NDR
NED DAVIS RESEARCH

Dynamic Allocation Strategy

SEPTEMBER 2023

Macro/Market Update

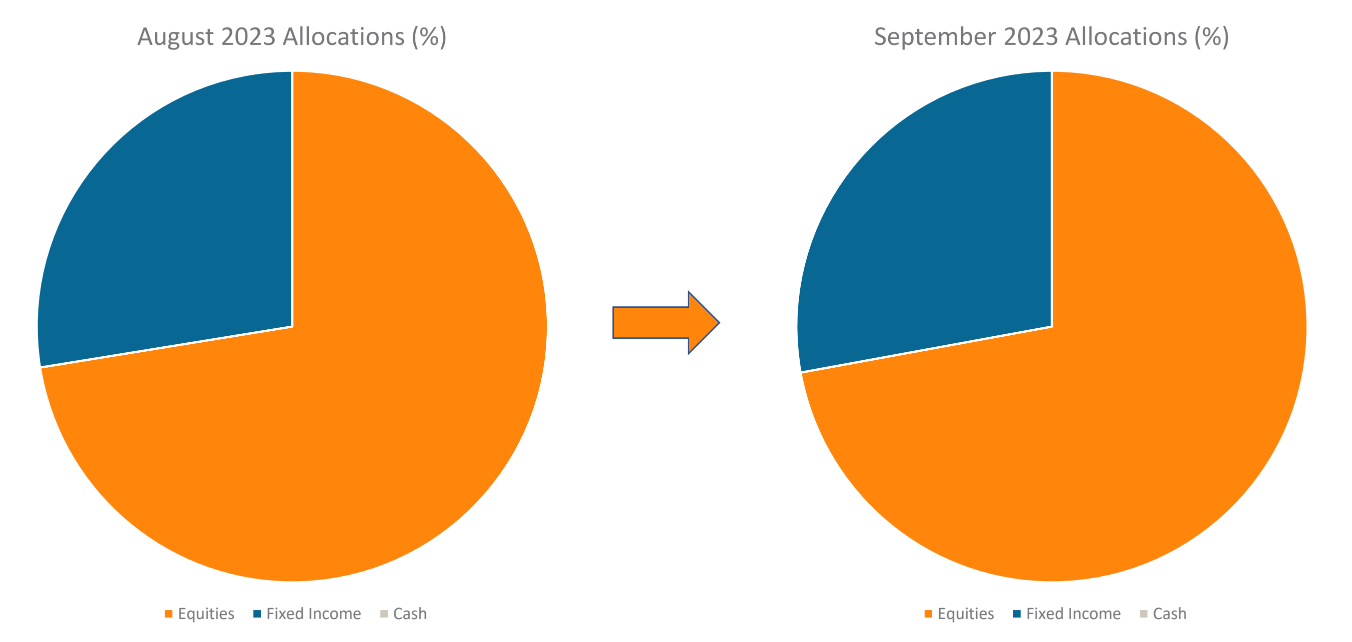
S&P Global Purchasing Managers' Index (PMI) data continue to signal a softening global economy. The global composite (services and manufacturing) PMI fell for a second straight month in July to its weakest reading since January. The continuous upside momentum from the first half of the year appears to be fading. Leading indicators within the PMI reports, such as new orders, backlogs, and future output all point to weakening momentum in the coming months.

Continued adjustments to the pandemic related imbalances have caused price pressures to ease considerably. The global composite input price index sank to a 33-month low in July. Although most of the price weakness has been in the manufacturing sector, services costs still grew at the slowest pace since December 2020.

However, the risk of global recession, which is historically associated with large, equity bear markets, doesn't appear to be a near-term risk. The latest PMI reading marked the sixth straight month of global expansion after declining throughout most of the second half of last year. The composite is also well above the threshold that has historically been associated with global recession. Furthermore, many emerging markets outside of China have maintained resiliency and are contributing to some stabilization in the manufacturing PMI. Among developed economies, growth remains positive in Japan, while the U.S. continues to grow, although at a slower pace compared to earlier in the year.

During August, the MSCI All Country World Index (ACWI) underperformed the Bloomberg Barclays Global Aggregate Bond Index by over 135 basis points (bps). It was the largest underperformance since December and only the second month this year where global bonds outpaced stocks. Still, global stocks have outpaced bonds for eight of the last eleven months. The August decline resembled the February-March correction, which started with excessive optimism and rising bond yields. Now as then, global equities have started to recover from a near-term oversold condition with optimism relieved and their long-term uptrend intact.

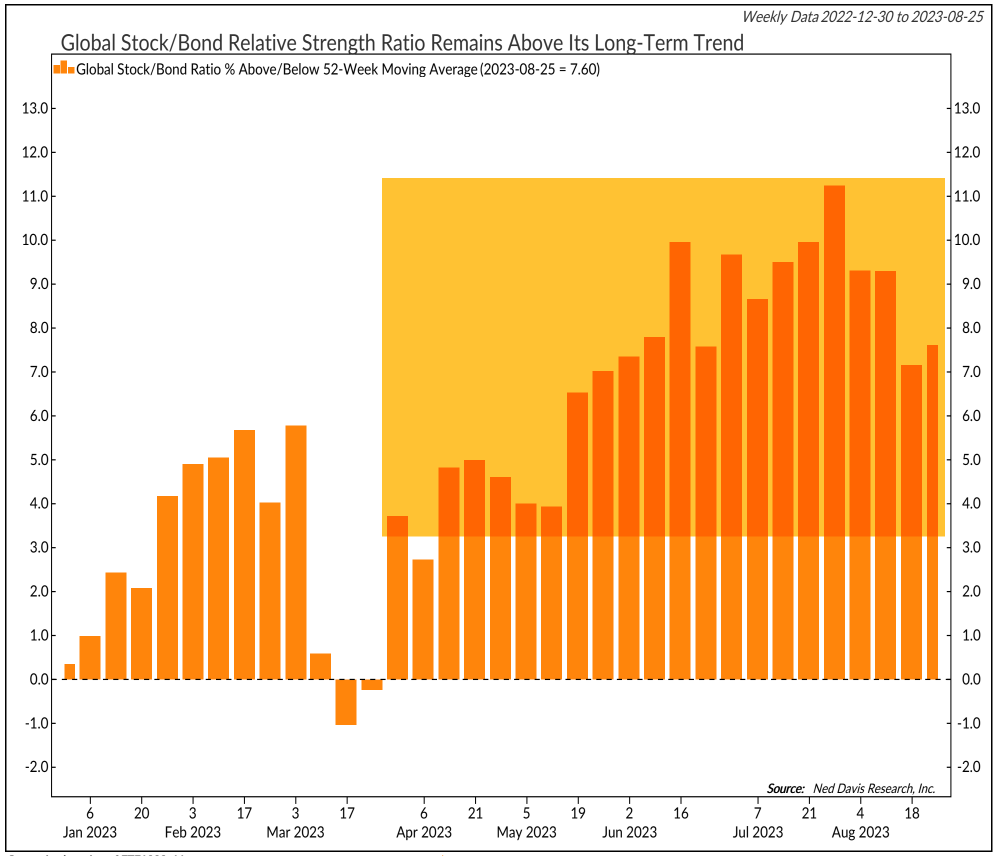
Asset Allocation Summary



* See Equity Allocation Summary for how the equity allocation is distributed
** See Fixed Income Allocation Summary for how the fixed income allocation is distributed

The equity allocation remained above benchmark weighting, as the model did not trade this month. The model uses a turnover reduction mechanism, which reduces trading. The proposed allocations did not deviate enough from the existing weightings to warrant a model rebalance.

The stock/bond relative strength indicator, which receives the greatest weighting in the model, compares the stock/bond ratio to its 52-week moving average. The stock/bond ratio is more than 7.5% above its one-year moving average. The spread between the relative strength ratio and its trend has been positive since the end of March (chart right). The trend continues to be equity's friend relative to fixed income.



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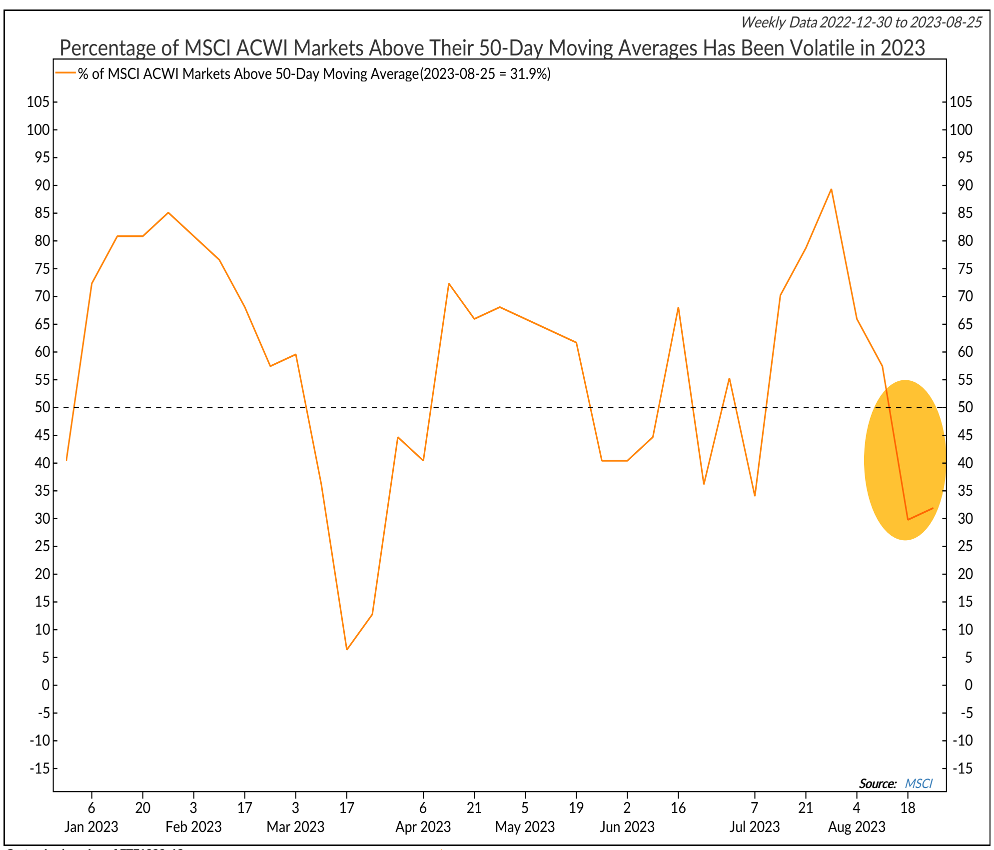

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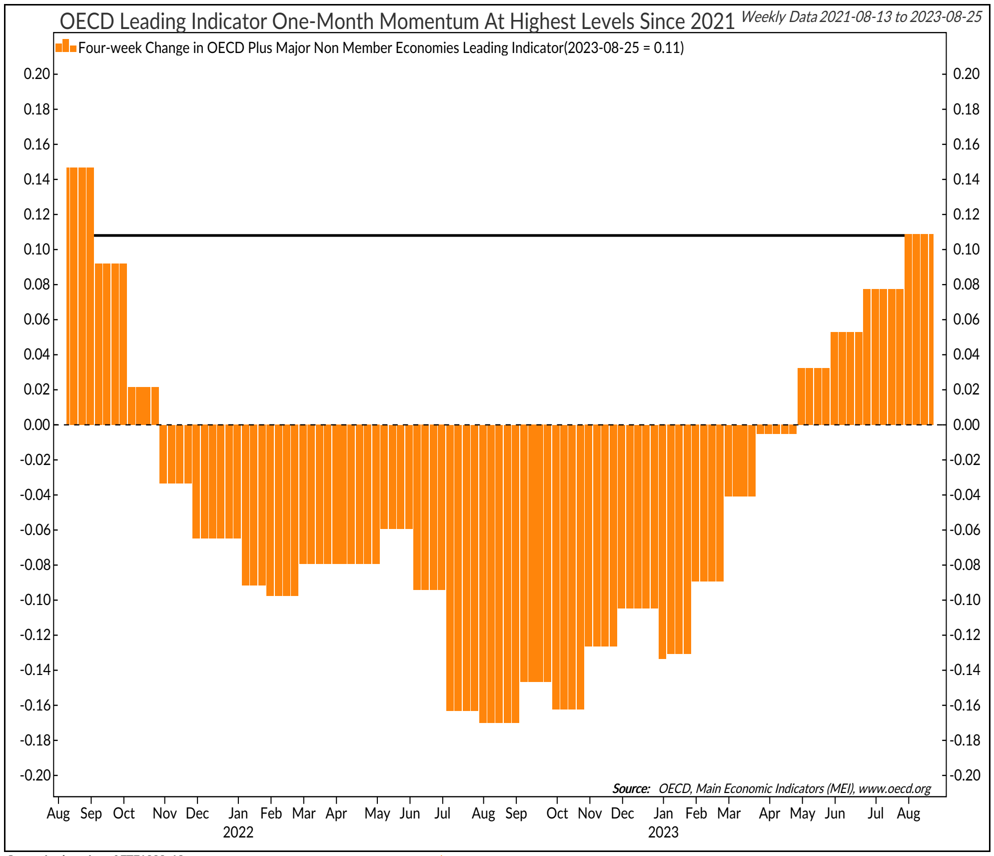
The percentage of global equity markets trading above their 50-day moving averages has experienced significant volatility in 2023. After jumping to almost 90% at the end of July, its highest level since November, the percentage of markets above their intermediate trends declined to less than 32% in August (chart left).

This indicator describes the underlying health of global equities, since it tracks the number of markets participating on the upside. Elevated breadth is important because if many stocks rally, even if a few run into trouble, enough stocks remain in uptrends that they can support the popular averages. Although declining upside participation is a risk, this could be a short-term move for this indicator due to the market pullback in what is still an uptrend.

The one-month change in the Composite Leading Indicator (CLI) has increased for the past four months after declining for 18-consecutive months (chart right). The monthly change in the CLI reached its highest level since August 2021.

The Organization for Economic Cooperation and Development (OECD) creates monthly CLIs for 35 economies to capture turning points in the growth cycle. Each CLI contains a wide range of indicators such as money supply, yield curve, building permits, consumer and business sentiment, share prices, and manufacturing production. Improvement in global economic momentum supports the equity trend.



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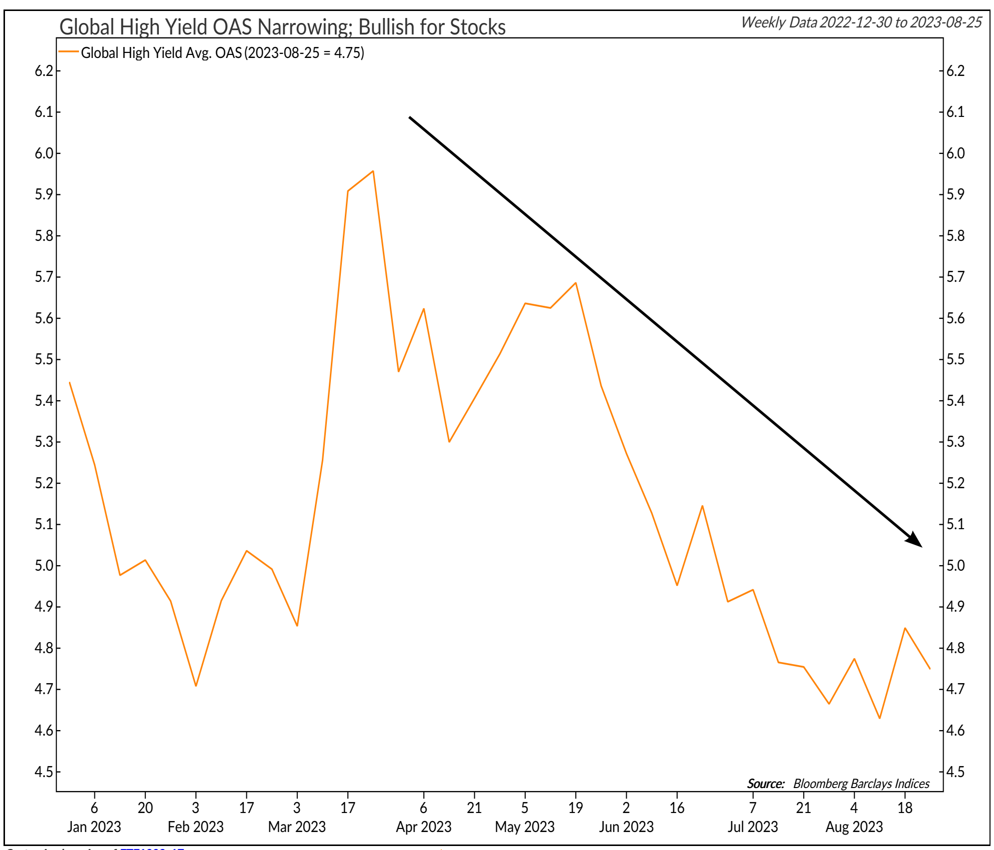

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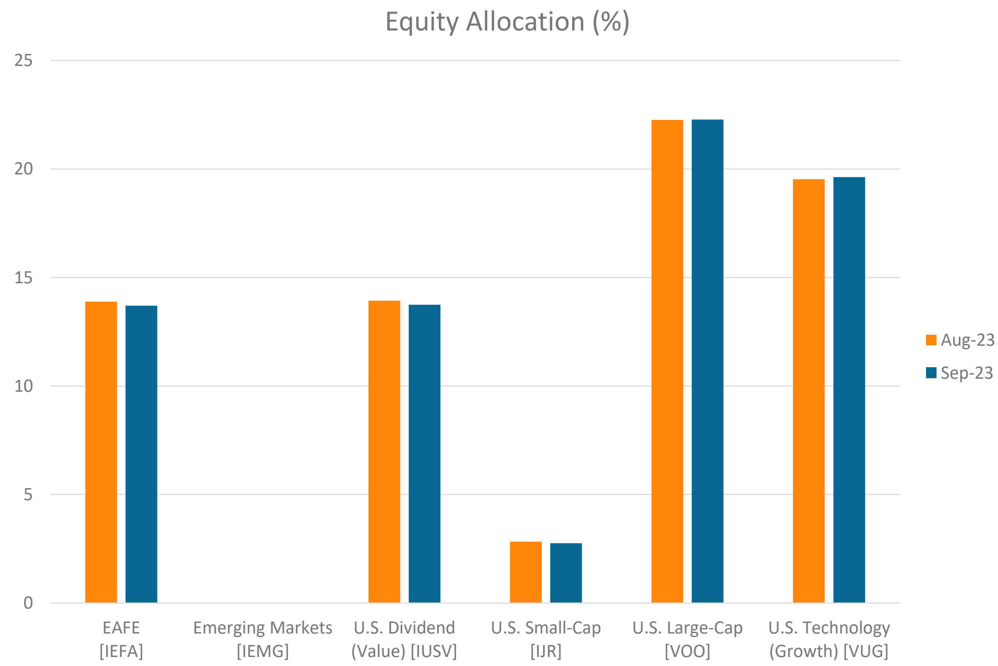
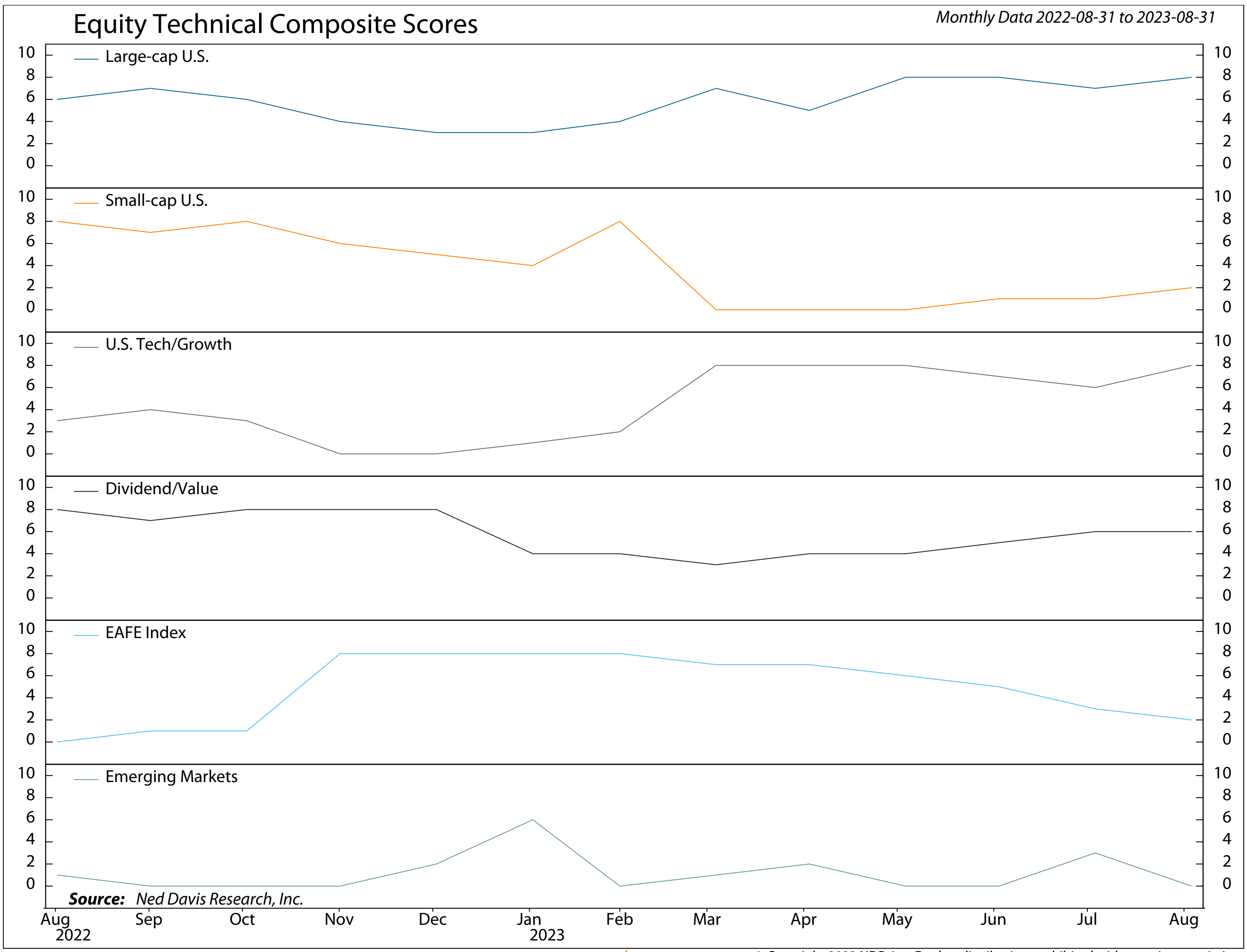
Global high yield option-adjusted spreads (OAS) widened by 125 basis points (bps) from early February until mid-March during the banking sector weakness. With global high yield OAS widening, bond investors demanded higher yields for taking on more risk.

However, since mid-March spreads have narrowed 120 bps (chart left), which indicates growing risk appetite and favors equities over fixed income.

Equity Allocation Summary

During August, all six equity areas declined more than 100 basis points (bps), which last occurred in February. After having its best month since January during July, Emerging Markets (IEMG) had its worst month since February, as it plummeted over 600 bps. U.S. Small-Caps (IJR) and International Developed (IEFA) dropped over 375 bps, while U.S. Value (IUSV), U.S. Growth (VUG), and U.S. Large-Caps (VOO) fell less than 300 bps. VUG and VOO each received more than 15% allocation for September (image at bottom).





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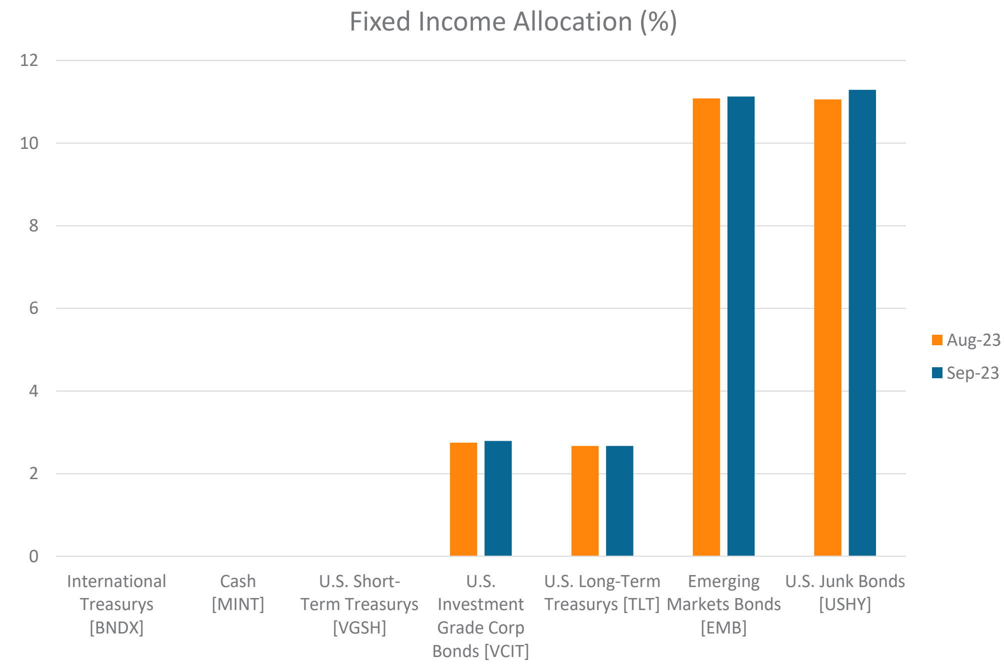
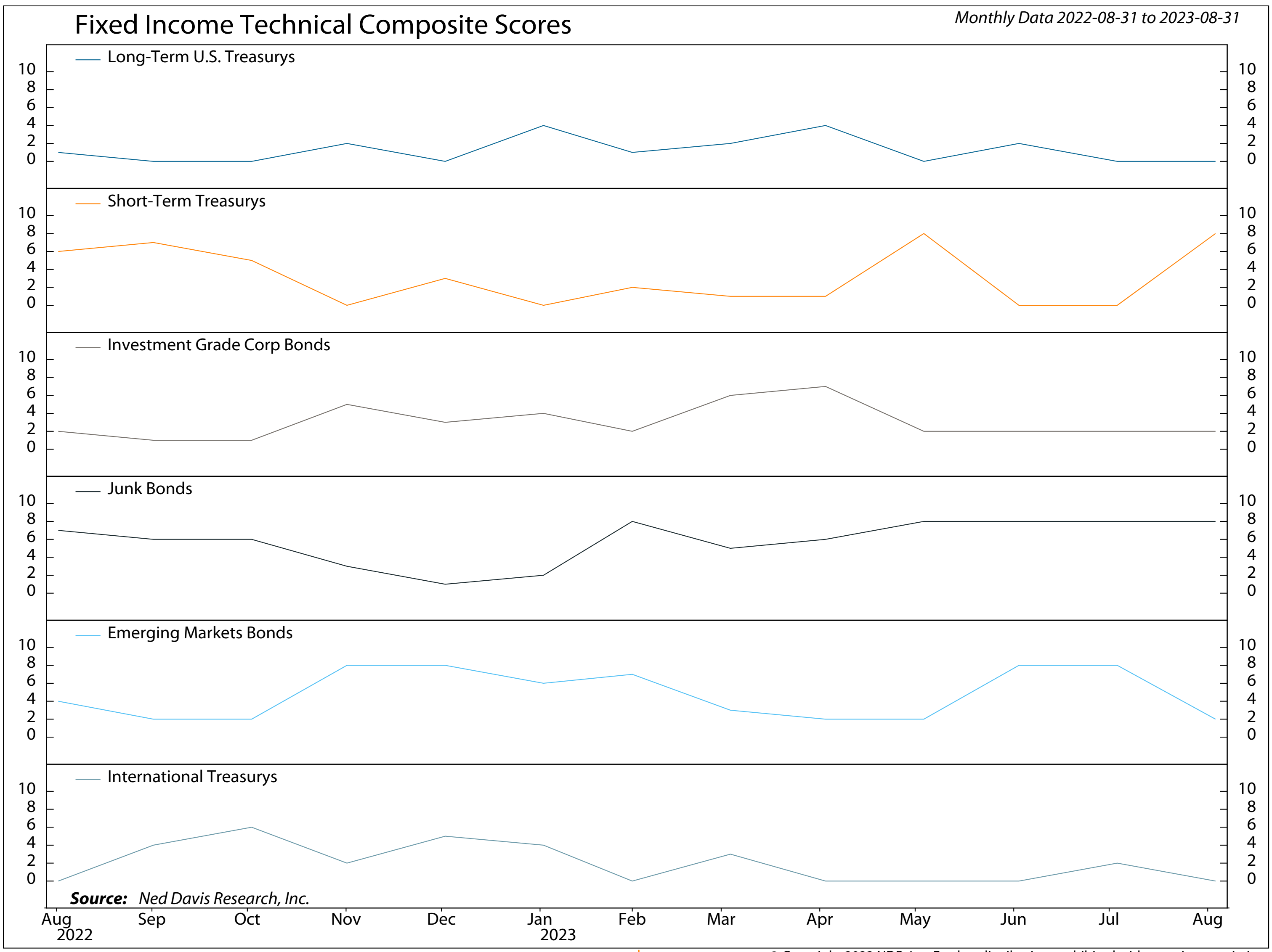
Fixed Income Allocation Summary

Last month, short-term Treasurys (VGSH), International Investment Grade (BNDX), and U.S. High Yield (USHY) produced positive returns. Emerging Markets (EMB) and U.S. Investment Grade Corporates (VCIT) declined at least 65 bps. U.S. Long-Term Treasurys (TLT) plummeted over 310 bps for August. TLT has declined more than 250 bps during eight of the last 13 months! EMB and USHY both have over 10% allocation for September (image at bottom).





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