Uncommon truths

Who will suffer most from US tariffs? Not China or the EU!

Chinese and European stock indices have easily outperformed US counterparts since the start of the year, despite the threat of tariffs. Perhaps this is because their respective trade surpluses with the US are small compared to their economies.

When President Trump won the 2016 election, the price of gold moved to a $230 premium to the fair value suggested by my econometric model (based on the US 10-year TIPS yield, the US 10-year inflation breakeven and the trade weighted value of the US dollar). At the time I supposed it was due to concerns about the geopolitical implications of a Trump presidency.

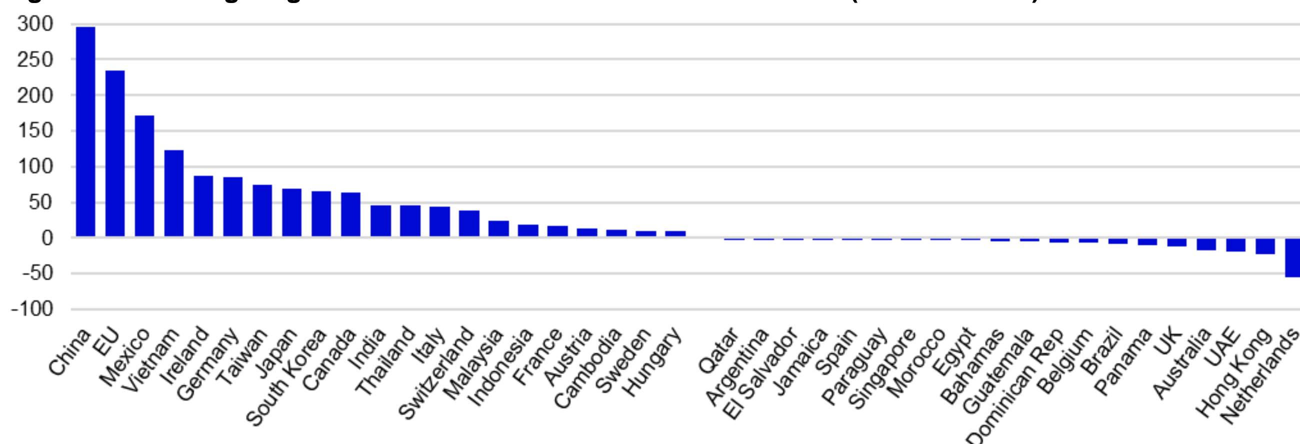
Well, we seem to be seeing a rerun, with gold around $2900. That is up nearly $400 since the end of August 2024, which is a gain of 15%, despite the rise in treasury yields and the dollar over the same period. I use the end of August as the reference date as that was when the opinion poll lead of Kamala Harris was peaking. Once again, I think that geopolitical tensions are behind the subsequent rise in gold, with trade disputes, rising tensions in the Middle East and Europe despairing at the approach to Ukraine (not to mention the possible annexation of Canada and Greenland!).

In the midst of all this, Germany is about to hold elections (on 23 February). Opinion polls suggest to me that a change of Chancellor is the most likely outcome (to Friedrich Merz of the CDU/CSU Union). However, with recent opinion polls putting the CDU/CSU alliance on 29%-32% of the vote, I think they will need to partner with the SPD party that leads the outgoing coalition (12%-18% of the vote in opinion polls). However, it is also possible that another party will have to be included in the coalition to give the government a parliamentary majority. Even worse, the FDP (the natural partner for the CDU/CSU) may fail to achieve the 5% of votes needed to sit in parliament, in which case Merz will face the uncomfortable choice between the Greens and one of the left-wing die Linke and BSW parties as the final coalition partner. This of course assumes that the AfD (around 20% of votes) remains unwelcome in any government.

So, Germany faces a change of Chancellor. However, the need for a coalition with unnatural partners may limit the scope for radical change. I think the two big issues for the new government will be reform of the debt brake and the approach to Ukraine (including the ramping up of defence spending). These issues are intimately linked (big spending programmes may require a change in laws concerning fiscal rules) but making progress could pave the way for a stronger German economy, especially if new military equipment is sourced locally (as I think it will increasingly be). Perhaps this is why German stocks have been so strong since the US election (outperforming US stocks by some margin, based on MSCI indices).

Turning to trade, it would appear that the threat of tariffs has not overly impacted European stock markets, which have outperformed US stocks over recent months (see **Figure 3**). This is interesting given that the EU seems to be in the firing line of President Trump (now with the bizarre suggestion that EU VAT is a form of tariff, despite applying to domestic as well as imported goods and services). **Figure 1** suggests that the EU's surplus in the trade of goods with the US is not far behind that of China, which explains the fixation by those in the US. Among EU countries, Germany has a large surplus with the US, which is no surprise. More interesting is that Ireland had an even bigger surplus in 2024.

Figure 1 – The largest goods trade imbalances with the US in 2024 (in USD billion)



Note: The chart shows the balance of trade in goods with the United States of America in 2024. The countries shown are the 20 (plus the EU) with the largest surplus with the US and the 20 with the largest deficit.
Source: US Census Bureau, LSEG Datastream and Invesco Global Market Strategy Office

Figure 1 shows those countries with the largest surpluses with the US and those with the largest deficits (the latter includes the Netherlands and the UK). There are a similar number of countries that have deficits to those that have surpluses but the latter tend to have larger imbalances, which is why the US had an overall deficit of around US$1.2trn in 2024.

However, when it comes to the pain potentially felt by trading partners that are subject to trade restrictions (including tariffs), **Figure 1** gives a distorted view since it doesn't allow for the size of the economies concerned. I think a better guide comes from dividing the trade imbalance by GDP, which is what is shown in **Figure 2**. Again the focus is on the 20 largest surpluses and deficits but this time as a share of GDP.

Though China, the EU and Germany may be targeted by the Trump administration, they disappear from the top 20 surplus list when the size of economies is considered. It would appear that the economies of Vietnam and Cambodia are most at threat if tariffs are applied across the board (their goods trade surpluses with the US amounted to 26% of their respective GDPs in 2024). After Guyana, Ireland is next in line at 15%, which again may come as a surprise. By way of comparison, Germany's goods trade surplus with the US to GDP ratio was 1.8% in 2024, while that of China was 1.6% and that of the EU 1.2%. This may also help explain why Chinese stocks have done so well of late (see **Figure 3**)

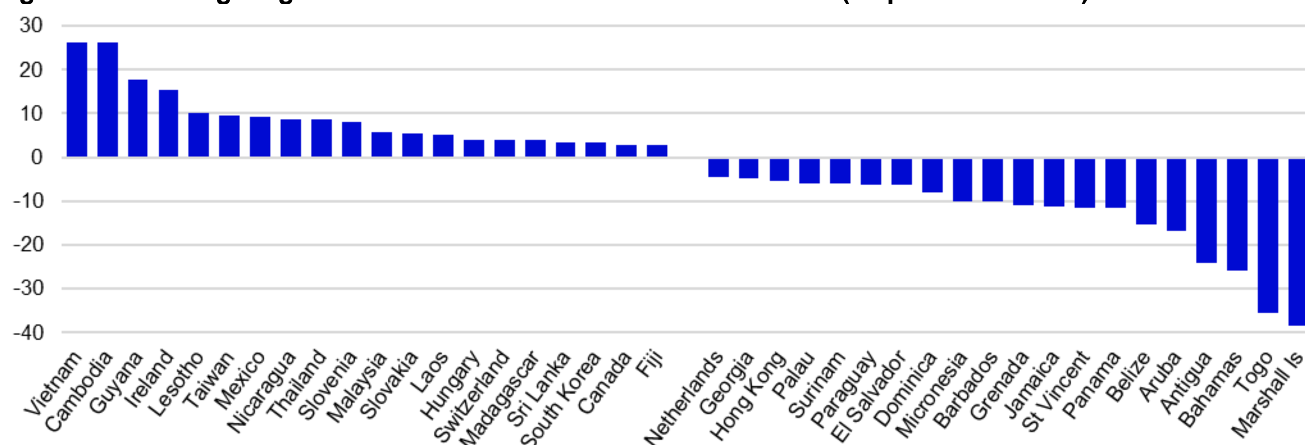
Figure 2 also suggests that some countries could gain from a "fairer" trade relationship with the US, if it leads to a smaller trade deficit. First in line would be the Marshall Islands (trade deficit with the US equal to 38% of GDP), while Hong Kong and the Netherlands are also in the top 20 deficit/GDP countries.

Of course, there are a number of problems with any such analysis. First, it assumes that tariffs are applied across all goods and countries in equal measure. Second, it ignores the fact that exports sent from a country such as Vietnam may be produced by foreign companies using it as a production base (including Chinese and US companies). Third, it ignores retaliation by trading partners and also second round effects (such as diversion of goods to other markets). Finally, it ignores trade in services in which the US tends to run a surplus ($293bn in 2024, compared to a goods deficit of $1,211bn). Strangely, the new administration never talks about services but it can make a big difference to the analysis of bilateral balances. For example, Ireland runs a big goods surplus with the US ($66bn in 2023) that is almost balanced by its deficit in services ($58bn in 2023, the latest full year available). Likewise Switzerland.

There is of course another big problem with this sort of analysis: it assumes the US runs a deficit because of unfair competition. However, from a national income accounting perspective, the current account balance is the difference between investment and savings. In 2024, the IMF estimates that US investment spending was 21.8% of GDP, close to the 21.4% in the EU. The big difference was in the rate of savings (18.2% of GDP in the US and 24.7% in the EU). Hence, the US ran a current account deficit, while the EU ran a surplus. The US current account imbalance cannot be eliminated unless the gap between savings and investment is closed (a rise in savings and/or less investment). That suggests the route to balance of payments equilibrium may involve a smaller US economy but don't say that too loudly! There isn't a lot that other countries can do about that.

All data as of 14 February 2025, unless stated otherwise.

Figure 2 – The largest goods trade imbalances with the US in 2024 (as percent of GDP)



Note: The chart shows the balance of trade in goods with the United States of America in 2024 compared to the size of each country's GDP. The countries shown are the 20 with the largest surplus/GDP with the US and the 20 with the largest deficit/GDP. The GDP data for Sri Lanka is as of 2022. Source: US Census Bureau, IMF World Economic Outlook, LSEG Datastream and Invesco Global Market Strategy Office

Figure 3 – Asset class total returns (%)

Data as at 14/02/2025	Index	Current Level/RY	Total Return (USD, %) 1w	1m	QTD	YTD	12m	Total Return (Local Currency, %) 1w	1m	QTD	YTD	12m
Equities												
World	MSCI	884	1.8	6.1	5.2	5.2	21.1	1.5	5.4	4.8	4.8	21.9
Emerging Markets	MSCI	1125	1.5	6.9	4.8	4.8	16.0	1.3	6.1	4.4	4.4	19.8
China	MSCI	73	7.4	19.0	13.6	13.6	45.9	7.2	18.7	13.5	13.5	45.5
US	MSCI	5854	1.5	4.9	4.4	4.4	24.3	1.5	4.9	4.4	4.4	24.3
Europe	MSCI	2217	3.5	11.1	10.8	10.8	15.2	1.9	8.4	9.4	9.4	16.7
Europe ex-UK	MSCI	2750	3.9	11.4	11.8	11.8	13.9	2.3	9.1	10.2	10.2	16.0
UK	MSCI	1308	2.0	10.0	7.6	7.6	20.0	0.4	6.4	6.8	6.8	19.3
Japan	MSCI	4018	0.4	6.7	2.2	2.2	7.5	0.9	2.8	-1.0	-1.0	8.6
Government Bonds												
World	BofA-ML	3.39	0.3	3.2	1.5	1.5	1.3	-0.1	1.7	0.4	0.4	2.2
Emerging Markets	BBloom	6.84	0.2	3.6	2.6	2.6	15.7	0.2	3.6	2.6	2.6	15.7
China	BofA-ML	1.56	0.0	1.2	1.0	1.0	7.2	-0.3	0.3	0.5	0.5	8.2
US (10y)	Datastream	4.48	0.1	2.9	1.3	1.3	2.5	0.1	2.9	1.3	1.3	2.5
Europe	Bofa-ML	2.73	1.4	4.3	1.8	1.8	1.7	-0.2	2.1	0.3	0.3	3.8
Europe ex-UK (EMU, 10y)	Datastream	2.40	1.2	4.2	1.5	1.5	0.1	-0.3	2.1	0.0	0.0	2.1
UK (10y)	Datastream	4.50	1.5	7.0	1.9	1.9	2.1	-0.1	3.4	1.2	1.2	1.6
Japan (10y)	Datastream	1.34	-0.9	3.0	1.2	1.2	-4.4	-0.4	-0.8	-2.0	-2.0	-3.4
IG Corporate Bonds												
Global	BofA-ML	4.68	0.7	3.0	1.6	1.6	5.3	0.2	2.2	1.1	1.1	6.0
Emerging Markets	BBloom	6.47	0.6	3.1	2.5	2.5	12.8	0.6	3.1	2.5	2.5	12.8
China	BofA-ML	2.33	0.2	1.0	0.7	0.7	4.5	-0.1	0.1	0.2	0.2	5.5
US	BofA-ML	5.30	0.3	2.5	1.3	1.3	5.7	0.3	2.5	1.3	1.3	5.7
Europe	BofA-ML	3.19	1.6	3.9	2.3	2.3	4.3	0.0	1.7	0.8	0.8	6.4
UK	BofA-ML	5.43	1.6	6.7	2.3	2.3	6.0	0.0	3.1	1.6	1.6	5.4
Japan	BofA-ML	1.46	-0.6	3.4	2.6	2.6	-2.0	-0.1	-0.4	-0.7	-0.7	-1.0
HY Corporate Bonds												
Global	BofA-ML	7.13	0.7	2.3	2.0	2.0	10.0	0.3	1.8	1.7	1.7	10.4
US	BofA-ML	7.36	0.2	1.7	1.6	1.6	10.3	0.2	1.7	1.6	1.6	10.3
Europe	BofA-ML	5.72	1.9	4.0	2.8	2.8	7.0	0.3	1.8	1.3	1.3	9.2
Cash (Overnight LIBOR)												
US		4.36	0.1	0.4	0.5	0.5	5.2	0.1	0.4	0.5	0.5	5.2
Euro Area		2.67	-0.3	0.1	0.1	0.1	-0.7	0.1	0.3	0.3	0.3	3.6
UK		4.45	0.2	-0.1	-0.3	-0.3	3.3	0.1	0.4	0.5	0.5	5.2
Japan		0.48	2.5	4.4	3.8	3.8	-2.0	0.0	0.0	0.0	0.0	0.2
Real Estate (REITs)												
Global	FTSE	1640	0.6	5.4	3.1	3.1	11.5	-0.9	3.2	1.6	1.6	13.7
Emerging Markets	FTSE	1187	2.0	6.0	0.9	0.9	3.9	0.4	3.8	-0.6	-0.6	6.0
US	FTSE	3256	0.3	4.2	2.5	2.5	15.9	0.3	4.2	2.5	2.5	15.9
Europe ex-UK	FTSE	2434	1.4	10.2	5.4	5.4	12.7	-0.2	8.0	3.8	3.8	15.0
UK	FTSE	818	3.9	11.6	4.1	4.1	0.5	2.2	7.9	3.3	3.3	-0.1
Japan	FTSE	2038	-0.8	8.2	5.7	5.7	3.5	-0.3	4.3	2.3	2.3	4.6
Commodities												
All	GSCI	3827	1.0	-0.3	4.7	4.7	9.8	-	-	-	-	-
Energy	GSCI	657	1.1	-4.1	3.2	3.2	5.0	-	-	-	-	-
Industrial Metals	GSCI	1725	0.5	2.6	4.8	4.8	13.8	-	-	-	-	-
Precious Metals	GSCI	3203	0.6	7.5	9.6	9.6	43.7	-	-	-	-	-
Agricultural Goods	GSCI	555	2.2	7.1	7.8	7.8	11.0	-	-	-	-	-
Currencies (vs USD)*												
EUR		1.05	1.6	1.8	1.3	1.3	-2.2	-	-	-	-	-
JPY		152.35	-0.6	3.7	3.2	3.2	-1.2	-	-	-	-	-
GBP		1.26	1.6	3.4	0.8	0.8	0.5	-	-	-	-	-
CHF		1.11	1.1	1.4	0.9	0.9	-1.5	-	-	-	-	-
CNY		7.25	0.5	1.1	0.6	0.6	-0.8	-	-	-	-	-

Notes: **Past performance is no guarantee of future results.** *The currency section is organised so that in all cases the numbers show the movement in the mentioned currency versus USD (+ve indicates appreciation, -ve indicates depreciation). Please see appendix for definitions, methodology and disclaimers.
Source: LSEG Datastream and Invesco Global Market Strategy Office

Figure 4 – Global equity sector total returns relative to market (%)

Data as at 14/02/2025	Global				
	1w	**1m**	**QTD**	**YTD**	**12m**
Energy	**-0.9**	**-5.9**	**-2.0**	**-2.0**	**-12.8**
Basic Materials	**0.0**	**0.0**	**1.8**	**1.8**	**-10.0**
Basic Resources	-0.2	0.6	3.3	3.3	-6.7
Chemicals	0.3	-0.9	-0.3	-0.3	-14.5
Industrials	**-0.4**	**-0.7**	**-0.5**	**-0.5**	**-2.5**
Construction & Materials	-0.5	-1.3	-1.2	-1.2	-3.7
Industrial Goods & Services	-0.4	-0.6	-0.3	-0.3	-2.4
Consumer Discretionary	**0.3**	**1.7**	**0.9**	**0.9**	**2.6**
Automobiles & Parts	-0.9	-7.5	-8.8	-8.8	0.2
Media	0.1	8.6	6.2	6.2	13.0
Retailers	0.2	3.0	2.7	2.7	13.2
Travel & Leisure	0.0	2.1	0.6	0.6	-0.9
Consumer Products & Services	1.6	4.4	4.4	4.4	-11.5
Consumer Staples	**0.3**	**0.0**	**-1.9**	**-1.9**	**-12.2**
Food, Beverage & Tobacco	1.0	0.6	-1.9	-1.9	-13.4
Personal Care, Drug & Grocery Stores	-0.8	-1.1	-1.9	-1.9	-10.0
Healthcare	**-2.4**	**-1.5**	**-0.1**	**-0.1**	**-12.4**
Financials	**-0.6**	**1.6**	**2.0**	**2.0**	**8.5**
Banks	-0.3	2.0	3.5	3.5	11.8
Financial Services	-0.6	1.9	1.5	1.5	6.8
Insurance	-1.1	-0.1	-0.9	-0.9	3.3
Real Estate	**-1.0**	**-0.2**	**-1.8**	**-1.8**	**-6.0**
Technology	**1.5**	**0.4**	**-0.7**	**-0.7**	**8.8**
Telecommunications	**1.1**	**2.9**	**2.9**	**2.9**	**1.6**
Utilities	**-1.0**	**-2.9**	**-3.6**	**-3.6**	**-1.8**

Notes: **Past performance is no guarantee of future results.** Returns shown are for Datastream sector indices versus the total market index. Source: LSEG Datastream and Invesco Global Market Strategy Office

Figure 5a – US factor index total returns (%)

Data as at 14/02/2025	Absolute					Relative to Market				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Growth	0.7	2.3	3.7	3.7	11.3	-0.9	-2.4	-0.4	-0.4	-10.2
Low volatility	0.7	4.5	3.4	3.4	16.7	-0.8	-0.3	-0.7	-0.7	-5.8
Price momentum	-0.1	5.6	7.5	7.5	25.1	-1.6	0.8	3.3	3.3	0.9
Quality	1.1	2.2	3.9	3.9	10.5	-0.4	-2.5	-0.2	-0.2	-10.9
Size	0.9	1.4	1.5	1.5	9.6	-0.7	-3.2	-2.5	-2.5	-11.6
Value	1.6	2.2	3.3	3.3	21.4	0.1	-2.5	-0.8	-0.8	-2.1
Market	1.5	4.8	4.1	4.1	24.0					
Market - Equal-Weighted	0.5	2.9	3.4	3.4	16.0					

Notes: **Past performance is no guarantee of future results.** All indices are subsets of the S&P 500 index, they are rebalanced monthly, use data in US dollars and are equal-weighted. Growth includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio); Low volatility includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months; Price momentum includes stocks in the top quintile based on their performance in the previous 12 months; Quality includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value); Size includes stocks in the bottom quintile based on their market value in US dollars. Value includes stocks in the bottom quintile based on their price to book value ratios. The market represents the S&P 500 index. Source: LSEG Datastream and Invesco Global Market Strategy Office

Figure 5b – European factor index total returns (%)

Data as at 14/02/2025	Absolute					Relative to Market				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Growth	2.3	9.3	7.3	7.3	14.3	0.5	0.5	-1.6	-1.6	-2.8
Low volatility	1.7	6.8	6.5	6.5	20.0	-0.2	-1.8	-2.2	-2.2	2.0
Price momentum	1.6	8.9	8.9	8.9	25.5	-0.2	0.1	-0.1	-0.1	6.7
Quality	1.1	7.2	7.3	7.3	19.0	-0.7	-1.4	-1.6	-1.6	1.2
Size	2.0	9.9	6.7	6.7	14.5	0.1	1.0	-2.1	-2.1	-2.6
Value	2.1	10.3	8.3	8.3	22.6	0.2	1.4	-0.6	-0.6	4.2
Market	1.8	8.8	9.0	9.0	17.6					
Market - Equal-Weighted	2.0	8.8	7.6	7.6	17.3					

Notes: **Past performance is no guarantee of future results.** All indices are subsets of the STOXX 600 index, they are rebalanced monthly, use data in euros and are equal-weighted. Growth includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio); Low volatility includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months; Price momentum includes stocks in the top quintile based on their performance in the previous 12 months; Quality includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value); Size includes stocks in the bottom quintile based on their market value in euros; Value includes stocks in the bottom quintile based on their price to book value ratios. The market represents the STOXX 600 index. Source: LSEG Datastream and Invesco Global Market Strategy Office

Figure 6 – Model asset allocation

	Neutral	Policy Range		Allocation	Position vs Neutral	Hedged	Currency
Cash Equivalents	**5%**	**0-10%**	↓	**0%**			
Cash	2.5%		↓	0%			
Gold	2.5%			0%			
Bonds	**40%**	**10-70%**	↑	**47%**			
Government	25%	10-40%	↓	25%			
US	8%		↓	12%		25%	JPY
Europe ex-UK (Eurozone)	7%		↑	7%			
UK	1%			2%			
Japan	7%		↓	0%			
Emerging Markets	2%			4%			
China**	0.2%			0%			
Corporate IG	10%	0-20%	↑	18%			
US Dollar	5%		↑	10%		50%	JPY
Euro	2%		↑	4%			
Sterling	1%			2%			
Japanese Yen	1%		↓	0%			
Emerging Markets	1%			2%			
China**	0.1%			0%			
Corporate HY	5%	0-10%	↑	4%			
US Dollar	4%		↑	3%			
Euro	1%		↑	1%			
Bank Loans	**4%**	**0-8%**		**8%**			
US	3%			6%			
Europe	1%			2%			
Equities	**45%**	**25-65%**		**35%**			
US	25%			10%			
Europe ex-UK	7%		↑	10%			
UK	4%		↑	6%			
Japan	4%			3%			
Emerging Markets	5%		↓	6%			
China**	2%			4%			
Real Estate	**4%**	**0-8%**	↑	**6%**			
US	1%			0%			
Europe ex-UK	1%		↑	2%			
UK	1%			2%			
Japan	1%		↑	2%			
Emerging Markets	1%			0%			
Commodities	**2%**	**0-4%**	↑	**4%**			
Energy	1%		↑	1%			
Industrial Metals	0.3%		↑	2%			
Precious Metals	0.3%			0%			
Agriculture	0.3%			1%			
Total	**100%**			**100%**			

Currency Exposure (including effect of hedging)			
USD	52%	↑	37%
EUR	19%	↑	26%
GBP	7%	↓	12%
JPY	13%	↓	13%
EM	9%	↓	12%
Total	**100%**		**100%**

Notes: **China is included in Emerging Markets allocations. This is a theoretical portfolio and is for illustrative purposes only. See the latest The Big Picture document for more details. It does not represent an actual portfolio and is not a recommendation of any investment or trading strategy. Arrows indicate the direction of the most recent changes.
Source: Invesco Global Market Strategy Office

Figure 7 – Model allocations for global sectors

	Neutral	Invesco		Preferred Region
Energy	**6.1%**	**Overweight**	↑	**EM**
Basic Materials	**3.3%**	**Neutral**	↑	**Japan**
Basic Resources	2.0%	Neutral	↑	Japan
Chemicals	1.3%	Neutral		US
Industrials	**12.9%**	**Underweight**		**US**
Construction & Materials	1.7%	Underweight		US
Industrial Goods & Services	11.2%	Neutral	↑	US
Consumer Discretionary	**14.8%**	**Underweight**		**US**
Automobiles & Parts	2.8%	Underweight		Europe
Media	1.2%	Overweight	↑	US
Retailers	5.6%	Overweight		US
Travel & Leisure	2.0%	Underweight		EM
Consumer Products & Services	3.1%	Underweight		Japan
Consumer Staples	**4.9%**	**Neutral**	↓	**US**
Food, Beverage & Tobacco	3.1%	Overweight		US
Personal Care, Drug & Grocery Stores	1.8%	Neutral	↓	Europe
Healthcare	**8.4%**	**Underweight**	↓	**US**
Financials	**16.1%**	**Overweight**		**US**
Banks	7.6%	Overweight		US
Financial Services	5.5%	Overweight		US
Insurance	3.0%	Neutral	↓	US
Real Estate	**2.6%**	**Neutral**		**Japan**
Technology	**24.4%**	**Neutral**		**EM**
Telecommunications	**3.3%**	**Underweight**		**US**
Utilities	**3.2%**	**Underweight**	↓	**US**

Notes: These are theoretical allocations which are for illustrative purposes only. They do not represent an actual portfolio and are not a recommendation of any investment or trading strategy. See the latest Strategic Sector Selector for more details.
Source: LSEG Datastream and Invesco Global Market Strategy Office

Appendix

Methodology for asset allocation, expected returns and optimal portfolios

Portfolio construction process

The optimal portfolios are theoretical and not real. We use optimisation processes to guide our allocations around "neutral" and within prescribed policy ranges based on our estimations of expected returns and using historical covariance information. This guides the allocation to global asset groups (equities, government bonds etc.), which is the most important level of decision. For the purposes of this document the optimal portfolios are constructed with a one-year horizon.

Which asset classes?

We look for investibility, size and liquidity. We have chosen to include equities, bonds (government, corporate investment grade and corporate high yield), bank loans, REITs to represent real estate, commodities and cash (all across a range of geographies). We use cross-asset correlations to determine which decisions are the most important.

Neutral allocations and policy ranges

We use market capitalisation in USD for major benchmark indices to calculate neutral allocations. For commodities, we use industry estimates for total ETP market cap + assets under management in hedge funds + direct investments. We use an arbitrary 5% for the combination of cash and gold. We impose diversification by using policy ranges for each asset category (the range is usually symmetric around neutral).

Expected/projected returns

The process for estimating expected returns is based upon yield (except commodities, of course). After analysing how yields vary with the economic cycle, and where they are situated within historical ranges, we forecast the direction and amplitude of moves over the next year. Cash returns are calculated assuming a straight-line move in short term rates towards our targets (with, of course, no capital gain or loss). Bond returns assume a straight-line progression in yields, with capital gains/losses predicated upon constant maturity (effectively supposing constant turnover to achieve that). Forecasts of corporate investment-grade, high-yield and bank loan spreads are based upon our view of the economic cycle (as are forecasts of credit losses). Coupon/interest payments are added to give total returns. Equity and REIT returns are based on dividend growth assumptions. We calculate total returns by applying those growth assumptions and adding the forecast dividend yield. No such metrics exist for commodities; therefore, we base our projections on US CPI-adjusted real prices relative to their long-term averages and views on the economic cycle. All expected returns are calculated in local currency and then, where necessary, converted into other currency bases using our exchange rate forecasts.

Optimising the portfolio

Using a covariance matrix based on monthly local currency total returns for the last 5 years and we run an optimisation process that maximises the Sharpe Ratio. Another version maximises Return subject to volatility not exceeding that of our Neutral Portfolio. The optimiser is based on the Markowitz model.

Currency hedging

We adopt a cautious approach when it comes to currency hedging as currency movements are notoriously difficult to accurately predict and sometimes hedging can be costly. Also, some of our asset allocation choices are based on currency forecasts. We use an amalgam of central bank rate forecasts, policy expectations and real exchange rates relative to their historical averages to predict the direction and amplitude of currency moves.

Definitions of data and benchmarks for Figure 3

Sources: we source data from LSEG Datastream unless otherwise indicated.

Cash: returns are based on a proprietary index calculated using the Intercontinental Exchange Benchmark Administration overnight LIBOR (London Interbank Offer Rate). From 1st January 2022, we use the Refinitiv overnight deposit rate for the euro, the British pound and the Japanese yen. The global rate is the average of the euro, British pound, US dollar and Japanese yen rates. The series started on 1 January 2001 with a value of 100.

Gold: London bullion market spot price in USD/troy ounce.

Government bonds: Current levels, yields and total returns use Datastream benchmark 10-year yields for the US, Eurozone, Japan and the UK, and the ICE BofA government bond total return index for the World and Europe. The emerging markets yields and returns are based on the Bloomberg emerging markets sovereign US dollar bond index.

Corporate investment grade (IG) bonds: ICE BofA investment grade corporate bond total return indices, except for in emerging markets where we use the Bloomberg emerging markets corporate US dollar bond index.

Corporate high yield (HY) bonds: ICE BofA high yield total return indices

Equities: We use MSCI benchmark gross total return indices for all regions.

Commodities: Goldman Sachs Commodity total return indices

Real estate: FTSE EPRA/NAREIT total return indices

Currencies: Global Trade Information Services spot rates

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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