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Global Asset Allocation: The View From Europe

November 2021

1 Market Perspective

- While moderating, global growth to remain above trend as it continues to emerge from COVID-19. Supply chain disruptions and energy shortages in some regions could be near-term headwinds to growth.
- Global monetary policy broadly on path towards tightening, albeit unsynchronised, with many emerging markets having already acted in response to higher inflation and to defend their currencies, while most developed market counterparts are more cautiously advancing towards tightening.
- Global yield curves likely to face higher short-term rates on central bank tightening, while longer rates could be biased higher on near-term inflation concerns, although upside may be limited as growth expectations and inflation pressures moderate.
- Key risks to global markets include persistent elevated inflation, central bank missteps, slowing China growth, supply chain disruption, energy shortages and increasing geopolitical concerns.

2 Portfolio Positioning

As of 31 October 2021

- We remain modestly underweight equities relative to bonds and cash given a less compelling risk/reward profile against a backdrop of elevated valuations with more moderate return expectations. Higher rates, rising input costs related to supply chain bottlenecks and fading monetary and fiscal policy could pose challenges to near-term earnings outlook.
- Within equities, we continue to favour value-oriented equities globally, US small-caps and emerging market stocks as we expect cyclically exposed companies to benefit from a supportive global growth profile, coupled with pent-up demand and inventory rebuilding as COVID-19 concerns abate.
- Within fixed income, we continue to favour shorter-duration and higher-yielding sectors through overweights to high yield bonds and emerging market debt supported by our constructive credit outlook.

3 Market Themes

Running on Empty

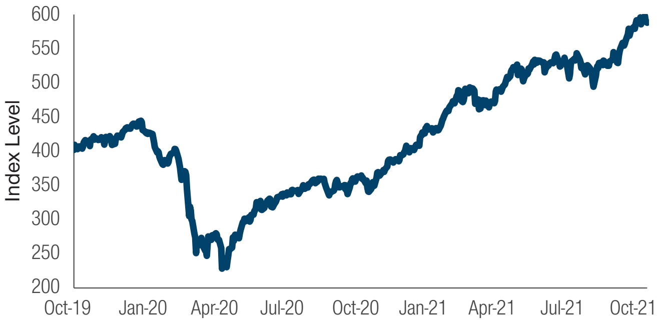
Just as the global economy is finally gaining traction after delta variant setbacks, some economies are facing severe energy shortages, with energy prices up over 70% since last year. The impacts are being felt across Europe, which is facing shortages of natural gas, threatening to leave households without heat as winter approaches. Meanwhile, China, which cut coal production to meet carbon emissions initiatives, has quickly reversed course as the cutbacks created shortages, leading to fears of moderating growth. In the US, although not seeing the same degree of supply concerns, fuel prices have more than doubled since last year amid stronger demand and lower production levels. What has also been exposed amid this energy crunch is the pace of the transition from traditional energy sources to renewables. While the push toward green initiatives continues, economies will need to balance decommissioning traditional sources of energy as they replace with renewables, otherwise economies could find themselves running on empty, particularly if faced with future shocks.

On Back Order

Supply chain concerns have reached a crescendo recently as skyrocketing demand is overwhelming already strained supply chains, threatening to introduce the difficult combination of high inflation and slowing economic growth. Companies are citing the supply chain bottlenecks at every link—including labour shortages, backlogs at ports, increased delivery times and limited trucking availability—leading to increased input costs and concerns about impacts on corporate margins. While higher wages may help consumers offset costs and companies with pricing power may be able to push through higher input costs for now, it looks like consumers and companies will have to navigate inflationary pressures well into the middle of next year. Although some of the supply chain pressures have eased in recent weeks, with the price of shipping containers reaching a peak, the holidays are just around the corner, and companies will likely still be struggling to get products on the shelves as consumers are faced with limited supply and higher prices.

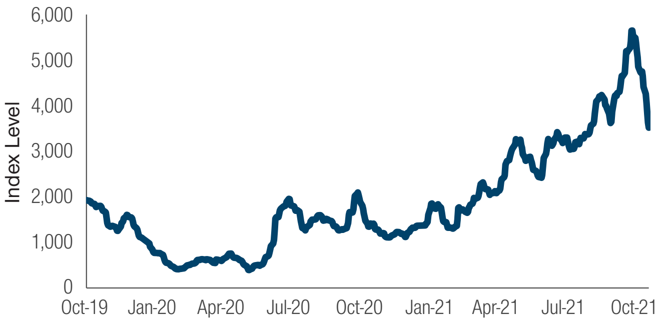
Commodity Prices[1, 2]

As of 31 October 2021



Shipping Costs[1, 3]

As of 31 October 2021



Past performance is not a reliable indicator of future performance.

[1] Figures are shown in US dollars.

[2] Prices are represented by the S&P GSCI Index (see Additional Disclosure).

[3] Costs are represented by the Baltic Dry Index (BDI).

Source: Bloomberg Finance L.P.

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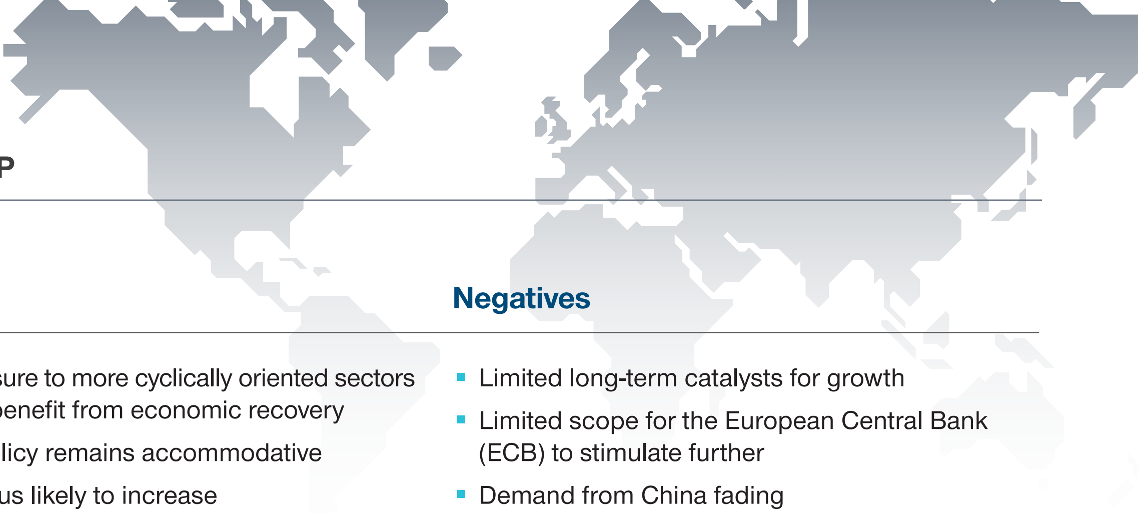
REGIONAL BACKDROP



	Positives	Negatives
Europe	▪ Higher exposure to more cyclically oriented sectors that should benefit from economic recovery ▪ Monetary policy remains accommodative ▪ Fiscal stimulus likely to increase ▪ Equity valuations remain attractive relative to the US	▪ Limited long-term catalysts for growth ▪ Limited scope for the European Central Bank (ECB) to stimulate further ▪ Demand from China fading ▪ Elevated energy prices and supply chain issues are weighing on economic growth
United Kingdom	▪ Services activity resilient despite shortages ▪ Most economic indicators show expansion, despite supply chain problems ▪ Surveys suggest only a small fraction of furloughed employees did not return to their jobs ▪ Bank of England (BoE) to raise rates more gradually than previously expected	▪ Demand weakness from lower household disposable income due to higher energy prices ▪ Steeper Phillips curve in the labour market means BoE will need to hike faster ▪ Demand risks from a delayed, but likely large, fiscal consolidation in two to three years remain ▪ Overheating housing market could pose future financial stability risk
United States	▪ Healthy consumer balance sheets and high savings rate ▪ Strong earnings growth ▪ Infrastructure spending likely to increase ▪ Delta variant spread appears to have peaked	▪ Supply chain issues are weighing on economic growth ▪ Elevated stock and bond valuations ▪ Elevated corporate and government debt levels ▪ Fed accommodation has peaked ▪ Fiscal stimulus has peaked

	Positives	Negatives
Japan	▪ Local stock markets continue to be attractive due to favourable relative valuation, light positioning and positive earnings trends ▪ The economic rebound looks sustainable, thanks to pent-up demand, inventory restocking and increase in business confidence ▪ The rise in mobility data and consumer spending supports the breakthrough of the services PMI above 50 for the first time since the pandemic started	▪ Supply chain disruptions in the auto sector, higher energy prices and Chinese economic slowdown are the key risks to watch ▪ Political concerns remain with the risk of surprising policies being released ▪ Stagnant productivity remains a structural issue for margins in the face of a tight labour market and inflationary pressures
Asia Pacific ex-Japan	▪ Regulatory overhand in China has likely peaked from here, with economic activity likely to increase in the next 12 months ▪ Australia's economy has proven to be more resilient than feared, even before the broader reopening phase ▪ There are early signs from Chinese policymakers that easing may be possible for next year, with a focus to boost bank lending ▪ A relatively cheap Australian dollar could see a rebound due to extreme speculative positioning, the repricing of yields and a normalisation of risk appetite into year-end	▪ Chinese economic weakness is already broad-based and sentiment remains fragile. Fears of contagion from the property sector or a policy misstep remain tail risks ▪ Surge in Australian yields on the back of higher inflationary pressures is creating uncertainties over future policy actions from the Reserve Bank of Australia ▪ Heightened political risks in China going into 2022 will create uncertainties and low incentives for local governments to step in if needed ▪ Australian equity valuations are not as favourable as they used to be
Emerging Markets	▪ Attractive equity valuations ▪ Exposure to cyclical areas of economy should benefit from broad global recovery ▪ Chinese regulatory actions likely to have peaked ▪ Vaccination rates are improving	▪ Accommodation from central banks is fading ▪ New coronavirus variants remain a threat ▪ Heightened political risk

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 October 2021

▼ 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			■				Valuations are elevated amid post-peak growth and stimulus levels. Earnings strength has buoyed equities thus far but may face a more challenging environment amid decelerating economic growth.
	Fixed Income					■		Yields biased higher on the back of elevated inflation as well as tightening global central bank policies, supportive of short duration posture. Credit sector fundamentals remain strong; yield advantage should remain supportive, although limited upside to valuations.
			Region					
EQUITIES	US			■				Elevated valuations reflecting a strong recovery, earnings strength, and low interest rates. Slowing growth, fading liquidity and the potential for higher interest rates could be headwinds. Cyclical sectors should continue to benefit from a strong macro backdrop, but a lot of good news is already priced in.
	Europe ex-UK			■				Elevated energy costs, low rate environment and lack of long-term growth catalysts remain concerns. However, cyclical orientation, low valuations among financials and improving fiscal stimulus expectations provide near-term support.
	UK	▼			■			Brexit adjustments probably exacerbate the effects of supply shortages and rise in energy prices.
	Japan					■		With vaccination rollout nearly complete, the domestic reopening is now underway. Attractive valuations, strong global trade outlook and improving corporate governance also provide tailwinds.
	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 (EM)					■		Valuations are very attractive, and Chinese regulatory pressures may have peaked. Global trade likely to improve as supply chain concerns ease and vaccine levels continue to improve.
			Style and Market Capitalisation					
	Global Growth vs. Value[1]			■				Value's cyclical orientation and financials exposure should benefit from unleashed pent-up demand, economic strength, higher rates and infrastructure spending. Growth remains vulnerable to elevated valuations and higher interest rates.
	Global Small-Cap vs. Large-Cap[1]					■		Small-caps should be supported by economic growth, attractive relative valuations, infrastructure spending and strong earnings outlook. However, elevated input costs and wage pressures could weigh on margins.

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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.

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 October 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.

		Underweight	Underweight	Neutral	Overweight	Overweight	Change	
FIXED INCOME	Euro Government Bonds	■						Europe is turning the coronavirus corner. Purchasing Managers' Indexes are at record highs, inflation is elevated and services activity is likely to pick up as European countries gradually open up.
	Euro Inflation Linked				■			Inflation may be more persistent than expected and higher than market expectations, leading to outperformance of inflation-linked bonds.
	Euro Investment-Grade (IG) Corporates				■			Technicals remain supportive, but there are still plenty of uncertainties around corporate fundamentals during the recovery. Little value at current spreads, though ECB buying remains supportive.
	US IG Aggregate		■					Scope for rates in Europe to rise more than in the US. However, stronger inflation and economic growth are expected in the latter.
	Global High Yield				■			Fundamentals supported by broadly positive macroeconomic backdrop, and carry versus investment grade is still attractive. However, further upside is limited due to tight spreads.
	EM Dollar Sovereigns			■				Attractive yield versus developed markets with improving growth and vaccine distribution outlook; however, idiosyncratic vulnerabilities persist regarding coronavirus spread/vaccine accessibility and central banks' actions to combat inflation.
	EM Local Currency				■			Yields remain modestly attractive relative to other core bond sectors, with potential upside from cheap currencies. However, China growth and regulatory risk, rising central bank rates and inflation are near-term headwinds.
	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	EUR vs. USD				■			The dollar may weaken as the European reopening accelerates. Europe is also a major beneficiary of the current global manufacturing boom.
	EUR vs. JPY		■					The yen remains a safe-haven currency. The valuation of the yen is at an attractive level after its recent sell-off.

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EUROPEAN INVESTMENT COMMITTEE

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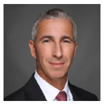

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