7th January 2025

<u>Summary:</u>

This note highlights some key risk observations from Qi's macro factor equity risk model: This model untangles the relationship between daily asset returns and macro factor returns, to identify factor exposures and, in turn, attribute returns and risk to macro

- Markets now believe the S&P500 is strong enough to withstand a strong dollar, positive real rates and continued Fed QT
- A positive dollar / S&P 500 relationship will be an important barometer of confidence in America First
- Small caps are still looking for Goldilocks – accommodative policy but alongside a strong nominal growth economy

The tables have turned in the macro drivers of Growth vs. Value – Growth is now less about the discount rate

Value outperformance is more likely in a risk-off backdrop where confidence on US asset reflation (higher USD / higher stocks) is fading

<u>Where are we?</u>

The great moderation is over -- the multi-decade period of goods deflation from China balanced by inflation in services (Education Healthcare, Real Estate) and managed by the FED with the power of the world's reserve currency behind it, appears to have ended. This presents various challenges to the macro framework: i) a new dispensation in the US that is clear about reducing imports, encouraging domestic production and targeting high nominal GDP ii) a slowing China further focusing on export of advanced manufactures to drive growth – e.g. EVs iii) a troubled Europe with the centre (Germany / France) facing fundamental economic/demographic and political problems iv) a strong US$ and a 10y approaching 5% in a highly indebted world. Whatever your investment style, watching macro and understanding the new relationships between global macro and market securities is a MUST.

<u>What are the critical macro factors to watch for equity markets…</u>

- **Inflation** – although moderating, PCE is still above FED target and will have a very significant impact on monetary policy. There is also significant prospective volatility => Trump import tariffs, CNY devaluation, AI productivity growth, Fiscal tightening
- **10y yield** – above 4.5% with real yields at ~2%. As the key discount rate for the world, this has a major impact on US and global investment and economy
- **US$** – at historically strong levels (almost parity with EUR). Rate differentials, GDP growth and Trump's economic/industrial policy will keep this an important factor to watch
- **Risk** – as usual credit spreads and the VIX will be the quickest to respond to fear and have to be tightly monitored

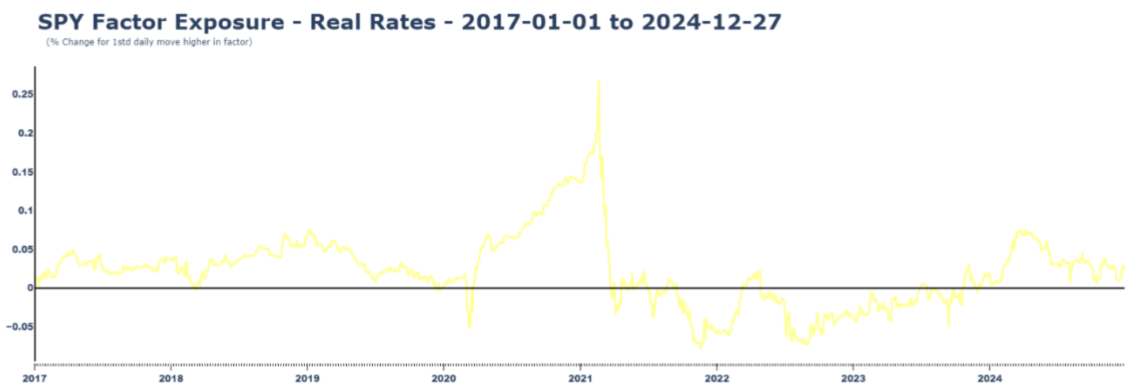
Large Caps, Small Caps, Value & Growth – Some key macro relationships

S&P 500

Let's look at the evolution of sensitivities to macro factors over the last five years that are key to watch going forward. It is interesting how this has evolved during the pre-Covid, Covid, Inflation worries and FED tightening concern periods. Although lingering concerns remain about inflation and the market wants it lower, overall, we seem to be coming out of the post Covid gyrations into a period where the SPX is strong enough to withstand a strong US dollar, positive real rates and continued FED QT.

Notice that the US dollar relationship on our models has turned positive for the first time in almost 3yrs. Why? Well the expectations are that a successful America First policy agenda can boost domestic growth and attract foreign investment, supporting US assets more broadly. It is also worth remembering that history shows US equity outperformance vs. RoW has more often than not been associated with Dollar strength (and vice versa).

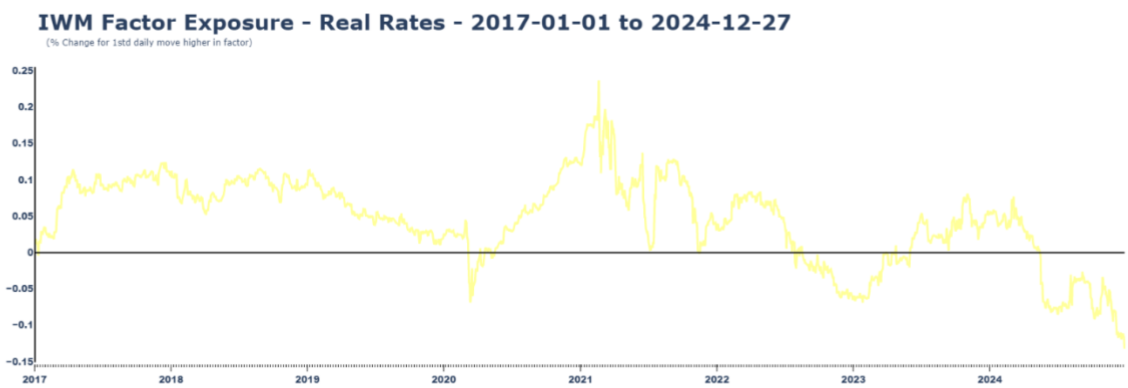
Given the success of Trump's policy agenda will have a large bearing on the performance of US assets, it follows that the strength of the positive relationship between the dollar and S&P500 (i.e. both the Dollar AND Stocks move up) may be seen as a barometer of confidence in Trump's domestic agenda.

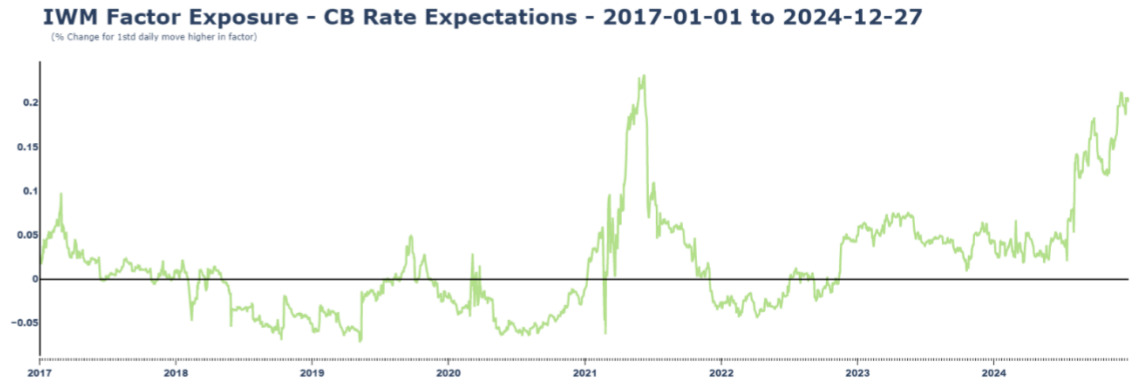


Russell 2000

The Russell 2000 has had a major evolution over the last few months. It now wants sharply lower real rates, the Fed to revert to QE but is comfortable with fewer Fed rate cuts (presumably reflecting a strong underlying economy).

The clear picture is that the R2K wants an accommodative monetary policy but with a strong nominal growth economy. If Trump succeeds in his NGDP targeting as a way to grow out of the US's debt/deficit problems then this would be positive for the Russell.





Growth & Value

Let us look deeper into the two key Styles that are the focus for many investors – Growth and Value. For most of the last 5 years we have seen the sensitivity of Growth to 10y real rates be more negative than the sensitivity of Value to real rates, i.e. Growth has been keener on lower real rates. Now that has changed, it is Value that is asking for greater accommodation (below) while Growth is actually positively sensitive to real rates.

The last 2 years have cemented the outperformance of Growth Stocks over Value Stocks. Indeed, the outperformance of Growth over Value continues a trend that has been in place since the start of the last decade through the biggest bull market of our generation!

However, a clear message of the last 2 years is that the fundamental drivers of Growth vs Value have changed.

The last decade norm was that Growth tended to be "hope" and so was much more sensitive to the discount rate on terminal value as current ROI prospects were poor. Now Growth shows prospects of much higher current ROI. The superior performance of Growth over the last 2yrs was largely in recognition of this far superior earnings profile, fueled by the secular AI narrative.

Contrast this with Value – across the forest of investment projects, the lower return ones are more likely to fall in the value camp – a lower ROI requires a lower cost of capital associated with a weaker Dollar / lower rates.

Quant insight