市場觀望
EYE ON THE MARKET
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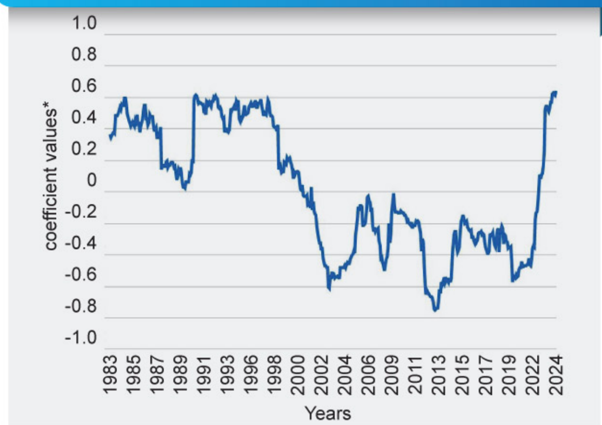
Diversified assets: a new regime needs a fresh approach

From infrastructure assets to local currency EM bonds, the article details the long-term investment opportunities.

For most of the past decade, markets have been in a regime of falling interest rates and low inflation. This environment has favoured the traditional "60/40" (equity/bond) portfolio – an approach that typically relies on equities for growth and bonds for diversification during periods of market stress, or negative correlation between equities and bonds. This changed in 2022. Central banks raised rates rapidly to counter high inflation. As a result, fears over slowing growth led to equities and bonds falling in tandem, despite typical expectations of bonds helping to counter equity market volatility.

Equity markets have moved on from the initial inflation and rates stress, partly driven by a handful of US technology companies and solid economic growth. However, bonds have continued to face a challenging market backdrop. Rate-cut expectations have been pushed further into the future, with the last mile of bringing down inflation proving challenging. Despite this, the absolute strength in equities has led to a strong rebound in "60/40" portfolios.

Correlation between equities and bonds



Source: abrdn, Refinitiv Datastream. The rolling 36 monthly correlation of the S&P 500 Index and the 10-year US Treasury Index, both in total return terms, USD, March 2024.
*These values range from -1.0 (perfect negative correlation) to 1.0 (perfect positive correlation).

Equity markets are now much more concentrated by region, sector, and individual company. The US is 63% of the MSCI AC World. Information technology is the single largest sector at 23%, with five businesses making up 14% of an index that contains over 2,800 companies. At the same time, long-term valuations are not particularly compelling – the S&P 500 trades at 22x forward earnings, well above long-term averages[1]. There's little margin for error if earnings disappoint.

Conversely, bond yields are significantly more attractive than in the past decade and can benefit from a rate-cutting cycle. So they are a better starting point for diversification.

Understandably, investors are asking for better ways to construct resilient portfolios. In doing so, they're increasingly looking for more diversified sources of growth and income: specifically, portfolios that might generate attractive long-term returns while providing resilience during periods of market or economic stress. In investors' view, multi-asset solutions that are diversified across a range of assets can help support the desire for more diversified and flexible portfolios.

Diversified assets

abrdn invests in traditional and alternative asset classes in an unconstrained and flexible way. In doing so, they try to offer a strong return potential, reliable long-term income and resilience across different economic scenarios.

abrdn looks for fundamentally attractive long-term investments, with differentiated risk and return drivers. This includes traditional and alternative asset classes. It's believed this helps to reduce volatility in the short term and lessens the reliance on any one asset class to deliver income and returns – a factor that abrdn thinks is particularly important in today's market environment. Over the past 10 years, they've seen significant growth in the breadth and depth of alternative opportunities that are available in daily traded, liquid forms. These assets potentially offer diversification benefits for portfolios.

Source: abrdn, June 2024. For illustration only.

Access to attractive alternative sectors

The real estate landscape is undergoing significant transformation because of economic and social structural forces. Global thematic trends – such as the reconfiguration of supply chains, the digitisation of the economy, and demographic shifts – are having a material impact on investment demand. Over the last 10 years, the importance of some sectors – such as data centers, large-scale logistics, and single-family rental accommodation – has grown. These changes necessitate an evolution in the built environment to align with an evolving economy and society.

The REIT market can provide investors with significant exposure to those sectors that are likely to be clear beneficiaries of growing structural trends. This contrasts with private real estate investments, which are largely focused on traditional real estate through a balanced portfolio. REITs hold a competitive edge in this area, thanks to the specialized skills and operational expertise required to manage assets in niche sectors – including data centers, rented residential properties, and healthcare facilities. The industry-leading platforms within the REIT market are more challenging and expensive for private-market peers to replicate, offering a significant competitive advantage to these companies in the years ahead.

What does a rate cut mean for real estate investment trusts (REITs)?

Historical research shows that over the 12 months when a real estate cycle begins to move from trough to recovery, listed real estate securities tend to outperform equities and private real estate. This is because of the correlation between bond yields and real estate valuations. The two asset classes share similar characteristics, such as long duration and predictable cashflows. This dynamic unfolded over the latter part of 2023, when the market first became more confident about the trajectory of rates. The FTSE EPRA NAREIT Developed Net Return Index outperformed the MSCI World, in USD terms, over both November (+125bps) and December (455bps). Historical research suggests this trend should continue when the Fed commences its cutting cycle later this year.

Re-emerging cost of capital advantage for REITs

REITs are starting to enjoy a cost of capital advantage, relative to private real estate peers, in some markets. With the balance sheets for REITs improving across several metrics since the Global Financial Crisis (GFC), they are in a stronger position to raise capital and grow through acquisitions. Meanwhile, private real estate investors may still be struggling to raise capital.

Despite strong underlying real estate fundamentals, this capital dislocation has created a number of attractive merger-and-acquisition and asset-level opportunities for REITs.

Backed by a stronger financial footing, and buoyed by attractive fundamentals, many REITs have been able to deploy capital at the bottom of the cycle. This has allowed them to grow externally through acquisitions and to benefit from above-market growth. This provides REITs with a distinct competitive advantage versus private-market peers who tend to rely on bank lending which remains challenging to source.

Outlook

Based on long-term expected returns framework, investors currently see less value in listed equities. This primarily reflects higher starting valuations, with US equities looking particularly expensive on multiple long-term valuation metrics. And while there may be reasons for optimism about factors such as the benefits of AI on productivity growth, investors also recognise there are multiple downside risks for equities.

For most of the past decade, investors have seen little long-term value in bonds, which reflects low expected returns. However, interest rates have risen sharply and bond yields are now more compelling. Over time, it's expected central banks to cut rates back towards neutral, supporting bond returns. However, as investors have seen in recent months, the path to this will not necessarily be smooth. And for credit, while total income may be compelling, credit spreads are pricing in a benign default environment, which leaves a limited margin for error.

While investors see selective opportunities in traditional asset classes, they remain cautious about relying on them alone to generate income and growth.

Instead, investors see several long-term opportunities in a much broader range of asset classes with attractive risk and return characteristics across market environments

- Infrastructure assets that offer capital growth potential and that benefit from long-term stable cashflows that are often inflation-linked. It's believed current valuations are compelling on a long-term basis and have the potential to generate strong risk-adjusted returns.
- Local currency emerging market bonds, which potentially offer attractive returns and diversification benefits.
- Floating-rate asset-backed securities, which offer a materially higher credit spread versus similarly rated corporate credit. In investors' view, they also provide structural protection from defaults over time.

- A variety of special opportunities – or assets with often idiosyncratic return drivers. For example, debt that is backed by healthcare royalties or precious metals royalties. Then there's litigation finance, where performance is based on the merits of a legal case rather than economic growth or inflation.

Source:
1. MSCI and abrdn, as of end May 2024.

Equity Outlook: Earnings Step Back into the Market Spotlight

Too many companies with solid earnings growth haven't been rewarded in narrow equity markets. That may be about to change.

Global equities advanced briskly in the first quarter as investors reconciled themselves to a new reality of interest rates staying higher for longer than expected. With macroeconomic concerns beginning to recede, investors think earnings growth is poised to take center stage as a driver of stock returns for a wider group of companies across equity markets.

When the year began, many investors believed that a series of interest-rate cuts from major central banks was imminent. While the range of potential macro outcomes was wide, the consensus anticipated a rapid succession of rate cuts early in the year to signal that the battle against inflation had been won. That didn't happen.

Turning Point for Equity Markets?

The market's resilience reflects a potential turning point for equity investors. After a prolonged period during which concerns about inflation, growth and interest rates dominated return patterns, corporate profits are regaining prominence—and growing optimism on the earnings outlook has propelled markets in the first quarter. If this trend continues, it's expected equity returns to broaden, following the extreme concentration of markets in the Magnificent Seven, a small group of US mega-cap stocks, over the last year.

On the surface, it might seem as though little has changed. During the first quarter, global growth stocks outperformed value stocks, as they did last year. Technology remained firmly at the top of US and global sector returns.

But beneath the surface, this doesn't look like a rerun of 2023. For one, the Magnificent Seven, seen as the biggest beneficiaries of artificial intelligence (AI), didn't behave like a cohesive cluster. While one of the chipmakers surged, there were two other companies within the Magnificent Seven that lagged. Investors don't think AI enthusiasm is a bubble about to burst, because it's being driven by real earnings growth across the technology industry, unlike during the dot-com bubble. However, diverging returns within the Magnificent Seven did reflect differences in each company's business results, based on reported earnings growth for the full-year 2023.

Change Is in the Air: Key Indicators Begin to Shift

It's too soon to say whether these patterns will persist within the mega-caps or across the broader market. But there is a whiff of change in the air, which investors have sensed in some key indicators.

Earnings growth looks promising and not just for the mega-caps. While the Magnificent Seven stocks as a group still boast higher earnings growth potential than the broader market, it's believed investors must be very selective in how they access this; the divergence of first-quarter returns within the cohort reinforced this lesson.

Beyond the mega-caps, consensus earnings forecasts are picking up. Despite regional differences, it's believed investors can find pockets of attractive growth opportunities in Europe and emerging markets, and even in China, despite its struggling economy.

Globally, the long-term earnings outlook is promising, too. It's indicated that global earnings growth forecasts for three to five years ahead have risen from extreme lows a year ago in nominal and real terms yet remain low in historical perspective. In other words, now is a good time to capture the potential for further improvements ahead.

Meanwhile, valuations are not as extreme as they may seem. US stock valuations have been stretched by the Magnificent Seven. But beyond the mega-caps, it's believed attractively valued opportunities can be found in companies with unappreciated earnings growth potential. The S&P 500 Equal Weight index, which better represents the broader US equity market, is trading at significantly lower price-to-forward earnings valuations than the cap-weighted index. Outside the US, valuations are lower, with shares in Europe, Australasia and the Far East (MSCI EAFE), as well as emerging-market stocks, trading at reasonably attractive levels relative to their long-term history.

Strategic Mindset for a Changing Environment

Identifying attractively valued stocks with strong earnings growth potential will require a strategic mindset that is attuned to the changing environment. It's believed equities will remain vital for investors to generate real returns, above levels of inflation that are higher than investors have seen over the last decade. However, the hurdle to achieving positive real returns will be higher. And even if interest rates come down, a higher level of nominal rates will compound the challenges to companies and investors.

In this environment, it's believed companies that can consistently earn above their cost of capital will be rewarded, while those that cannot do so will likely lag behind. High-quality businesses and fundamentals will be prized. **Healthy balance sheets, sound business models, competitive advantages and management skill will all be vital to delivering earnings growth in the years ahead that can support equity returns above inflation.**

Unfamiliar and evolving conditions will affect the fortunes of companies. As this process unfolds, it's expected the dispersion of earnings outcomes and stock returns to continue to widen. This, in turn, should create fertile ground for active managers to select stocks of companies that have not yet been recognized for their resilience and growth prospects. Even after a strong first quarter for stocks, equity portfolios that focus on business fundamentals through a clear earnings lens can capture attractive long-term return potential for investors as the market transitions to a new normal.

Source: AllianceBernstein, as of September 2024.