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Global Asset Allocation: The View From the UK

December 2021

1 Market Perspective

- Although expected to moderate from current levels, global growth and inflation remain above trend. New threats from coronavirus variants and continued supply chain disruptions and energy shortages could pose headwinds to growth, while placing upward pressure on inflation.
- Global monetary policy to continue path towards tightening with US Fed appearing more hawkish, while the European Central Bank and Bank of Japan maintain policy. Meanwhile, rate hikes continue to advance across emerging markets in response to higher inflation and to defend their currencies.
- Global short-term rates likely to trend higher with central bank tightening, while long-term rates react to lingering inflation pressures and renewed concerns about growth and policy missteps.
- Key risks to global markets include new variants, persistent inflation, supply chain disruption, energy shortages, central bank missteps, a downshift in China growth trajectory and increasing geopolitical concerns.

2 Portfolio Positioning

As of 30 November 2021

- We remain modestly underweight equities relative to bonds and cash given stocks' less compelling risk/reward profile, balancing elevated valuations against decent but moderating growth and potentially persistent inflation. Higher rates, rising input costs related to supply chain bottlenecks and fading monetary and fiscal policy could pose challenges to the near-term earnings outlook.
- Within equities, we continue to tilt towards cyclicality, maintaining overweights to value-oriented equities globally, US small-caps and emerging market stocks, where valuations are more reasonable and which should benefit from a continued path of recovery.
- We shifted a portion of our US value exposure into growth equities, where we find more companies with the potential to do well in a moderate growth environment and to moderately reduce the cyclicality of our positioning.
- Within fixed income, we continue to favour shorter-duration and higher-yielding sectors through overweights to high yield and emerging market debt supported by our constructive credit outlook.
- This month, we removed the partial hedge on the US dollar. We believe that market expectations for rate hikes next year are too aggressive, and risks remain of a negative outcome to negotiations with the European Union.

3 Market Themes

Not Too Hot, Not Too Cold

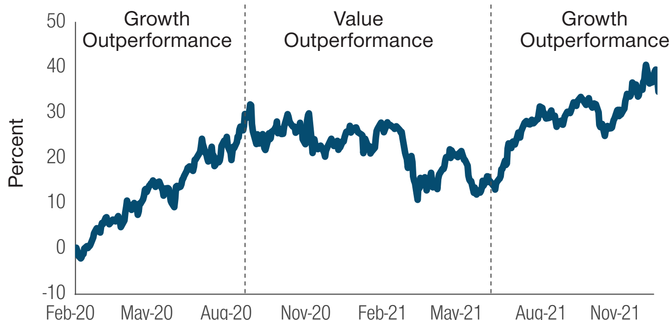
While stocks have broadly rallied nearly 80% off the lows of March 2020, leadership within has flip-flopped between expensive, defensive growth names to cheaper cyclicals and back again. The roller coaster ride has been driven by rotations from COVID-on to COVID-off, China regulatory fears and worries over Fed tapering. As we move into 2022, expectations are for moderating growth—yet still above potential—and easing inflationary pressures. Companies offering 'growth at a reasonable price' could be in vogue—where growth is not hot enough to drive the deepest cyclicals and not cold enough to need the defensiveness of high-flying growth companies. Reasonably priced, higher-quality companies that find themselves in the 'core' of the market are looking more attractive, particularly those paying dividends as forward return expectations are well below the more-than-15% annualised returns we've seen over the last decade.

Fed Up!

The Federal Reserve looks likely to accelerate its tapering of asset purchases when it meets later this month as it faces the risk that inflation does not recede as quickly as policymakers had hoped. With inflation at levels not seen in three decades, a tightening labour market and strong consumer spending, conditions seem to warrant tighter policy. Fed Chairman Jerome Powell and other committee members have increasingly hinted at accelerating the process, admitting that elevated inflation could persist longer than initially anticipated. Ending asset purchases earlier would give the Fed more flexibility to pull rate hikes forward, although Powell said the market should not link the two. While the Fed finally seems fed up with lingering inflation, the emergence of the omicron variant is a wild card that could weigh on growth, slow the nascent recovery in supply chains and add to inflation worries. Already a challenge unwinding policy at a pace not to destabilise growth, things have become a bit more tricky for the Fed.

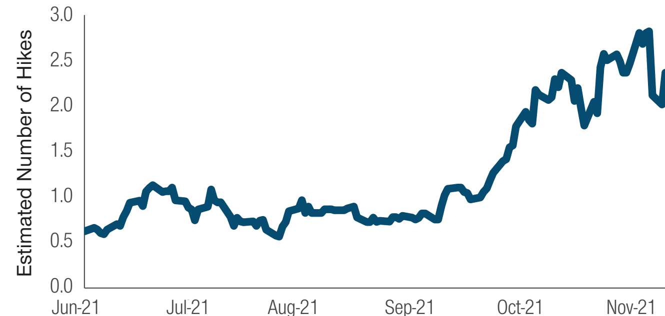
Large-Cap Growth vs. Value Performance[1]

As of 30 November 2021



Number of Rate Moves Priced In for December 2022[2]

As of 30 November 2021



Past performance is not a reliable indicator of future performance.

[1] Large-Cap Growth vs. Value returns are represented by the Russell 1000 Growth and Russell 1000 Value Indices, respectively. Figures are shown in US dollars.

[2] Data represent the estimated number of Fed moves priced into the current forward-curve structure for December 2022. Actual outcomes may differ materially from estimates. Estimates are subject to change.

Source: Financial data and analytics provider FactSet. Copyright 2021 FactSet. All Rights Reserved. Bloomberg Finance L.P. (see Additional Disclosure).

REGIONAL BACKDROP

	Positives	Negatives
United Kingdom	▪ Bank of England (BoE) December rate hike likely delayed due to omicron uncertainty ▪ Most economic indicators show expansion despite supply chain problems ▪ Labour market appears resilient to end of furlough ▪ Rapid booster campaign suggests greater resilience to omicron variant	▪ Omicron variant fear effect already seen in weaker UK services demand ▪ 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
Developed 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	▪ Elevated energy prices and supply chain issues are weighing on economic growth ▪ Rapidly rising COVID-19 concerns ▪ Limited long-term catalysts for growth ▪ Demand from China fading
United States	▪ Healthy consumer balance sheets and high savings rate ▪ Strong earnings growth ▪ Infrastructure spending likely to increase	▪ Supply chain issues are weighing on economic growth ▪ Significantly elevated inflation ▪ Elevated stock and bond valuations ▪ 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 ▪ Thanks to very low infection rates, the reopening of the economy is broad-based. Consumption and manufacturing leading indicators are at a two-year high ▪ Political risks are largely behind us. The upcoming fiscal stimulus is a tailwind for next year	▪ Amidst the omicron uncertainty globally, Japanese companies are the most exposed due to their high sensitivities to global economic momentum ▪ Funding pressures of the stimulus programme could bring back the topic of tax increases ▪ The rise in break-even inflation suggests inflationary pressures are also building in Japan
Asia Pacific ex-Japan	▪ Sentiment is gradually turning towards Chinese stocks, with foreign flows being positive ▪ Australian domestic consumption indicators point towards a snap bounce back from lockdowns, while the summer weather dampens risks from the new variant ▪ Inflationary pressures in China are far more subdued than in the western world, giving policymakers room to ease from here ▪ A relatively cheap Australian dollar could see a rebound due to extreme speculative positioning, the repricing of yields and a normalisation of commodity prices	▪ China's heavyweight tech sector remains under scrutiny with clouds around the future of VIEs, ADRs and dual listings ▪ Earning momentum in Australia is on a downward trajectory with the risk that dividend payouts got revised lower from this year's outsized figures ▪ Heightened political risks in China going into 2022 will create uncertainties and low incentives for local governments to step in if needed ▪ Australian inflation expectations are rising, which may lead to another surprise twist in the Reserve Bank of Australia's policy, with a rate hike earlier than communicated
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	▪ New coronavirus variants remain a threat ▪ Heightened political and regulatory risk ▪ Accommodation from central banks is fading

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UK INVESTMENT COMMITTEE POSITIONING

As of 30 November 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	Slight Underweight	Neutral	Slight Overweight	Overweight	Commentary
ASSET CLASSES	Equities			■				Valuations are elevated, but earnings strength has buoyed equities thus far. Decelerating economic growth, tightening central banks and renewed pandemic uncertainty may create a more challenging economic environment ahead.
	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 favourable; 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.
	Europe ex-UK			■				Potential for further lockdowns, elevated energy costs and low-rate environment remain concerns. However, cyclical orientation, reasonable valuations and improving stimulus expectations provide near-term support.
	UK				■			Brexit adjustments probably exacerbate the effects of supply shortages and rise in energy prices.
	Japan					■		Attractive valuations, strong global trade outlook and improving corporate governance provide tailwinds, but new variant could pose a threat to domestic reopening.
	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 vaccination levels continue to improve; however, virus uncertainty may delay progress.
	Style and Market Capitalisation							
	Global Growth vs. Value[1]			■				Value's cyclical orientation should benefit from pent-up consumer demand, elevated savings and economic strength supported by potential capex and infrastructure spending. However, a higher quality bias within value is warranted.
	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.

UK INVESTMENT COMMITTEE POSITIONING

As of 30 November 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.

	Asset	Change	Underweight		Neutral		Overweight	View
BONDS	UK Gilts		■					Strong activity and inflation data could trigger the next big bout of Bank of England hawkishness, but the impact of the omicron variant of the coronavirus increases uncertainty for policymakers.
	UK Inflation Linked					■		Inflation may prove to be more persistent than expected and higher than market expectations, leading to outperformance of inflation-linked bonds.
	UK IG Corporates	▼			■			The balance of risks has turned in favour of spread-widening.
	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 remains, but the impact of increased restrictions due to the new coronavirus are unknown.
	Global High Yield					■		Credit fundamentals remain strong, and demand for yield should persist amid low global rates. However, further upside is limited due to tight spreads.
	EM Dollar Sovereigns				■			More attractive valuations on recent weakness; however, emerging markets remain at risk to path of Fed tightening, progress towards coronavirus vaccinations and China-related uncertainty.
	EM Local Currency					■		Yields remain modestly attractive relative to other core bond sectors, with potential upside from cheap currencies. However, risk related to China, central bank tightening and persistent 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	GBP vs. USD	▼			■			Market pricing for rate hikes in 2022 is too aggressive, and risks from triggering Article 16 remain.
	GBP vs. EUR					■		The Bank of England has turned hawkish, while disappointing PMI data in the eurozone are likely to keep the ECB dovish.
	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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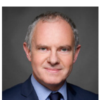

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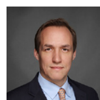

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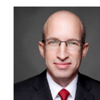

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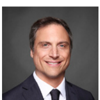

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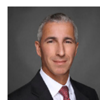

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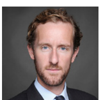

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