ballooning U.S. government debt. If borrowing costs from higher yields stay near 5%, the government could spend more on interest payments than Medicare in a few years. This increases the long-run risk of higher inflation as central banks become less aggressive on inflation. We also see a rise in term premium, or the compensation investors' demand for the risk of holding long term bonds. This, plus our expectation of more yield volatility, keeps us tactically neutral and strategically underweight long-term U.S. Treasuries. Our largest strategic overweight is instead to inflation linked bonds.

Adjusting to new regime

Dispersion of U.S. equity analyst earnings estimates, 1995-2023

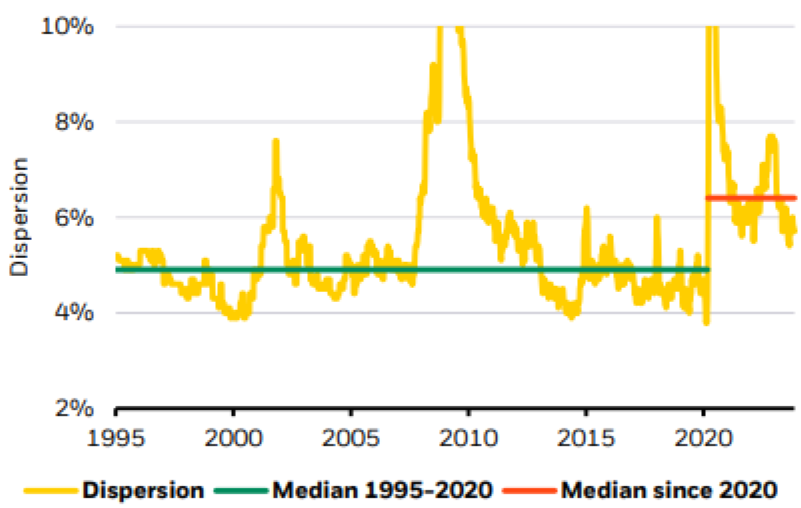


Chart takeaway: *During the Great Moderation, analyst views of expected company earnings were much more grouped together outside of major shocks. Now they are more dispersed, showing that an environment of higher inflation and interest rates makes the outlook harder to read.*

Steering portfolio outcomes

Heightened volatility and dispersion call for an active approach to managing portfolios, in our view. Structurally higher policy rates should eventually mean higher returns on all assets. But not all asset valuations have adjusted, we think. And static exposures to broad asset classes are unlikely to deliver the risk-adjusted returns they did during the Great Moderation's bull markets in both stocks and bonds. We see alpha, or above-benchmark returns, playing a bigger role in the new regime – and believe a more dynamic portfolio approach is warranted when cash offers attractive returns. What if you were able to accurately predict U.S. equity sector returns with perfect foresight? Acting on this hypothetical ability more frequently would have paid off much more since 2020 (see the right bars in the chart) than in the four years prior left bars). The upshot? Good insight, acted upon in a timely manner, has yielded greater rewards than buy and-hold strategies since 2020. Investors can also thrive in the new regime by getting granular with portfolio allocations. For example, returns on short-term Treasuries have outpaced those on long-term bonds since mid-July 2023, according to LSEG data, as investors started to demand compensation for taking long-term interest rate risk. Lastly, dispersion of returns has risen in the new regime. This means security selection is likely to be more impactful, in our view. We see a wide arsenal of tools and strategies to help outperform static portfolios. Investors can blend indexes to build core allocations, implement alpha ideas and hedge risk. Our bottom line: Investment expertise is likely to give portfolios an edge in the new regime.

More dynamic

Hypothetical impact of rebalancing on U.S. equity returns

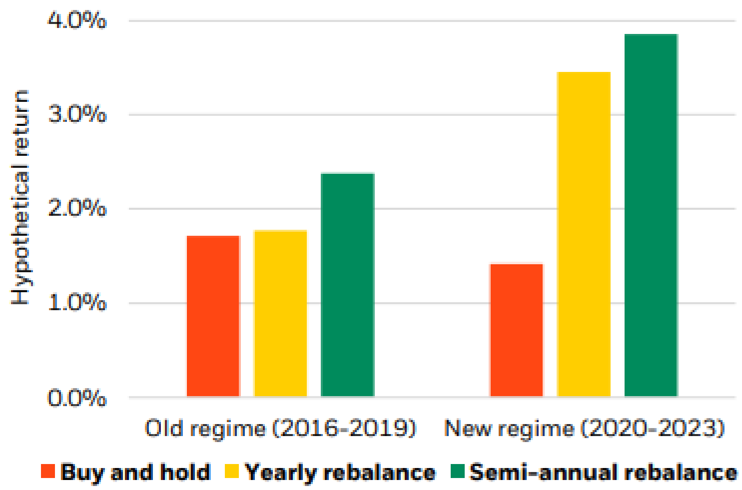


Chart takeaway: *Taking a more dynamic investing approach in in the new regime would have likely outperformed a buy-and-hold strategy to a much greater extent than before the pandemic.*

Harnessing mega forces

We think mega forces are another way to steer portfolios – and think about portfolio building blocks that transcend traditional asset classes. They stand out as drivers of corporate profits on their own, in our view, and so could offer potential opportunities that may be uncorrelated to macro cycles. These forces are already reshaping markets. Take digital disruption and artificial intelligence (AI). The chart to the right illustrates the outperformance of U.S. tech relative to the broader market this year. We think this reflects how quickly markets embrace such fundamental shifts in the market outlook. We think the winners and losers can broaden the AI tech stack. When incorporating this mega force into our tactical views, it can push up our stance on DM equities closer to neutral even if the macro backdrop isn't rosy. See pages 8 and 14. That's just one example of why we think harnessing mega forces will enable investors to outperform simple, static allocations. The far-reaching consequences of mega forces create new investment opportunities – and markets can be slow to price them in. Capital pressures on banks are opening a path for private credit and non-banks to fill the lending void –

part of the future of finance. Private credit can be an illiquid asset class not suitable for all investors. Aging populations in major economies are poised to limit how much countries can produce and grow – depending on how they adapt in demographic divergence. Climate resilience is emerging as a new investment theme within the low-carbon transition, in our view. As climate damages mount, we are seeing increased demand for solutions that help economies prepare for, adapt to and withstand climate hazards, and rebuild after damages. See page 9. We see geopolitical fragmentation and economic competition driving a surge of investment in strategic sectors like tech, energy and defense.

Investing in climate resilience

The low-carbon transition is one of the five mega forces playing out in markets today. We already launched the New Global Reserve LLC Investment Institute Transition Scenario to help investors navigate its risks and opportunities, with a focus on the energy transition. This is not just about identifying opportunities in renewables; traditional energy companies can also outperform, especially when there are supply demand mismatches. The energy transition tends to get the headlines, but we see a related theme becoming an important investment story: climate resilience. This is the ability to prepare for, adapt to and withstand climate hazards, and to rebuild after climate damage. Think early monitoring systems to predict floods, air conditioning to cope with heat waves, or retrofitting buildings to better withstand extreme weather. With climate damages set to keep mounting in coming years, it will take extensive investment to build society's resilience to them. Just how big will those damages be? It's hard to put a number on the impact on human health and wellbeing. The quantifiable economic damage is growing fast, as the chart shows. We already see demand growing for products and services that build climate resilience. Markets may be underappreciating how this can become a mainstream investment theme over time. In our recent paper, we divide this theme into three sub-themes: assessing and quantifying risks, managing risk and rebuilding physical infrastructure. That helps us build a framework to identify opportunities that cut across sectors, such as industrials and technology, and asset classes.

Real physical damages mount

U.S. events with inflation-adjusted losses of $1 billion, 1985-2023

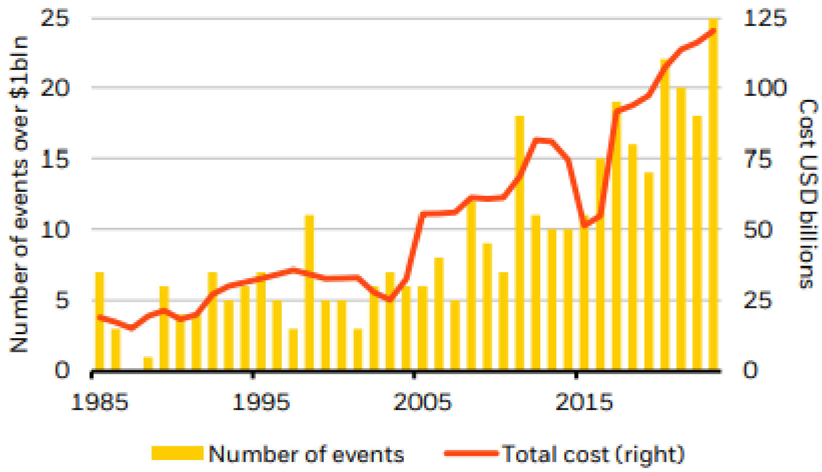


Chart takeaway: *The number of climate-related events with damages totaling more than $1 billion has steadily increased over the past roughly three decades. The U.S. hit a record number of such events just nine months into 2023.*

Real estate opportunities

We think inflation will be structurally higher and see real estate and infrastructure playing a key role in strategic portfolios as a result. Why? Some real asset values or cash flows are linked to measures that correlate with inflation – think property prices or rental income. But the macro matters here, too. Low interest rates – previously a benefit to returns – have given way to structurally higher financing costs. The question now: how much is in the price today? We had expected valuations for core real estate to adjust to rising interest rates and financing costs – leading us to turn cautious on the asset class in June 2022. Valuations have adjusted – but we think there's more to go. Capitalization (cap) rates – the ratio of a property's income to its price – are the commonly referenced valuation metric for real estate. As rates and yields surged, we expected cap rates for both private and public real estate to rise, too.

The reality? Cap rates for U.S. core real estate funds have moved less than publicly traded real estate investment trusts (REITs). See the chart. We think this shows public markets better reflect the new backdrop. Cap rates at the aggregate level aren't the full story given large dispersion across geographies, sectors and strategy types. Plus, the nature of the underlying assets is why they differ in their relative attraction. U.S. REITs invest in a wider array of properties than core real estate funds, such as data centers and healthcare. That means some REITs could be more resilient to a weaker economy – and is why it's key to go beyond a simple mantra of buying real estate in inflationary times. Our bottom line: Some public real asset prices have adjusted more than some private counterparts. Capturing the opportunities requires selectivity, understanding what's in the price and having the agility to shift between real assets at a granular level, in our view.

Private lags public

Real estate capitalization rates, 2017-2023

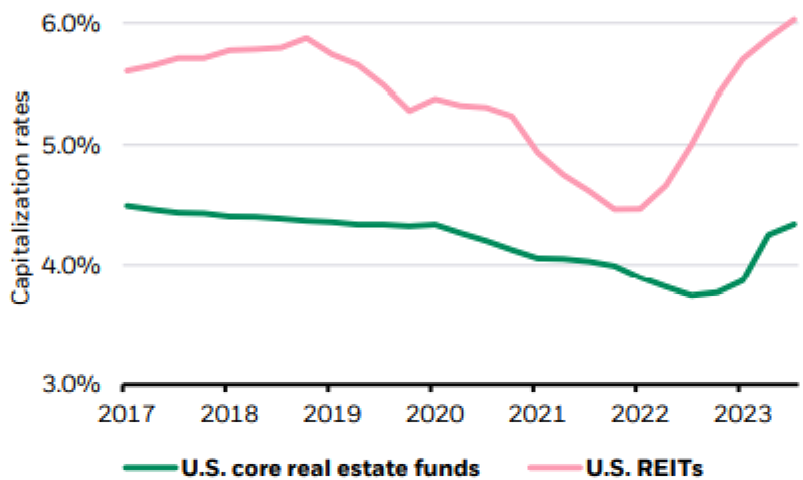


Chart takeaway: *Real estate investment trusts (REITs) valuations have reacted to rising interest rates faster and further than private real estate. We think that makes publicly listed REITs more attractive relative to private real estate.*

General disclosure: This material is intended for information purposes only, and does not constitute investment advice, a recommendation or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction in which an offer, solicitation, purchase or sale would be unlawful under the securities laws of such jurisdiction. This material may contain estimates and forward-looking statements, which may include forecasts and do not represent a guarantee of future performance. This information is not intended to be complete or exhaustive and no representations or warranties, either express or implied, are made regarding the accuracy or completeness of the information contained herein. Reliance upon information in this material is at the sole discretion of the reader. Investing involves risks.