



Global Asset Allocation: The View From Europe

December 2022

1 Market Perspective



- Uncertainty persists for the global economic outlook as hawkish central banks battle with high inflation in the face of weakening growth expectations.
- The US Federal Reserve has signalled a moderation in the pace of tightening but remains committed to taming inflation, acknowledging the potential for a higher-for-longer terminal rate.
- Heading into the winter months, the European Central Bank (ECB) faces a more challenging energy-driven inflation battle. Having remained steadfast, the Bank of Japan (BOJ) may be forced to ease yield curve controls as inflation takes hold and rate differentials have weakened the yen.
- Emerging market (EM) central banks are nearing the peak of their rate hiking cycles but may need to hold rates firm to defend against weakening currencies. Uncertainty surrounding Chinese economic growth is increasing as officials ease economic policy while balancing COVID lockdowns and recent unrest.
- 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 30 November 2022



- We are underweight stocks, remaining cautious on the weakening outlook for growth and earnings amid still elevated inflation and active central banks.
- We remain modestly overweight cash relative to bonds given attractive short-term yields, while longer rates remain vulnerable to inflation and potential headwinds from duration if rates rise further.
- 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 emerging market debt, where attractive valuations offer reasonable compensation for risks and fundamentals remain generally supportive. Default rates are expected to rise from today's historically low levels towards longer-run averages with higher yields providing a buffer should credit spreads widen. We also hold a modest overweight to high quality government bonds as a risk-off ballast to equities.

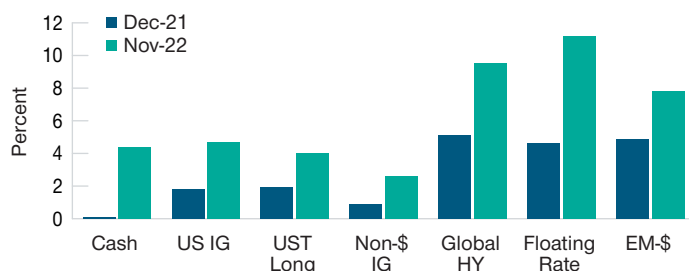
3 Market Themes

Took the Pain, Now the Gain?

The year 2022 is shaping up to be one of the worst years of performance across global fixed income markets as yields were driven sharply higher by central banks battling decades-high inflation. The pain was not unique to fixed income markets as equities broadly moved in sync, leaving investors in diversified portfolios with few places to hide. As painful as the year has been, fixed income markets are looking more attractive today than they have in more than a decade. With yields now at higher levels and expectations for inflation moderating amid slowing growth next year, fixed income markets could be well positioned for positive returns as central banks' tightening slows. Even for investors on the sidelines awaiting a better entry into risk assets, cash is finally getting compensated. Credit markets also look more appealing today with higher yield bonds yielding more than 9%, providing attractive income and a buffer should spreads widen. And while there is a high probability of recessions hitting major economies next year, credit fundamentals remain relatively strong, supporting our analysts' expectations for a modest increase in defaults towards longer-run averages. So as markets enter 2023 still facing significant risks to the growth outlook, fixed income markets could prove their value through both higher income and a return to providing diversification benefits.

Fixed Income Sector Yields

31 December 2021 vs. 30 November 2022



Past performance is not a reliable indicator of future performance.

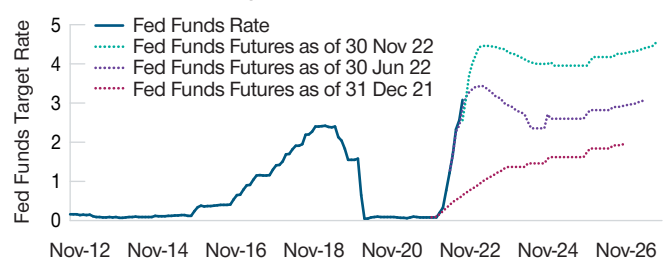
Sources: Bloomberg Index Services Limited, J.P. Morgan Chase, Haver Analytics/Federal Reserve Board and Bloomberg Finance L.P. (see Additional Disclosures).

Pace Yourself!

Minutes from the Fed's November meeting pointed to a growing consensus to moderate the pace of interest rate hikes, while at the same time suggesting the potential for a higher terminal rate which could be sustained for an extended period. After having raised rates at a historically fast pace of 75 basis points for the fourth consecutive time, a growing contingent of members cautioned that the level of rates may ultimately prove higher than necessary to contain inflation. Given that tighter monetary policy implemented today can take more than a year to flow through the economy, it is increasingly difficult for the Fed to judge if they've provided enough medicine to contain inflation or unnecessarily overdosed the economy. The release of the minutes coincided with multiple Federal Open Market Committee (FOMC) members publicly suggesting a downshift was in the works and the market certain of a 50-basis-point move in December. The Fed is not the first central bank pulling back on the pace of hikes, as several other developed and emerging market central banks have already slowed their trajectories. So, while a downshift seems warranted by the Fed, by citing the potential for rates remaining higher for longer, they have given the market notice to pace itself, as they intend to achieve their goal no matter how high the climb or how long it takes.

Market Playing Catch-Up to Fed

30 November 2012 Through 30 November 2022





REGIONAL BACKDROP

Positives

- Europe**
- Fiscal spending is likely to increase
 - Resilient labour market
 - Supply chain issues improving rapidly

Negatives

- Recession risk is very high
- Industrial production will be curtailed by energy shortages
- ECB is tightening
- Sovereign debt risks are rising
- Limited long-term catalysts for earnings growth

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- United Kingdom**
- Energy cap will partially offset mortgage and energy shocks to household finances
 - The labour market remains strong

- The Bank of England will raise interest rates to high levels
- Fiscal consolidation will further weigh on demand next year
- A recession and sharp house price declines next year appear likely

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- United States**
- Strong corporate and consumer balance sheets
 - Resilient labour market
 - Supply chain issues are improving rapidly

- Persistently high inflation
 - Restrictive monetary policy
 - Labour supply shortages
 - Deteriorating corporate margins
-

Positives

- Japan**
- Earnings outlook remains healthy relative to other regions
 - The policy setting remains accommodative with no change expected, both monetary and fiscal
 - The Japanese yen is expected to remain cheap, boosting competitiveness

Asia Pacific ex-Japan

- Early signs of COVID policy changes in China bode well for a reopening sometime in 2023
- China company valuations remain undemanding with solid earnings growth being forecast in the next 12 months
- In Australia, consensus expects the Reserve Bank of Australia to moderate the pace of tightening going forward, reducing pressure on rising yields

Emerging Markets

- Chinese authorities are easing monetary and credit conditions and providing housing market support
- Equity valuations are attractive relative to the US
- COVID restrictions are being gradually loosened

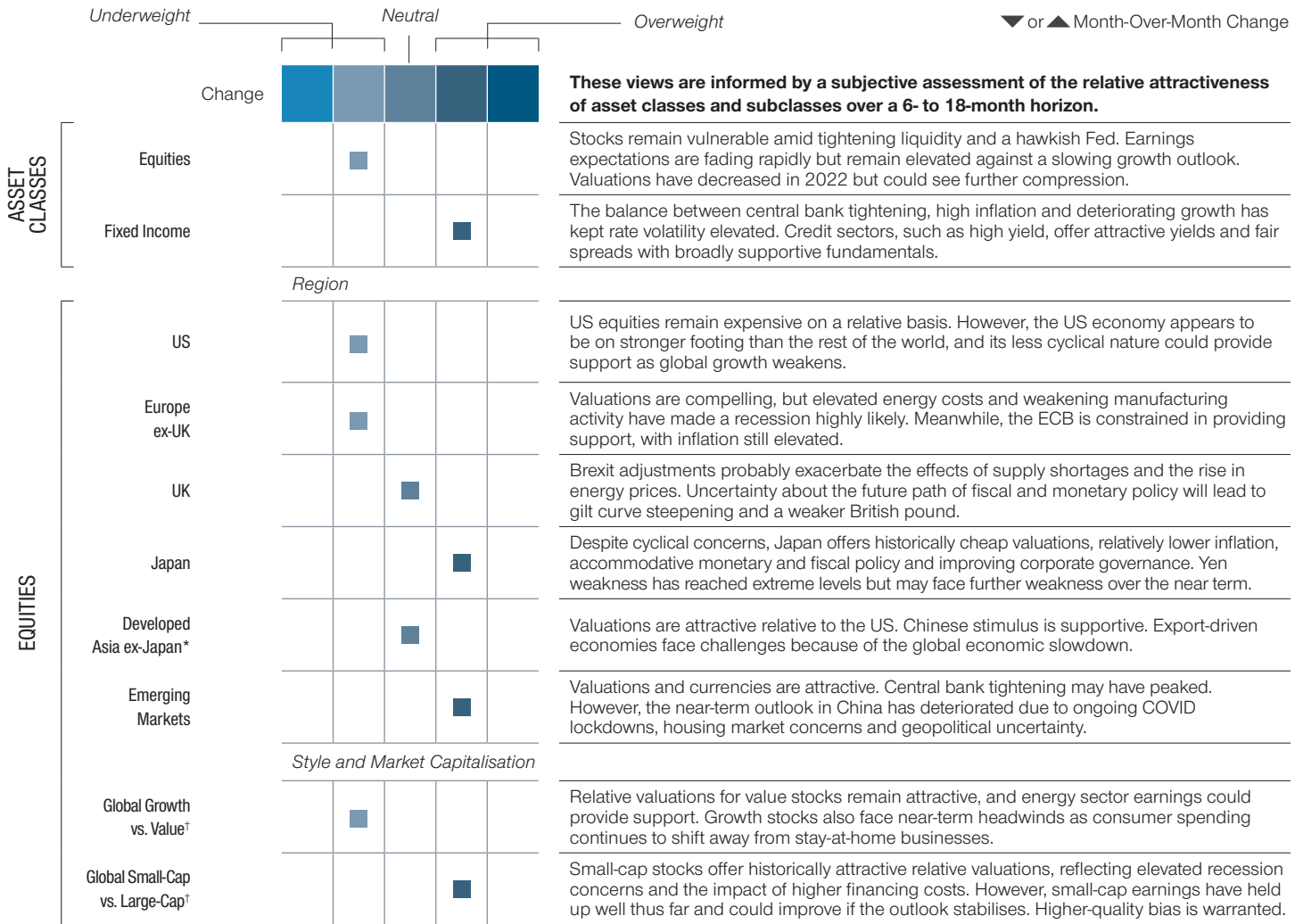
Negatives

- Earnings expectations are building around the reflationary theme, leaving investors at risk of being disappointed
- A disorderly exit of BOJ's yield curve control policy would spark volatility in the financial system
- The global economic slowdown is a concern for the export-heavy stock market

- Uncertainties around the exit strategy from China's dynamic zero-COVID policy may create a disorderly re-opening
- Foreign investors remain cautious towards Chinese assets until there is greater clarity on the growth trajectory for 2023
- In Australia, consumer spending is slowing in advance of mortgages being reset in 2023. Inflationary pressures also remain, dampening expectations for a clear pivot in policy setting

- Global trade volumes are slowing
- COVID lockdowns remain a headwind to economic growth
- Chinese housing concerns have impacted industrial activity
- Chinese regulatory actions are weighing on confidence
- Geopolitical risks are elevated

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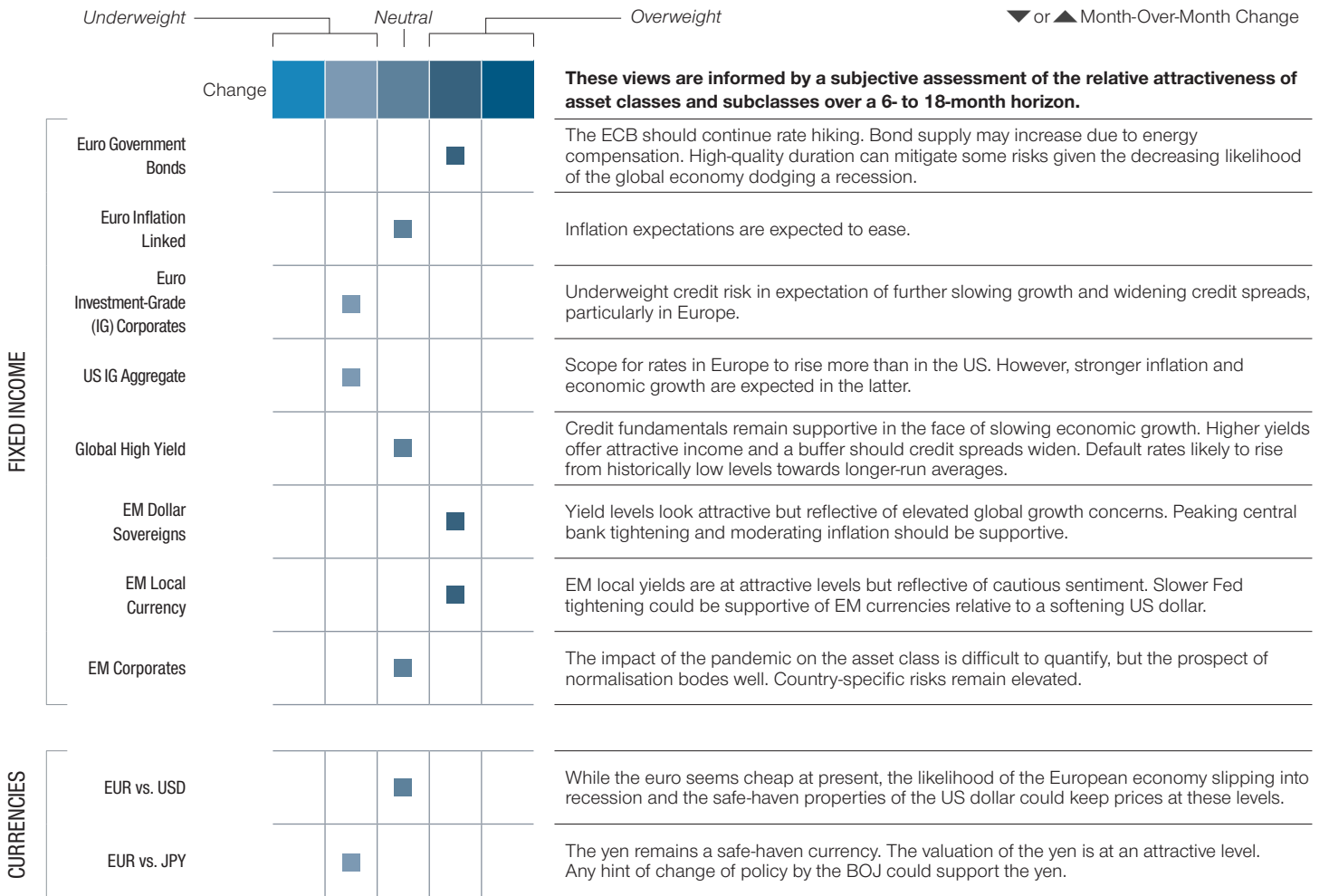


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*Includes Australia.

[†] 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.

The asset classes across the equity and fixed income markets shown are represented in our multi-asset portfolios. Certain style and market capitalisation asset classes are represented as pairwise decisions as part of our tactical asset allocation framework.



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