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INVEST WITH CONFIDENCE

Global Asset Allocation: The View From Europe

March 2022

1 Market Perspective

- Global economic growth is expected to moderate over the course of the year but remains above trend. Expectations for a moderation in inflation over the year may be stalled by inflationary pressures resulting from the conflict in Ukraine.
- Despite rising geopolitical risk impacting growth, developed market central banks are advancing toward tighter policies, the US Federal Reserve is expected to raise rates in March, the European Central Bank is curbing asset purchases and the Bank of Japan remains on hold. Emerging market central banks may need to raise interest rates to defend currencies against a stronger US dollar and to contain inflation.
- Short-term rates are biased higher with central banks tightening, while long-term rates balance concerns of slowing growth, the trajectory of inflation and risk-off sentiment.
- Key risks to global markets include the conflict in Ukraine, accelerating inflation off already high levels, central bank missteps, emergence of COVID-19 variants and China's growth trajectory.

2 Portfolio Positioning

As of 28 February 2022

- While valuations are off recent peaks, we remain underweight equities given moderating growth and earnings outlook amidst an active Fed and inflation concerns. Within fixed income, we remain overweight cash as longer rates remain biased higher.
- Within equities, we trimmed our overweight to US value stocks and into growth equities to take profits following a period of strong outperformance by value stocks and reduced the overweight to Japanese equity to further de-risk our positioning.
- Within our fixed income allocation, we continue to favour inflation-linked securities and shorter-duration and higher-yielding sectors through overweights to emerging market debt and high yield bonds, supported by our still-constructive outlook on fundamentals, while keeping a cautious eye on liquidity amidst higher volatility.

3 Market Themes

Chaos and Consequences

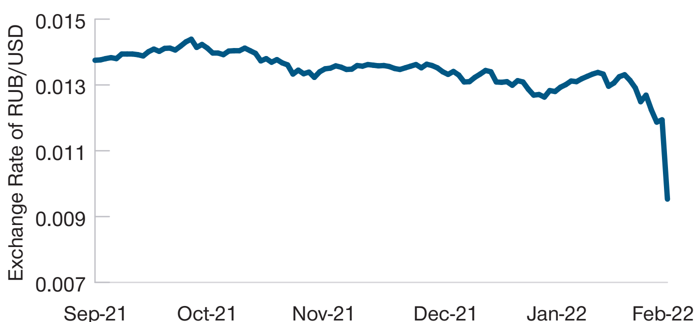
Russia's invasion of Ukraine has shocked the world, and while the immediate concerns are the human toll on the Ukrainian people, the implications and aftermath will be felt far beyond the region. With the European continent being thrown into chaos not seen since World War II, it's no surprise to see markets unsettled as they try to comprehend the impacts. In response to the aggression, the West has successfully collaborated by implementing several punishing sanctions targeting Russian banks, the Russian central bank and Russian sovereign debt, which have sent the ruble on a downward spiral and could devastate Russia's economy. However, so far, the sanctions have stopped short of penalising Russian energy companies, given Europe's, and especially Germany's, heavy reliance on Russian energy supply and the potential negative inflationary impacts of an energy price shock on already high prices related to the pandemic. As this situation continues to unfold, the consequences could be far-reaching, weighing on global growth and further accelerating inflation—especially given the area of conflict's notable contributions in energy and food to the rest of the world.

In and Out of Style

Equity markets' rough start to the year facing high inflation and a more aggressive Fed has only gotten worse amidst rising geopolitical issues in Ukraine, with the S&P 500 Index down roughly 8% year-to-date. Notable as the sell-off has deepened is that growth stocks have continued to underperform, where they are typically seen as more defensive in risk-off environments. Year-to-date, Russell 1000 Value Index stocks are down as well, but just 3%, while the Russell 1000 Growth Index has fallen over 14%, largely due to fears that already high inflation could worsen and lead the Fed on a more aggressive tightening trajectory. Although more cyclically oriented, value stocks have held up relatively well; nearly all of the positive contribution came from energy, which makes up 15% of the Russell 1000 Value Index and is up over 30% year-to-date. With the conflict continuing to unfold in Ukraine, as investors and central banks evaluate the balance of rising inflation pressures and slowing growth with the possibility of stagflation, growth and value stocks may be out of style.

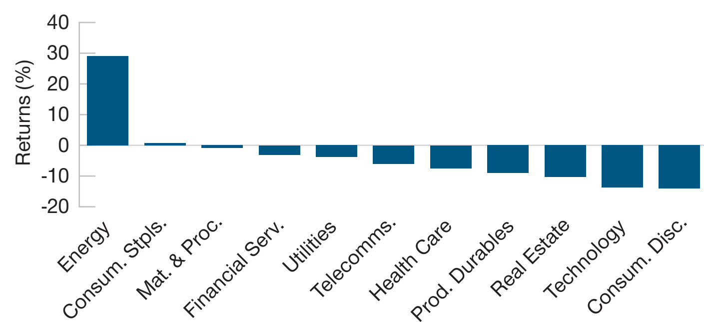
Russian Ruble Relative to the US Dollar

As of 28 February 2022



Year-to-Date Equity Sector Returns[1]

As of 28 February 2022



Past performance is not a reliable indicator of future performance.

[1] References the Russell 1000 Index. Source: London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group") (see Additional Disclosure). Sources: Bloomberg Finance L.P., financial data and analytics provider FactSet. Copyright 2022 FactSet. All Rights Reserved.

REGIONAL BACKDROP

	Positives	Negatives
Europe	▪ Fiscal stimulus increasing ▪ Monetary policy remains accommodative ▪ Equity valuations attractive relative to the US	▪ Ukraine conflict likely to continue to exacerbate energy shortages ▪ Industrial production dampened by supply chain challenges ▪ Limited long-term catalysts for earnings growth ▪ US dollar strength likely to remain a headwind
United Kingdom	▪ Most economic indicators show expansion despite supply chain problems ▪ The labour market is historically very strong ▪ Rapid opening up will support economic bounceback ▪ Majority of UK gas from outside Russia	▪ Bank of England will hike multiple times in 2022 on the back of strong wage and price inflation ▪ Despite little direct exposure, UK still likely to be affected by much higher gas prices ▪ Demand weakness from lower household disposable income due to higher energy prices as a result of Russia-Ukraine conflict may lead to small technical recession at the end of the year ▪ Very tight labour market means higher wage growth and stronger inflationary pressure
United States	▪ Strong corporate and consumer balance sheets ▪ Pent-up demand for services and capex	▪ Fed tightening expected at a rapid pace ▪ Elevated stock and bond valuations ▪ Supply chain issues limiting economic activity ▪ Significantly elevated inflation ▪ Fiscal stimulus has peaked

	Positives	Negatives
Japan	▪ Local stock markets continue to be attractive due to favourable relative valuation and healthy earning expectations ▪ Domestic fiscal support and easy monetary policy should prolong the economic recovery ▪ Despite the risk-off environment, the Japanese yen remains cheap and still boosts competitiveness	▪ Leading economic indicators are weakening on the back of the omicron wave, supply shortages and rising input prices. Hopefully, this will prove to be transitory ▪ Unexpected political risks resume as Prime Minister Fumio Kishida pushes for a less market-friendly agenda than his predecessors ▪ Inflationary pressures may be underappreciated due to rising commodity prices, communication costs increases and hopeful wage negotiations
Asia Pacific ex-Japan	▪ Loosening financial conditions in China starting to flow into the system, albeit at a reasonable pace ▪ A tight Australian labour market supports the ongoing recovery in consumer spending, with wages accelerating at a pace close to the targets of the Reserve Bank of Australia (RBA) ▪ Chinese economic activity is likely to reaccelerate from here after a short soft patch due to the Olympics, COVID-19 outbreaks and property concerns ▪ Australian assets proved to be more resilient to current geopolitical risks than the rest of the world, benefitting from higher commodity prices	▪ Until problems in the Chinese real estate sector are resolved, risk appetite will remain weak ▪ The RBA's dovish stance looks unsustainable and might create volatility when it catches up to market expectations ▪ A strong Chinese yuan, backed by a solid current account surplus, is tightening financial conditions ▪ Rising yields on the horizon raise concerns over a hot Australian property market
Emerging Markets	▪ Chinese authorities are easing regulatory and credit conditions ▪ Equity valuations attractive relative to the US ▪ COVID-19 vaccination rate is rapidly increasing	▪ Global trade remains impacted by supply chain issues, geopolitical uncertainty and COVID-19 restrictions ▪ US dollar strength likely to remain a headwind ▪ Central bank accommodation is fading

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 28 February 2022

Underweight — *Neutral* — *Overweight*   ▼ or ▲ Month-Over-Month 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.**
	Change						
ASSET CLASSES	Equities		■				Valuations off recent peaks but remain vulnerable to further rerating amidst Fed tightening policy and potential for significant economic weakness in Europe. Earnings growth to remain positive but moderating, with potential headwinds from rising wage and input costs.
ASSET CLASSES	Fixed Income				■		Global central bank policies shifting to a tighter stance and elevated inflation pressuring yields higher, supportive of short duration posture. Credit sector fundamentals remain favourable; recent risk-off environment has led to improved valuations.
	Region						
EQUITIES	US		■				Elevated valuations off recent peaks but remain challenged by Fed tightening, persistent inflation, geopolitical risks and decelerating earnings growth. Growth orientation of US market makes it more susceptible to rising rates.
EQUITIES	Europe ex-UK		■				Cyclical orientation and reasonable valuations attractive, but Russia-Ukraine conflict poses a significant risk due to the rising energy costs and impact of financial sanctions.
EQUITIES	UK			■			Brexit adjustments probably exacerbate the effects of supply shortages and the rise in energy prices.
EQUITIES	Japan				■		Attractive valuations, recent fiscal stimulus, stable global trade outlook and improving corporate governance should provide tailwinds.
EQUITIES	Developed Asia ex-Japan*			■			Valuations are attractive relative to the US. Chinese stimulus and successful containment of the coronavirus are supportive. Export- and commodity-driven economies face challenges.
EQUITIES	Emerging Markets (EM)				■		Valuations are very attractive; however, risk-off sentiment could remain a headwind. Improving outlook in China and fading COVID-19 waves are supportive, although recent conflict in Ukraine could weigh on global trade and pressure inflation higher.
	Style and Market Capitalisation						
EQUITIES	Global Growth vs. Value[1]		■				Relative valuations for value stocks remain attractive, but the gap has narrowed considerably, and the cyclical outlook has moderated. While growth stocks' valuations have become less challenging, they will continue to be pressured by rising rates and slowing earnings.
EQUITIES	Global Small-Cap vs. Large-Cap[1]				■		Small-cap stocks offer attractive relative valuations and still-strong earnings growth. However, elevated input costs, wage pressures and heightened market volatility could challenge performance. Higher quality bias is warranted.

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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 28 February 2022

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 Class	Change	Underweight	Underweight	Neutral	Overweight	Overweight	View
FIXED INCOME	Euro Government Bonds		■					Given the European Central Bank's likely change in quantitative easing, supply and demand imply that bunds are likely to continue to sell off for the rest of the year.
FIXED INCOME	Euro Inflation Linked					■		Inflation may be more persistent than expected and higher than market expectations, leading to outperformance of inflation-linked bonds.
FIXED INCOME	Euro Investment-Grade (IG) Corporates			■				The balance of risks has turned in favour of spread-widening.
FIXED INCOME	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.
FIXED INCOME	Global High Yield					■		Credit fundamentals remain solid and default risk remains low; however, continued spread volatility amidst rising rate concerns and risk-off sentiment expected.
FIXED INCOME	EM Dollar Sovereigns				■			Valuations are becoming more attractive as risk-off sentiment drives yields higher. EM still challenged by fiscal pressures, broader market volatility, slowing growth in China, coronavirus concerns and tighter central bank policies.
FIXED INCOME	EM Local Currency					■		As the conflict in Ukraine unfolds, yields continue to sell off, allowing for more attractive entry points. Fed tightening and flight to safety keep upward pressure on the USD, which may force EM central banks to raise rates.
FIXED INCOME	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					■		Improvements in Germany's trade balance should support a stronger euro going forward.
CURRENCIES	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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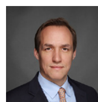

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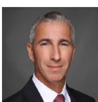

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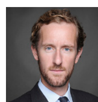

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