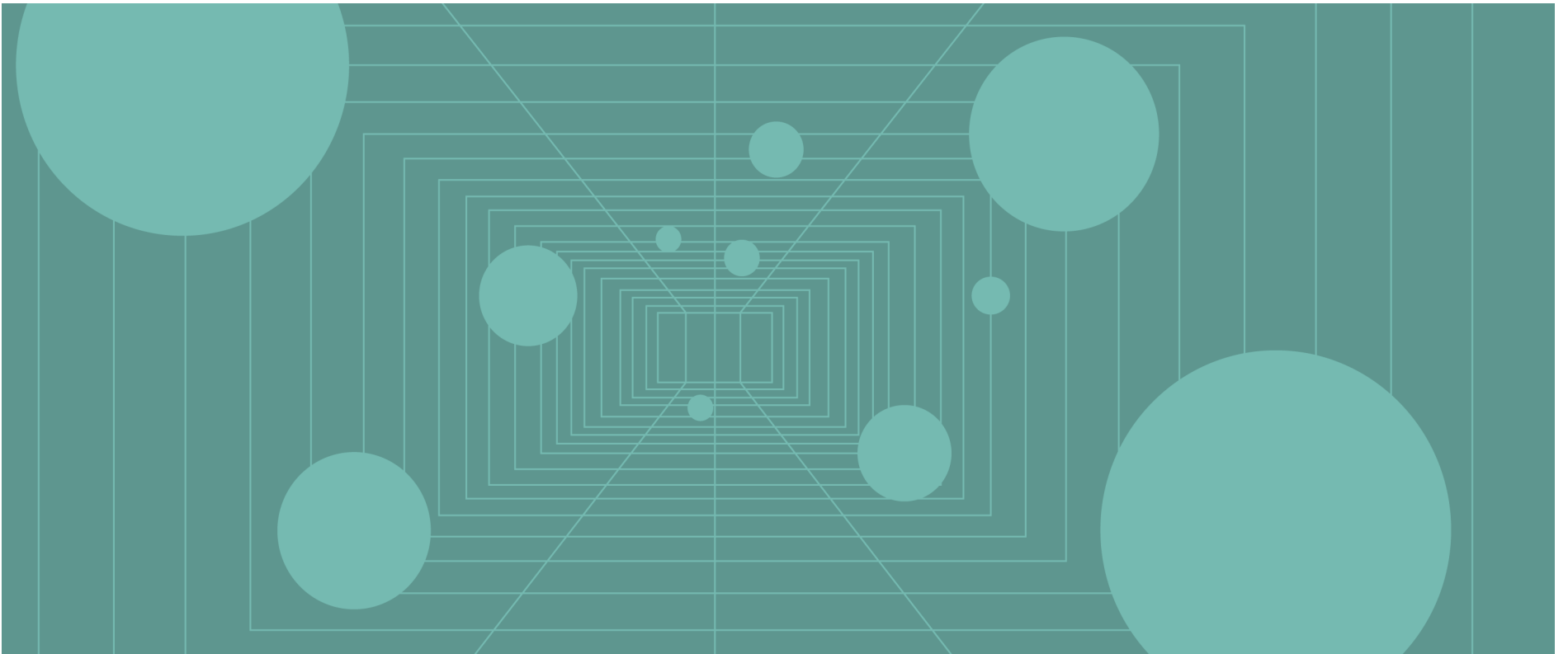


# TACTICAL CA HOUSE VIEWS





## Overview of Tactical CA House Views

May 31, 2024

Our house views are intended to generate excess returns over a three- to five-year horizon. Sizing of tactical positions should reflect an investor's risk tolerance, liquidity needs, and other holdings.

### CURRENT POSITIONS

OVERWEIGHT	UNDERWEIGHT	RECOMMENDED SINCE
China All Shares	Global Equities	1/31/2022
California Carbon Allowances	Global Equities	10/31/2021
Developed Markets ex US Small-Cap Equities	Developed Markets ex US Equities	9/30/2023
US Small-Cap Equities	US Equities	4/30/2022
Developed Markets Value Equities	Developed Markets Equities	6/30/2020
Long US Treasuries	Treasuries	9/30/2023



# Overweight China All Share Equities vs Global Equities

Recommended Since January 31, 2022

**INVESTMENT THESIS:** We expect Chinese equities will outperform global equities, given depressed relative valuations and oversold levels of momentum, which appear disconnected from expectations of stronger near-term economic and corporate earnings growth in China. Increased fiscal and monetary stimulus will be the catalysts to unlock current valuation discounts.

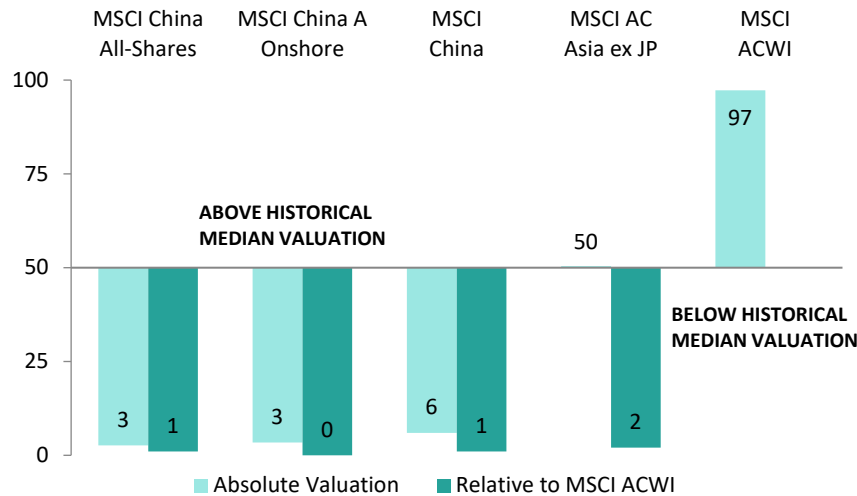
- **KEY SUPPORT #1:** Chinese equities have underperformed global equities in recent years. As a result, equity valuations are in the bottom decile of historical data dating back to 2005. Moreover, the gap between Chinese and global equity valuations remains near record wide levels relative to history, which also suggests Chinese equities may be underpriced. Although, Chinese equities have shown a recovery since February, relative momentum remains at oversold levels, offering further upside potential as China’s economy stabilizes.

- **KEY SUPPORT #2:** We expect Chinese equities to benefit from additional monetary and fiscal policy easing. Recent economic data show signs of improvement, and analysts expect real GDP growth and corporate earnings growth in China to be higher than many major developed economies in 2024–25. The end of Fed tightening may allow the PBOC to act more aggressively without further impacting the RMB. Further stimulus could trigger a sharp rebound given oversold levels of valuations and momentum.

- **KEY RISKS:** Further economic weakness and US-China political tensions are two key risks. On the former, the economy is facing challenges associated with weak domestic demand, the property sector, and debt levels. The economy needs further stimulus, without which economic growth may be challenged. On the latter, an escalation in US-China tensions could further impact investor sentiments and fund flows to China. However, we think current valuations reflect these risks and expect Chinese equities will outperform global equities.

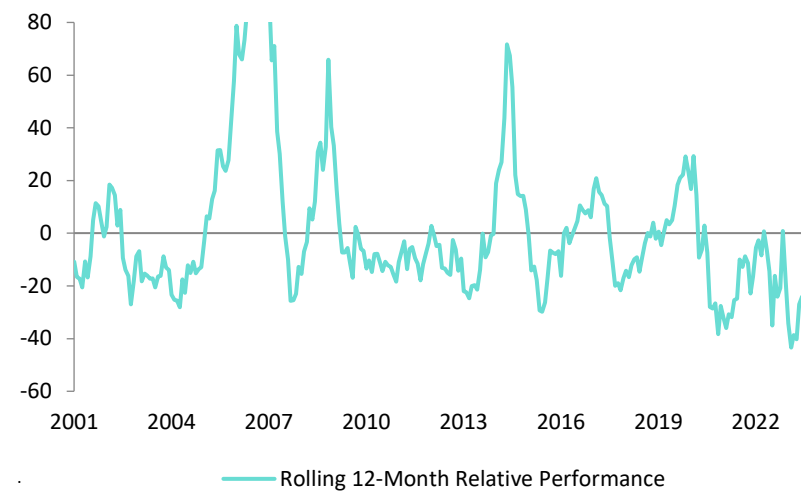
## ROE-ADJUSTED P/E: PERCENTILE

March 31, 2005 – May 31, 2024



## RELATIVE PERFORMANCE: MSCI CHINA ALL-SHARES VS ACWI

December 31, 2001 – May 31, 2024 • USD • Total Return • Percent (%)





# Overweight California Carbon Allowances vs Global Equities

Recommended Since October 31, 2021

**INVESTMENT THESIS:** We expect California Carbon Allowances (CCAs) will outperform global equities, given our expectation that supply/demand fundamentals are likely to help narrow the gap in prices between CCAs and the EU carbon allowance program. We prefer owning physical allowances over futures implementation. Regulated entities are allotted free allowances for a portion of their emissions and must purchase additional credits to satisfy remaining obligations.

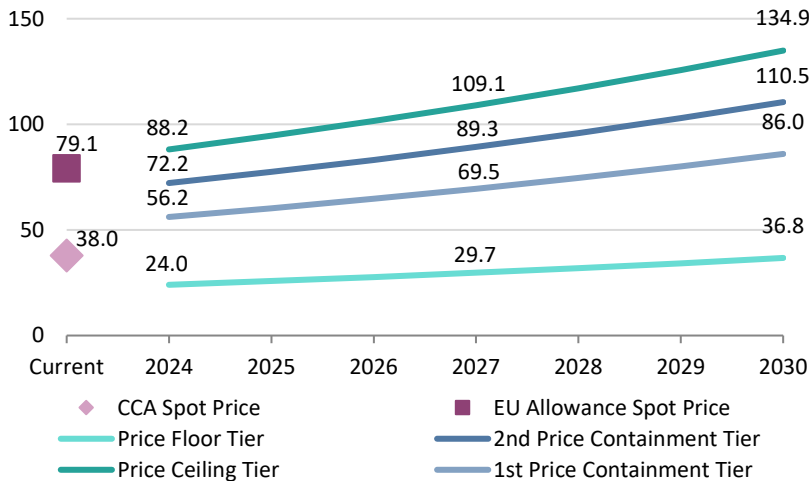
- KEY SUPPORT #1:** California projects that its cap-and-trade program will be needed to meet its 2030 mandatory emissions target. Accordingly, the state must reduce CCA supply relative to demand. On April 9, the California Air Resources Board (CARB) issued a Standardized Regulatory Impact Assessment as a step toward pursuing an increase in emissions reduction targets to the cap-and-trade program and is exploring allowance budgets beyond 2030 through 2045. These changes will increase expected CCA deficits, which in more mature carbon markets have typically led to price increases.

- KEY SUPPORT #2:** CCAs trade at a discount to EU carbon prices. We expect CCAs will increase toward current EU price levels. We anticipate that relative to equities, CCAs downside is lesser, while the upside is much greater. The CCA price will receive an additional boost as the CARB targets a 48% reduction in emissions by 2030, requiring a 264 million reduction in CCAs between 2025 and 2030.

- KEY RISKS:** Regulatory changes present the biggest risk to CCAs, although the program is well established and provides significant revenue to the state of California. Further, demand for carbon credits will decrease in a recession putting downward pressure on carbon prices, potentially more than equities. CCAs can experience short-term volatility related to technical issues in the options and futures markets. Finally, global equity performance may exceed our expectations. From an implementation perspective, rolling futures cost an estimated 3%-5% annually, while options for owning physical allowances are limited.

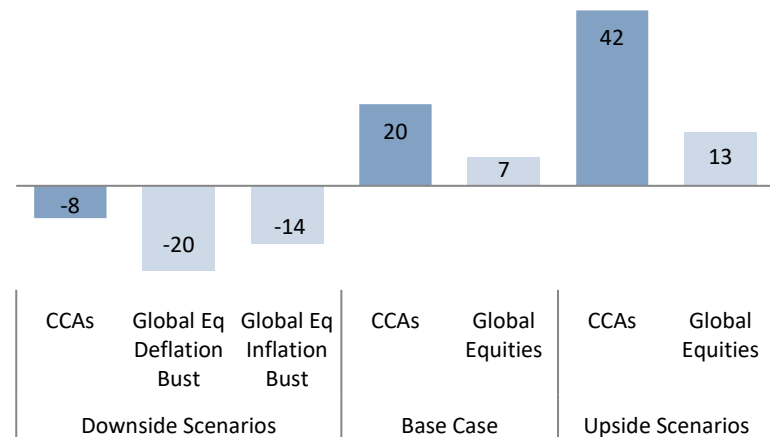
## CCA PRICE COMPARED TO EU AND PRICE CONTAINMENT TIERS

As of May 31, 2024 • US Dollars



## RETURN PROJECTION SCENARIOS: CCAs VS GLOBAL EQUITIES

As of May 31, 2024 • 3-Yr Annualized Average Compound Return (%)



Sources: Bloomberg L.P., MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: For the left-hand side chart, spot prices are based on near month futures contract prices. Price tiers increase by 5% plus inflation per year, which is assumed to equal US TIPS 10-year breakeven inflation. Price containment tiers are thresholds at which additional allowances are made available as a hedge against higher costs. For the right-hand side chart, for CCAs, the downside scenario assumes prices decline to the 2026 price floor; the base case assumes prices increase to \$65, converging toward current EU ETS carbon prices; and the upside scenario assumes prices increase to the 2026 price ceiling. For global equities, the deflation bust downside scenario assumes that normalized P/E ratios decline by 50% and the nominal normalized earnings growth rate averages -2% year-over-year. The inflation bust downside scenario assumes the same P/E contraction with an average growth rate of 2.5%. The base case for global equities assumes today's normalized P/E is unchanged during the period and the growth rate reflects recent averages. The upside scenario assumes that normalized P/E increases by a decile (or to the all-time max if current P/E ratios are already above the 90th percentile) and an average growth rate of 6%.



# Overweight Developed Markets ex US Small Caps vs Developed Markets ex US Equities

Recommended Since September 30, 2023

**INVESTMENT THESIS:** We expect developed markets (DM) ex US small-cap equities will outperform their mid- to large-cap counterparts, given their low relative valuations, strong earnings growth outlook, and still-weak performance momentum (despite the rally in 4Q 2023). DM ex US small caps perform best during economic upswings—with limited downside during recessions—making the current valuation discount particularly attractive.

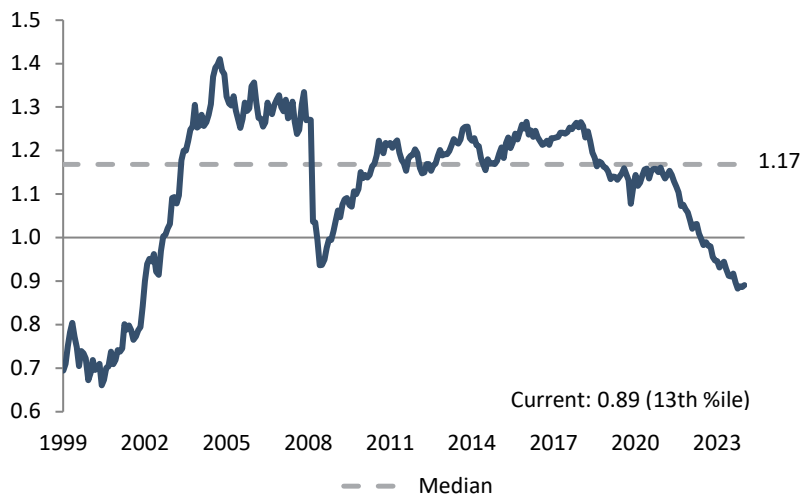
▪ **KEY SUPPORT #1:** DM ex US small-cap equities trade at enticing valuation levels relative to their mid- and large-cap peers. In fact, small caps trade at an 11% discount, according to our preferred normalized earnings multiple, compared to their typical 17% premium. Historically, small caps consistently outperformed mid/large caps over subsequent three-year periods when starting valuations traded at a discount. Small caps appear adequately priced for an economic downturn scenario, and a recovery in economic activity—such as the recent rebound in Europe—would support their performance vis-à-vis mid/large caps.

▪ **KEY SUPPORT #2:** The valuation backdrop and earnings growth outlook suggest that DM ex US small caps are primed for a rebound. Although performance was strong in 4Q 2023, upside potential for the trade remains. Analysts expect EPS growth of 15% in the next 12 months, compared to 7% for the mid- and large-cap universe. The expected earnings outperformance is broadly based across geographies and sectors. Small-cap price levels are now 17% below their three-year peak, whereas large caps have rebounded more quickly (1% below peak). Taken together, we expect the performance gap to narrow.

▪ **KEY RISKS:** Relative to large caps, small caps have higher leverage, lower profitability, and are prone to larger drawdowns in a risk-off scenario. Real estate is the largest sector overweight and is concentrated in Japan. Easy monetary policy has protected performance, but any shift to tightening—such as the Bank of Japan’s (BOJ) rate hike in March—could pose a headwind. Still, further monetary tightening by the BOJ is likely to be moderate and gradual.

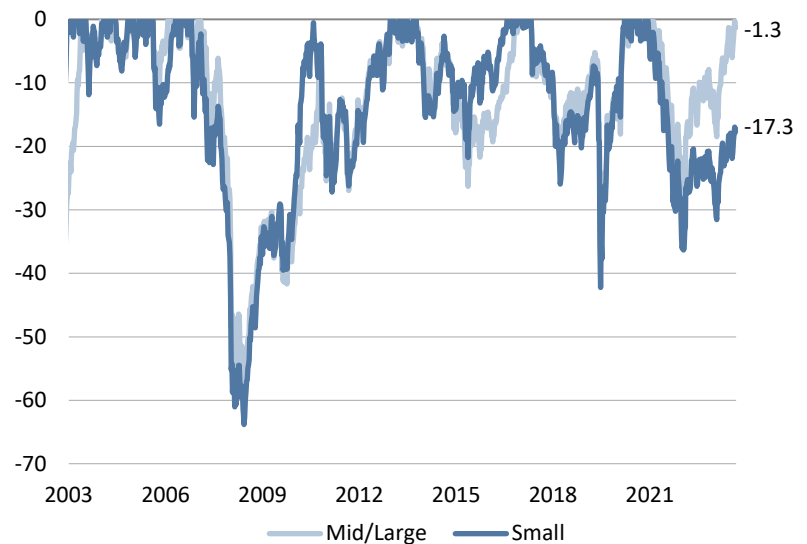
## RELATIVE NORMALIZED VALUATIONS: DM EX US SC VS LARGE/MID CAP

May 31, 1999 – May 31, 2024



## DRAWDOWN FROM ROLLING 3-YR HIGH: DM EX US EQUITY

January 1, 1993 – May 31, 2024 • US Dollars • Percent (%)



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Relative normalized P/E data are monthly and are based on an adjusted price-to-cash earnings ratio. The cyclically adjusted price-to-cash earnings (CAPCE) ratio is calculated by dividing the inflation-adjusted index price by trailing five-year average inflation-adjusted cash earnings. Cash earnings are defined as net income from continuing operations plus depreciation and amortization expense. MSCI does not publish cash earnings for banks and insurance companies and therefore excludes these two industry groups from index-level cash earnings. Drawdown data are weekly and based on index price levels.



# Overweight US Small-Cap Equities vs US Equities

Recommended Since April 30, 2022

**INVESTMENT THESIS:** We expect small-cap equities will outperform their mid- to large-cap counterparts in the United States, given their valuation discount and strong profitability. We like the relative diversifying benefit from their sector exposures. Small-cap equities have historically tended to perform best in the recovery stage of business cycles, and investors could see significant benefit when fundamentals rebound.

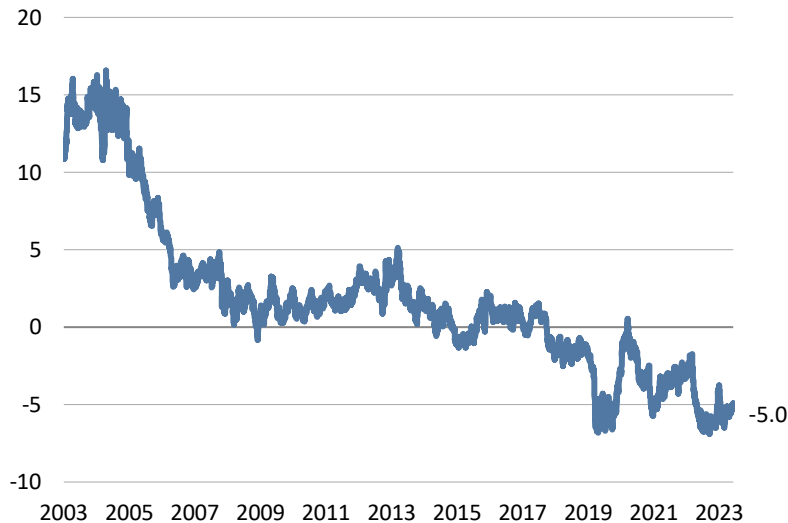
▪ **KEY SUPPORT #1:** US small-cap valuations are steeply discounted relative to US mid- to large-cap equities. The S&P 600® Index trades at a 43% discount to the MSCI US Index's 21.3 normalized price-to-cash earnings multiple, the widest discount on record based on history back to 2003. Investors have also assigned higher multiples to expected earnings for large-cap stocks relative to small caps. The price-to-forward earnings multiple for the MSCI US Index is 21x, 1.4 times higher than that for small-cap stocks. This is 54% higher than the median of 0.9 that has been observed over the past 20 years.

▪ **KEY SUPPORT #2:** Recent US government initiatives, such as the Infrastructure Act, the CHIPS Act, and the Inflation Reduction Act, could provide incentives for some reshoring of supply chains that would benefit certain sectors overweight in small-cap stock indexes. In the case of the Infrastructure Act, a substantial amount of funding is still yet to be awarded. The industrials and materials sectors, which could see direct benefit from this impending spending, have higher relative weights in the S&P 600® Index compared to the MSCI US Index.

▪ **KEY RISKS:** Small-cap companies have lower margins and tend to be more cyclical than larger-cap stocks, and thus are more vulnerable to an economic slowdown. Moreover, the recent boom in mega-cap tech stocks saw small caps lag substantially, and a continuation of that rally could further widen the performance gap.

## 5-YR EXCESS RETURN S&P 600® VS MSCI USA

December 31, 2003 – May 31, 2024 • Rolling 5-Yr Relative AACR (%)



## RELATIVE NORMALIZED P/E RATIO: S&P 600® VS MSCI USA

December 31, 2003 – May 31, 2024





# Overweight Developed Markets Value Equities vs Developed Markets Equities

Recommended Since June 30, 2020

**INVESTMENT THESIS:** We expect value equities to outperform broad equities in developed markets, given the style’s attractive valuation multiples, our expectation that it will outperform when economic activity improves, and that a secular shift to more normalized interest rate policy could be more supportive to value equities than the broad index.

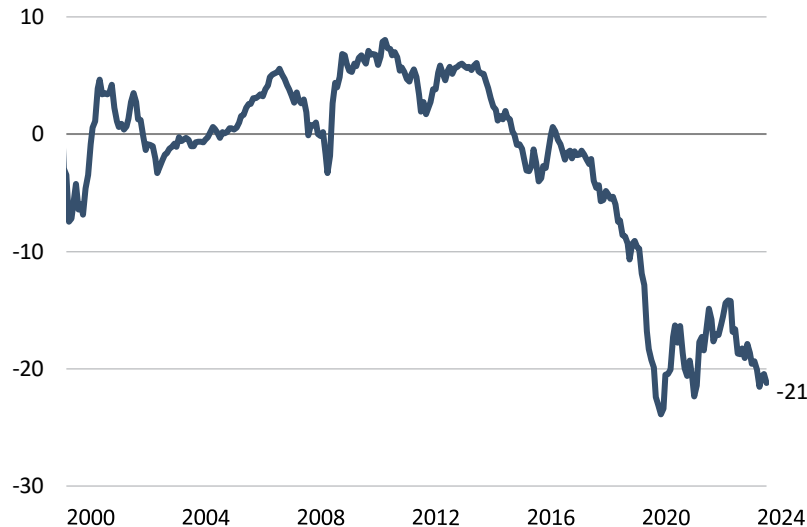
▪ **KEY SUPPORT #1:** Value equities trade at a discount relative to broad equities. Using the MSCI World Value Weighted Index and the MSCI World Index as our proxies, value equities trade at 9.2 times trailing five-year cyclically adjusted earnings, while broad equities trade at 15.4 times. That gap is wider than the typical valuation gap between these two blocs and has widened after the recent surge in AI-related tech stocks pushed growth valuations higher. The relative valuation is now 21% below the long-term median discount, after bottoming at 24% in late 2020. A further closing of that valuation discount would support value equity performance.

▪ **KEY SUPPORT #2:** Value equities have often held up better than broader equities in higher rate environments. Investors have continued to dial back expectations for the number of rate cuts that global central banks will make this year, suggesting that costs of capital will remain higher than in the past decade. This should support value, particularly relative to growth stocks that could see headwinds from higher-for-longer rates.

▪ **KEY RISKS:** Value tends to underperform in recessions, given its larger exposure to cyclical sectors. Downturns are also associated with reductions in costs of capital, which tend to be beneficial to sectors that value indexes often underweight, such as information technology. Moreover, the recent boom in artificial intelligence stocks could persist, which could keep growth stock valuations elevated.

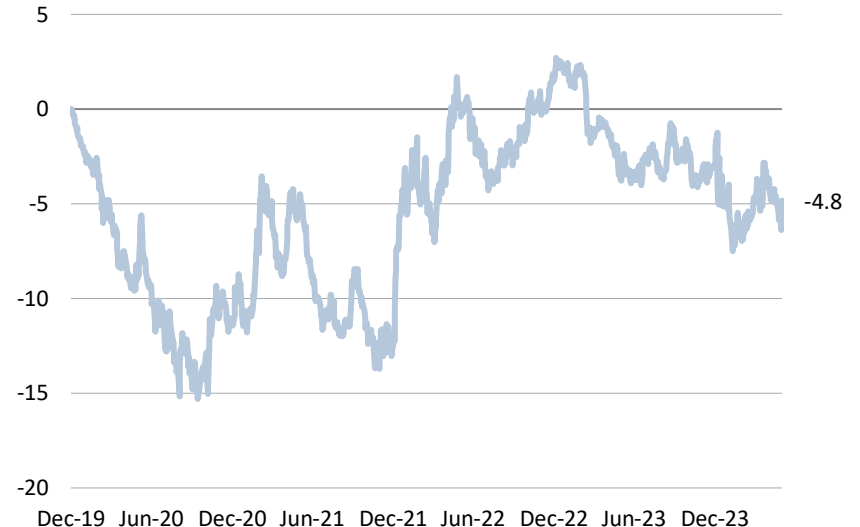
RELATIVE NORMALIZED P/E RATIO: PERCENT (%) FROM MEDIAN

January 31, 2000 – May 31, 2024



CUMULATIVE RELATIVE RETURN SINCE PRE-PANDEMIC LEVEL

December 31, 2019 – May 31, 2024 • Percent (%)



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties. Notes: Relative normalized P/E ratio and relative returns are both based on the MSCI World Value Weighted Index versus the MSCI World Index. All data are in US Dollar terms. Relative normalized P/E data are monthly and are based on an adjusted price-to-cash earnings ratio. The cyclically adjusted price-to-cash earnings (CAPCE) ratio is calculated by dividing the inflation-adjusted index price by trailing five-year average inflation-adjusted cash earnings. Cash earnings are defined as net income from continuing operations plus depreciation and amortization expense. MSCI does not publish cash earnings for banks and insurance companies and therefore excludes these two industry groups from index-level cash earnings. Performance data are daily and are based on total returns net of dividend withholding taxes.



# Overweight US Long Treasury Securities vs US Treasury Securities

Recommended Since September 30, 2023

**INVESTMENT THESIS:** We expect US Long Treasury securities to outperform US Treasury securities over a one- to three-year period given they appear both oversold and cheap. In addition, the economic and policy backdrop should become more supportive in the second half of 2024 if economic activity, inflation, and Fed policy rates return to more normal levels as expected.

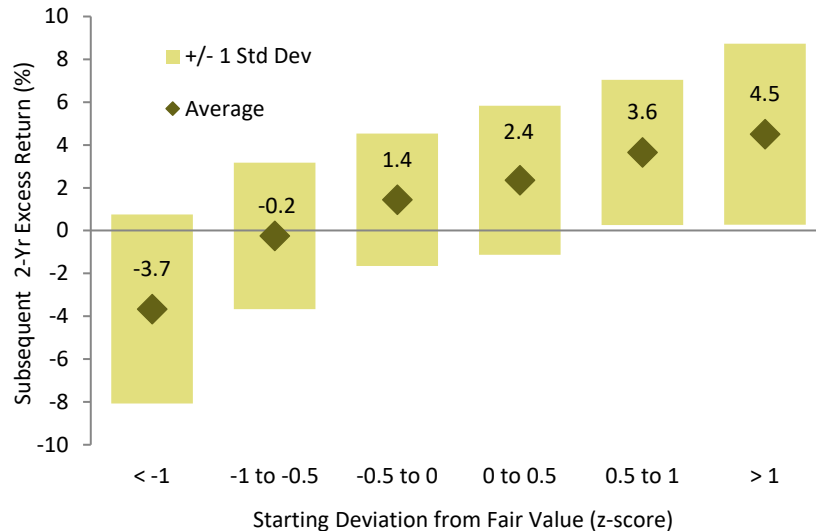
▪ **KEY SUPPORT #1:** The sharp rise in interest rates has resulted in one of the worst bond bear markets on record, with US Long Treasury securities declining as much as 40% over the previous three years. However, the sell-off appears to have bottomed due to softer inflation and a signal from the Fed that it is done hiking rates and plans to cut rates at some point in the near future. US Long Treasuries tend to outperform heading into and following the first Fed rate cut, suggesting this trade has upside if/when the Fed begins cutting rates.

▪ **KEY SUPPORT #2:** Treasury valuations became extremely cheap in 4Q 2023. Ten-year Treasury yields peaked at 5%, more than 1 standard deviation above their estimated fair value of 4.1%. While valuations have normalized somewhat, they still favor extending duration in fixed income portfolios. Ten-year Treasury bonds were yielding 4.5% as of May 31, which is 0.5 standard deviations above fair value. We would look to close this trade if valuations fell below their fair value, all else equal.

▪ **KEY RISKS:** The major concern for this trade is resilient US growth persists and adds to inflationary pressures, which could force the Fed to consider additional rate hikes. However, in our view, this risk is low as the bar to hike rates is high. Challenging supply and demand technicals are also a headwind for Treasury securities given the low term-premium. Non-US investors should consider the impact of FX volatility and regional differences in economic and policy outcomes.

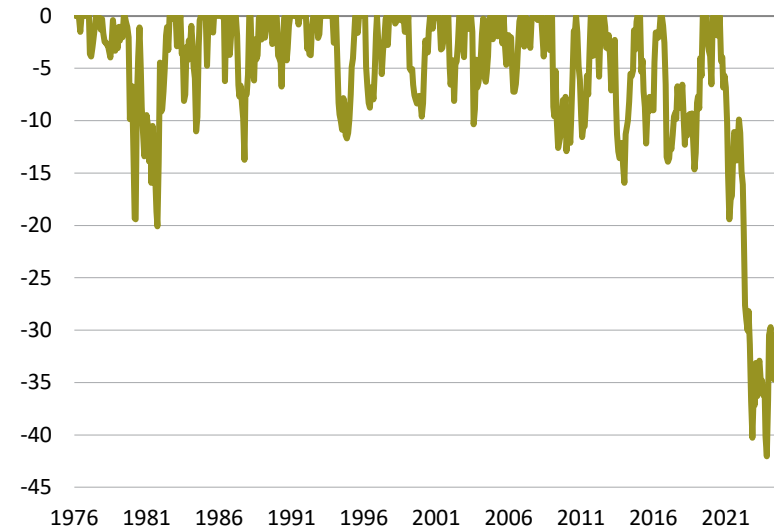
## US LONG TREASURIES VS TREASURIES: VALUATIONS & PERFORMANCE

January 31, 1973 – May 31, 2024 • Average Annual Compound Return



## US LONG TREASURIES: ROLLING 3-YR MAX DRAWDOWN

January 31, 1973 – May 31, 2024 • Total Return (%)



Sources: Bloomberg Index Services Limited, Federal Reserve, Thomson Reuters Datastream, US Department of Commerce - Bureau of Economic Analysis, and US Department of Labor - Bureau of Labor Statistics. Notes: The starting deviation from fair value is the deviation of ten-year US Treasury yields from their fair value shown as a z-score. Fair value is estimated using a multiple linear regression model that includes trailing ten-year real GDP and headline CPI growth. GDP data are as of March 31, 2024, and CPI data are as of April 30, 2024.





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