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Global Asset Allocation: The View From Europe

September 2022

1 Market Perspective

- While seeing increasing evidence of moderating inflationary pressures in some countries, central banks likely to remain steadfast in tightening policies as inflation is not likely to return to target levels in the near term.
- The US Federal Reserve (Fed) strongly reinforced its commitment this past month to its tightening policy, prioritising inflation fighting over economic growth. Despite facing prospects of weaker growth, the European Central Bank (ECB) is expected to ramp up rate hikes to fend off energy-driven inflation pressures, while the Bank of Japan (BoJ) remains on the sidelines.
- Several emerging markets (EM) are being forced to tap in to reserves to defend their currencies against the rallying US dollar and elevated import costs, while China continues to try and incrementally bolster growth through supportive policies as the country contains the spread of the coronavirus.
- Key risks to global markets include central bank missteps, persistent inflation, potential for a sharper slowdown in global growth, China's balance between containing the coronavirus and growth and geopolitical tensions.

2 Portfolio Positioning

As of 31 August 2022

- We remain moderately cautious on risk through our underweight to equities and overweight to fixed income. Slowing growth and declining earnings remain a challenge for equities, while persistent inflation and higher rates could weigh on fixed income.
- Within equities, we are nearly balanced between value and growth. The slowing growth backdrop is unfavourable for cyclicals, while higher rates weigh on growth-oriented equities.
- Within fixed income, we are overweight high-quality government bonds to mitigate the sensitivity of portfolios to an economic slowdown or recession.

3 Market Themes

It Fooled You Once...

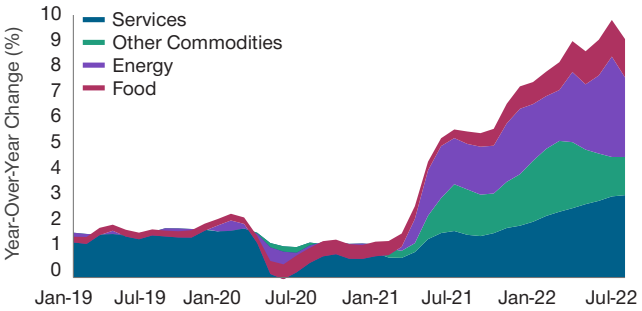
Coming out of the annual Jackson Hole meeting, Fed Chairman Jerome Powell's speech, unsurprisingly, had a strong tone reinforcing the Fed's intention to fight inflation at any cost, a 180-degree reversal of his 'inflation is transient' tone delivered the same time last year. But, just like last year when the Fed misread the growing threat of persistent inflationary forces and underacted, they may be misreading the trajectory of inflation once again. While lingering supply chain impacts from the pandemic and the Russia-Ukraine conflict over the past year further exacerbated inflationary pressures, we are now starting to see key input costs—such as oil, lumber and copper—sharply decline. Recent jobs data have also pointed to higher participation rates, which should help ease the tight labour market and pressure on wages and while other 'stickier' components of inflation—such as rents and owners' equivalent rents—are still on the rise, the pace has moderated in recent months. Although it is unlikely that inflation returns to the Fed's 2% target anytime soon, it could be falling a lot faster than suggested by the Fed's tightening, leaving markets to wonder if next year's speech will be about rate cuts.

House of Cards

Pandemic-fuelled demand for space, ultralow mortgage rates and low supply proved the perfect mix that set the US housing market on fire, with home prices surging over 40% since the start of the pandemic. Unfortunately, the tides have turned amid tighter Fed policy, as mortgage rates have spiked higher, with the 30-year fixed rate moving from below 3% up to 6% since early 2021. That abrupt leap in rates has quickly stifled demand, sending prices and sales lower, and is already forcing some mortgage lenders to begin layoffs amid the downturn. While there is clearly some excess in home valuations, particularly in certain regions that saw the strongest demand, it may be a stretch to draw parallels to the 2008 house of cards that came crashing down, as credit fundamentals of borrowers today are less of an issue. In fact, many buyers, and particularly first-time home buyers, have been sidelined as climbing financing costs are continuing to keep affordability out of reach and more than offsetting the recent softness in home prices. However, going forward, the real impact of a weakening housing market may be on sectors of the economy, such as construction spending and mortgage lending, as well as broader consumer spending.

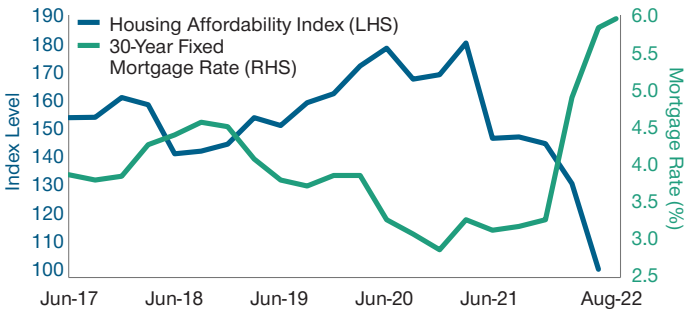
Contribution to CPI by Category

As of 31 July 2022



Housing Affordability vs. Mortgage Rates

As of 31 August 2022



Past performance is not a reliable indicator of future performance.

Source: Bloomberg Finance L.P.

The 30-Year Fixed Mortgage Rate reflects the U.S. Home Mortgage 30 Year Fixed National Average Index (Source: Bankrate.com).

REGIONAL BACKDROP

	Positives	Negatives
Europe	▪ Fiscal spending likely to increase ▪ Equity valuations attractive relative to the US ▪ European Union unity is strengthening for now	▪ Recession risk is very high ▪ Industrial production will be dampened by energy shortages ▪ ECB is tightening ▪ Sovereign debt risks are rising ▪ Limited long-term catalysts for earnings growth
United Kingdom	▪ The labour market remains strong ▪ Economic growth has remained resilient but is starting to slow	▪ Further interest rate increases from the Bank of England are likely ▪ Consumer confidence is very weak, pointing to a risk of recession ▪ Inflation is highly problematic for policymakers, consumers and businesses
United States	▪ Strong corporate and consumer balance sheets ▪ Pent-up demand for services and capex ▪ Resilient labour market ▪ Supply chain issues improving rapidly	▪ Persistently high inflation ▪ Restrictive monetary policy ▪ Challenging environment for earnings

	Positives	Negatives
Japan	▪ Earnings remain healthy; with buybacks at record levels, shareholders should be rewarded ▪ The policy setting remains accommodative ▪ The Japanese yen is cheap; with interest rate differentials stabilising, the currency should appreciate	▪ Leading economic indicators continue to be weak due to elevated input prices ▪ Inflation is pushing investors to question the 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 economic slowdown in China implies further stimulus support; risk sentiment also remains low, which is typically a good entry point for investors ▪ China company valuations remain undemanding with solid earnings growth being forecast in the next 12 months ▪ In Australia, consumer spending remains healthy despite headwinds; consensus expects the Reserve Bank of Australia to moderate the pace of tightening going forward, reducing pressure on yields	▪ Risks of renewed mobility restrictions in China are increasing with the virus spreading in certain provinces ▪ Investors are waiting for outcomes of the upcoming Party Congress for further clarity on the future economic priorities ▪ In Australia, expectations for future earnings are becoming more cautious to reflect the weakening economic momentum ▪ Inflationary pressures mean policy tightening is not over, while the housing market has peaked as evidenced by prices/activity levels
Emerging Markets	▪ Chinese authorities are easing monetary, regulatory and credit conditions ▪ Equity valuations are attractive relative to the US ▪ COVID concerns have decreased	▪ Chinese regulatory actions are weighing on confidence ▪ Chinese housing concerns have impacted industrial activity ▪ Geopolitical risks are elevated ▪ Global trade volumes are slowing

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 August 2022

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

		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 CLASSES	Equities		Despite a recent bounce, stocks remain vulnerable amid tightening liquidity and a hawkish Fed. Earnings expectations are beginning to be pressured by slowing economic growth and persistent cost inflation.
ASSET CLASSES	Fixed Income		Tighter global central bank policies and elevated inflation are counteracting recession fears to keep yields range-bound. Credit spreads offer reasonable compensation for risk with prospects for defaults to rise from historically low levels.
	Region		
EQUITIES	US		US equities remain expensive on a relative basis. However, the less cyclical nature of the US economy should provide some support as global growth weakens.
EQUITIES	Europe ex-UK		Valuations are compelling, but elevated energy costs and weakening manufacturing activity have made a recession highly likely. Meanwhile, the ECB is unable to provide support with inflation concerns rising.
EQUITIES	UK		Brexit adjustments probably exacerbate the effects of supply shortages and the rise in energy prices.
EQUITIES	Japan		Despite cyclical concerns, Japan offers cheap valuations, relatively lower inflation, an improving outlook for the yen, an accommodative monetary policy stance and improving corporate governance.
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		Valuations and currencies are attractive. The medium-term outlook in China appears attractive due to prospects for significant policy support and less stringent COVID lockdowns; however, further outbreaks remain a risk.
	Style and Market Capitalisation		
EQUITIES	Global Growth vs. Value†		Relative valuations for value stocks remain attractive, and energy sector earnings could provide support. However value stocks may weaken as inflation concerns give way to increasing recession risks.
EQUITIES	Global Small-Cap vs. Large-Cap†		Small-cap stocks offer historically attractive relative valuations, reflecting elevated recession concerns. However, thus far, small-cap earnings have held up well during economic weakness and could improve dramatically if the outlook stabilises. Higher-quality bias is warranted.

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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.

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 August 2022

Underweight — Neutral — Overweight

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		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.
FIXED INCOME	Euro Government Bonds		Duration mitigates some risks given the reducing likelihood of the global economy dodging a recession.
	Euro Inflation Linked		Inflation expectations are expected to ease.
	Euro Investment-Grade (IG) Corporates		Underweight credit risk in expectation of further slowing growth and widening credit spreads, particularly in Europe.
	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		Credit fundamentals and the default outlook remain stable but may be challenged as economic growth continues to deteriorate. Yields are still at compelling levels despite recent rally, but spread volatility is expected to continue.
	EM Dollar Sovereigns		Yield levels are attractive in select markets versus developed markets, but relative valuations are closer to fair value and in line with risks. Prospects for stimulus from China are supportive.
	EM Local Currency		EM yields are at attractive levels amid central bank tightening and risk-off sentiment. Potential for EM currency stabilisation would be supportive.
	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		While the euro seems cheap at present, the readjustment of ECB hiking expectations could keep its price versus the US dollar at these levels.
	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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