



# Global Asset Allocation: The View From Europe

July 2022

## 1 Market Perspective



- Inflation concerns remain at the forefront for central banks and investors as global growth continues to trend lower amid supply disruptions, geopolitical challenges and reduction of liquidity, setting the stage for a challenging macro backdrop.
- The US Federal Reserve (Fed) remains committed to its tightening policy, hinting at a steady path forward to further combat inflation. The European Central Bank (ECB) has telegraphed its plan to end asset purchases and begin raising rates despite a fragile macro backdrop, while the Bank of Japan (BOJ) remains steadfast on its policy of yield curve control.
- While most emerging market (EM) central banks continue to tighten policy in response to heightened inflation and weak currencies, China policies remain supportive following the easing of pandemic-related lockdowns to help bolster growth.
- Key risks to global markets include central bank missteps, persistent inflation, impacts of the Russia-Ukraine conflict, potential for a sharper slowdown in global growth and China's balance between containing COVID-19 and growth.

## 2 Portfolio Positioning

As of 30 June 2022



- Despite more attractive valuations following recent declines, we remain cautious on equities given a more challenging earnings environment amid slowing growth and tighter financial conditions. We retain our overweight positioning in fixed income.
- We reduced our overweight to value stocks as the first half of the year concluded. Energy has strongly outperformed, while supply issues are easing and demand is weakening as growth slows and prices increase. The cyclical nature of value may fall from favour.
- Within fixed income, we added exposure to euro government bonds, moving duration similar to that of the benchmark, in preparation for an economic slowdown or recession.
- Holdings of inflation-linked bonds were trimmed as inflation expectations seem to be moving past their peak.

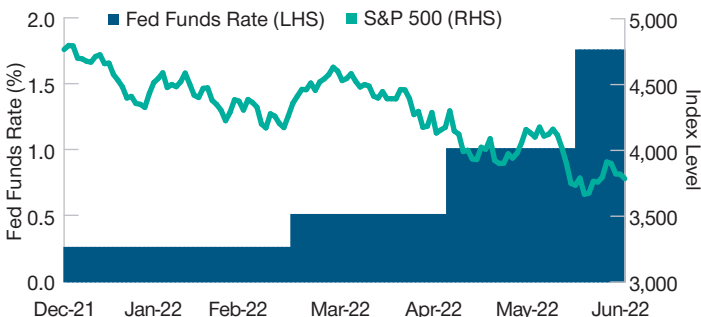
## 3 Market Themes

### Kaput!

For the last several decades, the Fed has had the luxury of pursuing its dual mandate—maximum employment while maintaining price stability—amid anchored low inflation. Major shocks to the economy and markets, including the global financial crisis and outbreak of COVID, could be combatted with aggressive rate-cutting and trillions of dollars in quantitative easing with little fear of stoking inflation. This environment was beneficial for the Fed and investors who became complacent in expecting a Fed “put” would be there to provide a backstop when a crisis occurred. Unfortunately, the Fed’s aggressive easing this time around came alongside unprecedented fiscal stimulus, flooding consumers and corporations with cash and the release of pent-up demand colliding with severe supply shortages related to COVID lockdowns. Add in the energy and agricultural shortages tied to the Russia-Ukraine conflict and you have the perfect storm for runaway inflation. Unfortunately for the Fed, they can’t fix supply and will likely remain steadfast in tightening policy to combat inflation, even if it risks pushing the economy into recession—meaning for now that the Fed “put” is kaput.

### Fed Funds Rate vs. US Equities

As of 30 June 2022



Past performance is not a reliable indicator of future performance.

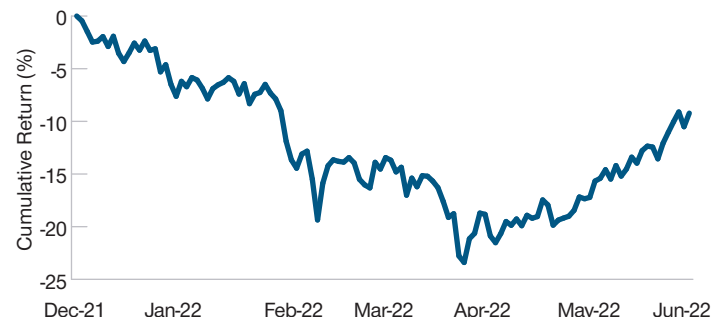
Chinese equities are represented by the Shanghai Shenzhen CSI 300 Index. Figures shown in Chinese yuan. Sources: Bloomberg Finance L.P. and S&P. See Additional Disclosures.

### Change of Tone

China’s stock market had fallen by nearly 24% towards the end of April this year as strict lockdowns related to the country’s zero-COVID policy weighed on the growth outlook. With evidence now showing that COVID-19 infections are abating, lockdowns have been eased and inbound traveler quarantine requirements have been halved, allowing China’s economy to gradually reopen. This shift in sentiment comes at a time when the People’s Bank of China has pledged to maintain supportive monetary policy to aid the country’s recovery, with a cautious eye on stability. Recent statements from President Xi Jinping pledging government support for parts of the technology sector, citing their larger role in the economy’s future, also seemed to suggest an easing of regulatory crackdowns experienced last year. In a matter of months, the negative sentiment surrounding China has shifted to it being the “new bull market,” with Chinese stocks up close to 20% off April’s lows. While still early in reopening and with China’s economic data just starting to show signs of improvement, the tone inside and outside China suggests that the worst may be past, at least for now.

### Chinese Equities Rebounding Sharply Since April

As of 30 June 2022





## REGIONAL BACKDROP

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### Positives

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- Europe**
- Fiscal spending is likely to increase
  - Equity valuations are attractive relative to the US
  - European Union unity is strengthening

### Negatives

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- The Russia-Ukraine conflict has driven energy prices sharply higher
- Industrial production has been dampened by supply chain challenges
- There are limited long-term catalysts for earnings growth
- ECB support is likely to fade in the near term

- United Kingdom**
- The labour market remains very strong
  - Economic growth has remained resilient
  - House prices remain firm

- Further interest rate increases from the Bank of England are likely
- Consumer confidence continues to fall, underpinning rising risks of recession
- Inflation is highly problematic, with producer and consumer price increases edging to new highs

- United States**
- Strong corporate and consumer balance sheets
  - Pent-up demand for services and capex

- The Fed is tightening at a rapid pace
- Inflation remains elevated
- Supply chain issues are limiting economic activity

## Positives

## Negatives

- Japan**
- Earnings remain healthy; with buybacks at record levels, shareholders should be rewarded
  - The policy setting remains accommodative with upcoming elections reinforcing the supportive tone
  - The Japanese yen is cheap; with interest rate differentials stabilising, the currency should appreciate

- Leading economic indicators continue to be weak due to supply shortages and rising input prices
- Inflation is pushing investors to question BOJ's commitment to its yield curve control policy
- The global slowdown is a concern for the export-heavy stock market

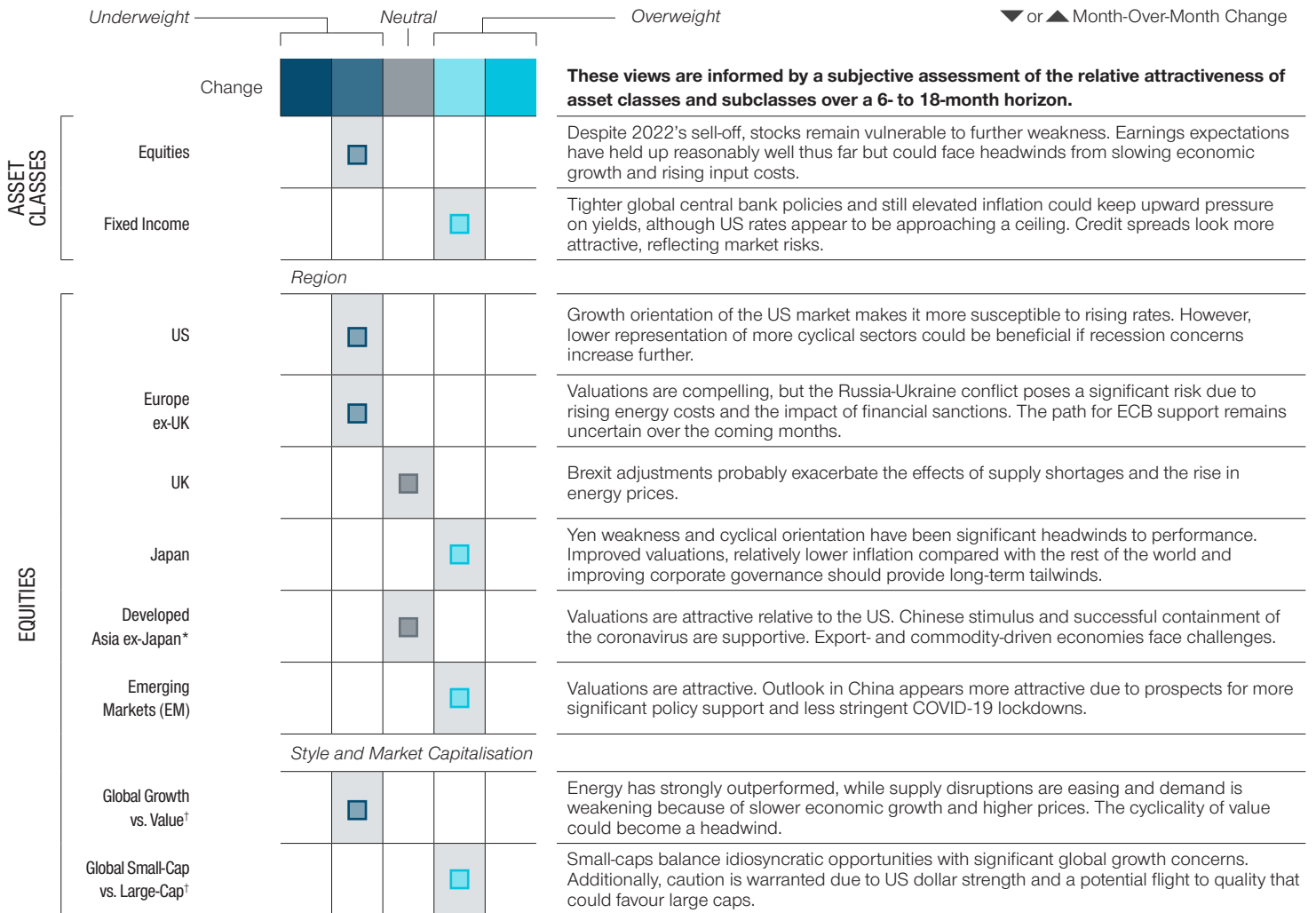
- Asia Pacific ex-Japan**
- The long-awaited policy-driven rebound in China seems finally underway
  - Local sentiment in China is turning towards the stock market, reinforcing the appeal to this contrarian and diversifying trade for foreign investors
  - A tight Australian labour market, generous wage increases and healthy saving rates support the ongoing recovery in consumer spending
  - The move higher in long-term yields might have gone too far, too fast. A decrease in yields would be beneficial for Australian assets

- Risks of renewed mobility restrictions in China remain
- The Chinese unemployment rate rose in big cities, explaining why consumers are cautious
- Expectations for future earnings are becoming more cautious to reflect the weakening of the economic momentum
- An unpredictable Reserve Bank of Australia policy adds to volatility in bond yields

- Emerging Markets**
- Chinese authorities are easing monetary, regulatory and credit conditions
  - Equity valuations are attractive relative to the US

- Global trade remains impacted by supply chain issues and geopolitical uncertainty
- Fiscal pressures remain a challenge

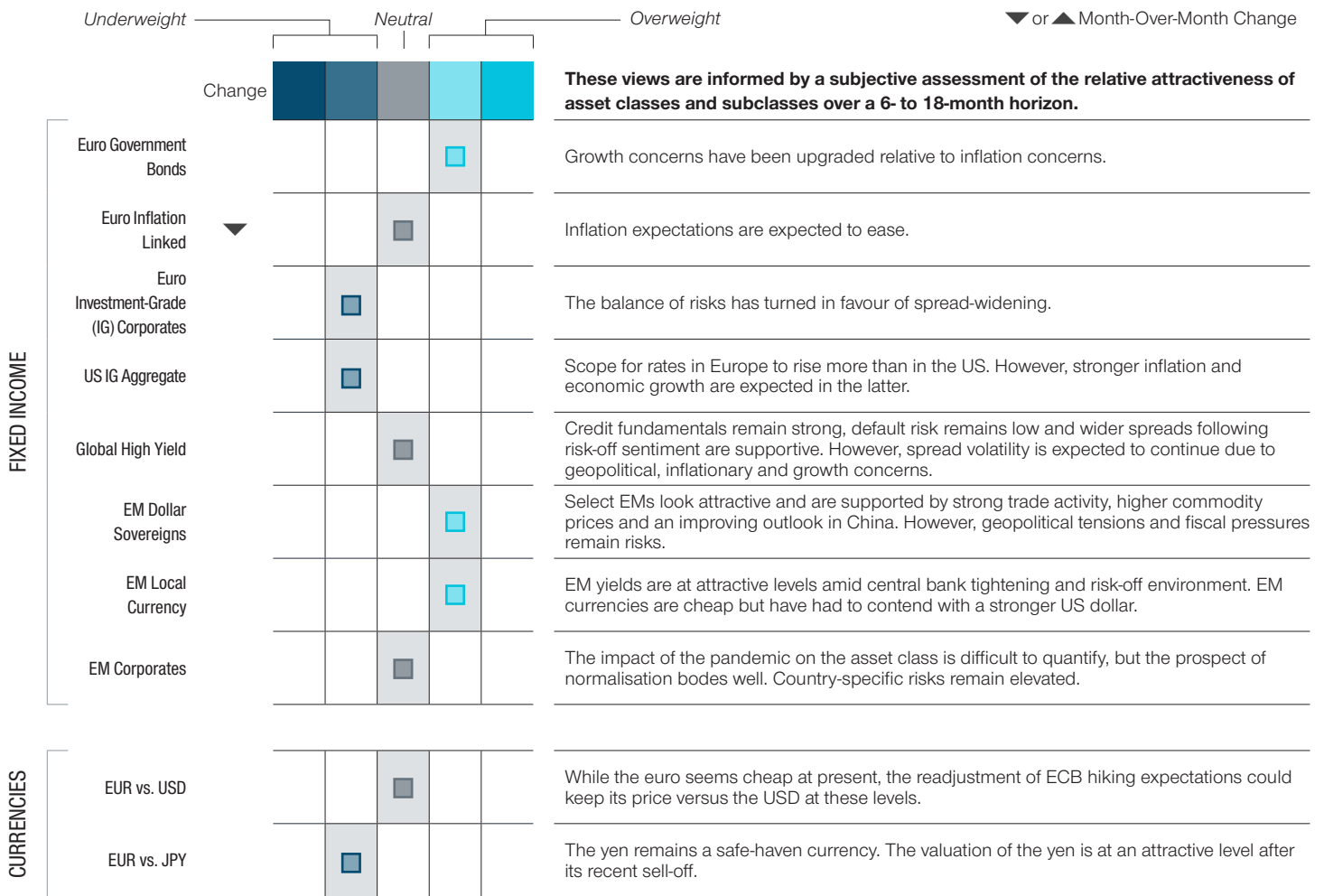
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\*Includes Australia.

† 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.



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