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INVEST WITH CONFIDENCE

Global Asset Allocation: The View From the UK

July 2021

1 Market Perspective

As of 30 June 2021

- Global economic growth to remain strong through the back half of the year, albeit off peak levels, as monetary and fiscal policy support moderates from crisis-level highs.
- Longer-term interest rates likely challenged to move higher as growth moderates, inflation softens from recent peaks and Federal Reserve moves closer to tapering asset purchases, while short-term rates could begin to price in tighter policy leading to a flattening yield curve.
- While still supportive, global monetary policy should continue to see a gradual trend towards tightening among central banks, notably within emerging markets (EM), facing rising inflation.
- Key risks to global markets include the path forward for the coronavirus, elevated inflation, central bank missteps, higher taxes, stricter regulatory environment and increasing geopolitical concerns.

2 Portfolio Positioning

- We remain modestly underweight equities relative to bonds and cash as the risk/reward profile looks less compelling for equities and could be vulnerable to fading policy support, increased rate volatility, high inflation levels and potential tax increases.
- Within equities, we continue to favour value-oriented equities globally, US small-caps and EM stocks as we expect cyclically exposed companies to continue to benefit from strong economic growth and global reopening.
- Within fixed income, we continue to have a bias towards shorter-duration, higher-yielding and inflation-sensitive sectors through overweights to high yield bonds, emerging market local currency debt and corporates and inflation-linked gilts.

3 Market Themes

Easy on the Austerity

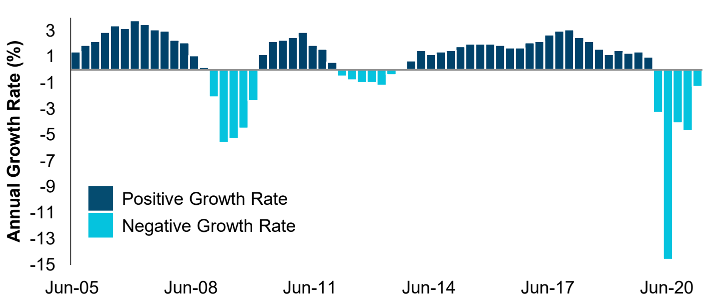
Following a shaky start to its vaccine rollout, Europe appears to be recovering as businesses are reopening and lockdowns continue to ease in some areas. As the European Central Bank debates the extension of its EUR 1.85 trillion asset purchase programme, due to expire next March, additional fiscal stimulus is being rolled out through the unprecedented European Union recovery fund, worth up to EUR 800 billion. While the fund shows signs of growing unity among member nations, lines are being drawn once again as members take sides on scaling back monetary policies put in place amid the pandemic. Leaders such as Mario Draghi, Italy's prime minister, warn that shifting back to austerity too soon could ignite another decade-long recovery similar to the post-global financial crisis period. With Europe already lagging the US and China, shifting back to austerity too soon could prevent the region from heading on a path towards more sustainable growth.

Curbing Our Enthusiasm

Global equity markets represented by the MSCI All Country World Index have returned nearly 12% year-to-date in US dollar terms amid signs that the worst of the pandemic may finally be behind us. But, as supportive trends that have fueled the global economic growth rebound start to fade, it's hard to envision equity markets expanding at the same record pace. In the back half of the year, we expect that growth will be off peak levels, monetary policy will continue to tighten, fiscal stimulus will be at lower levels and higher taxes are likely. Adding to these headwinds, equity markets are sitting at elevated valuations supported by low interest rates, input costs are rising and earnings growth is expected to moderate next year. Despite these trends, equities remain attractive as pent-up demand continues to be unleashed and, while moderating, growth remains elevated. However, the ultra-easy environment is changing quickly and may lead to more volatility ahead, so investors may need to curb their enthusiasm for equity returns going forward.

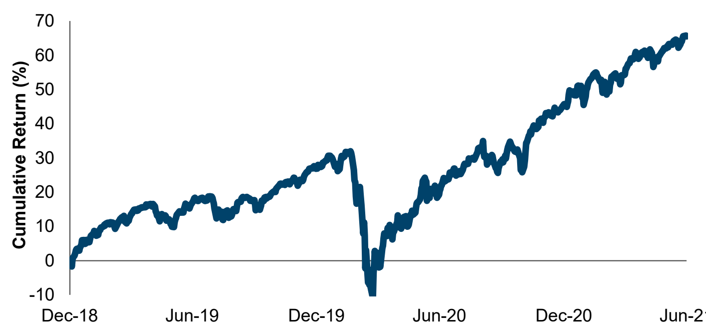
Euro Area GDP

As of 30 June 2021



Global Equity Index Returns[1,2]

As of 30 June 2021



Past performance is not a reliable indicator of future performance.

[1] Global Equity Index is represented by MSCI All Country World Index (see Additional Disclosure). Total return in US dollars.
[2] Source: FactSet. Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved.
Sources: Haver Analytics, Bureau of Labor Statistics, IMF.

United Kingdom

Positives

- Best vaccination progress in Europe, and vaccine hesitancy remains low
- Investment tax super deduction to support strong recovery
- All social distancing restrictions dropped—services will excel
- Brexit deal achieved

Negatives

- Large rise of the delta variant could make consumers cautious until current COVID-19 wave subsides
- Demand risks from a delayed, but likely very large, fiscal consolidation in two to three years remain
- Bank of England to remain very hawkish in light of strong real economy data
- Overheating housing market could pose future financial stability risk

Developed Europe

Positives

- Higher exposure to more cyclically oriented sectors that should benefit from economic recovery
- Pace of vaccinations has significantly improved
- Monetary and fiscal policy remains accommodative
- Equity valuations remain attractive relative to the US

Negatives

- Limited long-term catalysts for growth
- Limited scope for European Central Bank to stimulate further
- Brexit likely to negatively impact trade
- Potential for new coronavirus variants to cause continued outbreaks

United States

Positives

- Vaccinations widely distributed, case count near lows
- Infrastructure spending bill likely to be passed
- Healthy consumer balance sheets and high savings rate
- Strong earnings expectations

Negatives

- Elevated stock and bond valuations
- High corporate and government debt levels
- Fed dovishness has peaked
- Corporate taxes likely to rise

	Positives	Negatives
Japan	▪ Economic data are slowly improving, especially in services and consumer-related sectors ▪ Domestic stocks are overdue to catch up with the global reflation play ▪ Policy setting remains extremely accommodative, with unspent fiscal funds expected to offer further boost to the economic recovery	▪ The pandemic is not yet under control with states of emergency being pushed back ▪ Valuation derating remains a headwind despite strong earnings growth ▪ Capital spending outside of information technology is disappointing and could be a risk for future earnings growth
Asia Pacific ex-Japan	▪ Chinese economic growth remains solid, but domestic drivers now need to contribute more. An impressive vaccination pace should remove uncertainties related to local outbreaks ▪ Chinese equity consolidation looks overdone on the back of supportive flow dynamics and clarification on tech regulations ▪ Economic data in Australia continue to roar, boosted by strong commodity prices and construction-related activities ▪ Australian business capex expected to rebound to support future earnings growth	▪ The leading Chinese economic indicators are starting to roll over following a fading monetary impulse ▪ Consumer spending in China is still lagging the recovery and below expectations. Local COVID-19 outbreaks don't help sentiment ▪ Early signs of inflationary pressures seen in the Australian housing and construction markets. There have been mentions of a housing bubble in some reports ▪ The Reserve Bank of Australia might change its policy guidance abruptly as it upgrades the economic forecasts. Beware of a U-turn for financial conditions
Emerging Markets	▪ Exposure to cyclical areas of the economy should benefit from a broad global recovery ▪ Commodity prices are elevated ▪ Chinese economy remains strong ▪ Equity valuations attractive relative to developed markets	▪ COVID-19 risk remains high in Central Asia and Latin America ▪ Vaccine supply and distribution infrastructure are well behind developed markets (excluding China) ▪ Stimulus from China is fading ▪ Limited ability to enact fiscal stimulus (excluding China)

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Underweight — *Neutral* — *Overweight*   ▼ or ▲ Month-Over-Month Change

Change	Underweight		Neutral	Overweight		**These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.**
ASSET CLASSES						
Equities		■				While peaking, growth remains supportive; however, elevated valuations leave little room for upside. Equities could also be vulnerable to fading policy support, coronavirus challenges, input cost inflation, tax increases and higher rates.
Bonds				■		Yields are rangebound as they face countervailing forces of higher inflation versus past peak growth and tightening global central bank policies. Solid fundamentals but upside limited for credit sectors.
EQUITIES — *Region*						
US		■				Elevated valuations reflecting strong recovery and earnings rebound. Rising rates and taxes could be headwinds. Cyclical sectors should continue to benefit from strong macro backdrop, but a lot of good news is already priced in.
Europe ex-UK		■				Cyclically oriented sector profile, low valuations among financials, fiscal support and improving vaccination rate supportive. However, long-term catalysts for sustained growth are scarce.
UK				■		Vaccination pace is likely to lead to easing lockdown and strong real activity.
Japan				■		Despite year-to-date weakness and challenges in vaccine rollout, cyclical exposure should be supportive along with attractive valuations and improving global trade outlook.
Developed Asia ex-Japan*			■			Valuations attractive relative to the US. Chinese stimulus and successful containment of virus are supportive. Export and commodity-driven economies face challenges.
Emerging Markets				■		Exposure to global trade and elevated commodity prices offer strong tailwinds. However, fading Chinese stimulus, potential Fed tapering and vaccine distribution challenges remain concerns.
Style and Market Capitalisation						
Global Growth vs. Value[1]		■				Deep cyclical orientation of value stocks combined with attractive relative valuations and rising rates could be catalysts for further rotation out of growth. Vaccine supply constraints and the outbreak in India are sources of uncertainty.
Global Small-Cap vs. Large-Cap[1]				■		Early-cycle exposure remains supportive for small-caps, and idiosyncratic opportunities are plentiful. Meanwhile, steeper yield curve and improving global economic outlook should benefit large-caps given cyclical orientation and exposure to international trade.

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* Includes Australia.

[1] For pairwise decisions in style and market capitalisation, positioning within boxes represents positioning in the first-mentioned asset class relative to the second asset class.

UK INVESTMENT COMMITTEE POSITIONING

As of 30 June 2021

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.

		Change	Underweight	Underweight	Neutral	Overweight	Overweight	
BONDS	UK Gilts			■				We remain underweight given the potential for yields to move higher as the UK is progressing with opening up its economy, the UK's strong economic recovery and rising inflationary pressures.
	UK Inflation Linked					■		While inflation expectations are on the rise, actual inflation can surprise on the upside.
	UK IG Corporates					■		Market technicals remain supportive, but there are still plenty of uncertainties around corporate fundamentals during the economic recovery.
	US IG Aggregate			■				Scope for rates in the UK to rise more than in the US. However, stronger inflation and economic growth are expected in the US.
	European IG Aggregate	▼		■				High-frequency indicators suggest scope for very fast catch-up growth in the next one to two months. Vaccination pace is healthy and cases are still falling, but delta variant risk is likely to emerge.
	Global High Yield					■		Limited upside from elevated valuations, and relative yields still attractive versus alternatives within fixed income. Fundamentals and commodity rebound broadly supportive.
	EM Dollar Sovereigns				■			Sector offers attractive yield versus developed markets, with improving growth broadly supportive; however, vulnerabilities across countries vary in coronavirus spread, rising inflation and susceptibility to rising rates.
	EM Local Currency					■		Valuations remain modestly attractive; improving macro backdrop and potentially weaker US dollar could provide tailwinds. Shift higher in US rates and EM central bank rate hikes could be a headwind.
	EM Corporates	▲				■		The impact of the pandemic on the asset class is difficult to quantify, but the prospect of normalisation bodes well. Country-specific risks remain elevated.
CURRENCIES	GBP vs. USD	▲				■		The valuation of the pound is more attractive after recent weakness. The US Federal Reserve has become more dovish in its rhetoric, while the Bank of England may turn more hawkish.
	GBP vs. EUR	▲				■		We expect a stronger economic recovery in the UK than in the eurozone and for the pound to continue its positive momentum against the euro. One risk to our view is the spread of the delta variant.
	GBP vs. JPY				■			The pound may appreciate against the yen; however, we retain a neutral bias given the yen's safe-haven properties.

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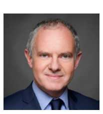
UK INVESTMENT COMMITTEE



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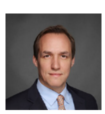

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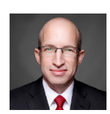

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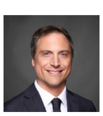

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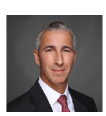

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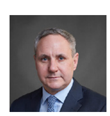

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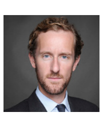

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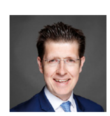

Tomasz Wieladek
International Economist

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