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How should I position for a "Goldilocks" scenario?

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Our base case is for the US economy to grow this year, albeit at a slowing rate. But we can also envision a more constructive, "Goldilocks" scenario.

Pre-emptive Fed interest rate cuts alongside still-robust economic growth and falling inflation would drive strong performance in equity and bond markets. Investors looking to position for potential gains in a “Goldilocks” scenario, while also faring well in a base case scenario, can consider US small-cap stocks, small- and mid-cap stocks in Europe and Switzerland, ESG engagement strategies, and emerging market equities.

We see a path for the US to experience a "Goldilocks" outcome.

- US economic activity could hold up better than markets expect, especially given the strength of the consumer and their balance sheets.
- US inflation could fall faster than expected, as the economy continues to normalize after the pandemic.
- Even in these instances, the Federal Reserve could pre-emptively cut rates to avoid clashing with the presidential election cycle.

Investing in smaller companies could fare especially well in this instance.

- US small-cap stocks could be particular beneficiaries, given higher shares of floating rate debt and appealing valuations, relative to large-cap equities.
- Easing financial conditions and solid balance sheets also support selective small- and mid-cap opportunities in Europe and Switzerland.

- ESG engagement strategies in stocks could also outperform, given the strategy's bias toward smaller firms.

The outlook for emerging market stocks would be even brighter in this scenario

- High developed market interest rates weighed on EM assets over the past two years, so easing financial conditions should boost sentiment and multiples.
- EM stocks historically outperformed when the US dollar declined (which would likely follow in our "Goldilocks" scenario).

Did you know?

- US small-cap stocks could rally swiftly on improving leading indicators. For example, the ISM New Orders has contracted for 16 months in a row. Historically, the longest period of contraction has been 18 months. A rising ISM New Orders reading usually corresponds with small-cap outperformance.
- Eurozone SMID cap valuations have rarely been more compelling, trading at 20-year relative lows versus large-caps.
- Even in our base case scenario, we expect higher earnings growth for EM equities (low double digit) versus developed market peers (mid- to high single digit) for 2024.

Investment view

Building robust portfolios depends on positioning for multiple growth and market scenarios. It's possible that the US experiences a "Goldilocks" outcome where growth beats expectations, inflation falls faster, but the Fed cuts rates pre-emptively to minimize clashes with the election cycle. Rate-sensitive parts of the world equity market—small-and-mid-cap stocks, ESG engagement equity strategies, and EM stocks—would likely outperform in this scenario, warranting some exposure in a diversified portfolio.

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