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Global Asset Allocation: The View From Europe

October 2022

1 Market Perspective

- The global economic outlook remains uncertain as central banks balance reining in high inflation against a weakening growth backdrop.
- The US Federal Reserve (Fed) reinforced its commitment to bring down inflation, recently raising its projected rates path at the risk of economic pain. Energy-driven inflation gives the European Central Bank (ECB) a more challenging task amid a divergence in fiscal flexibility across the European Union's members. The Bank of England is caught between battling high inflation and bond market volatility impacting its pension system, forcing a temporary pivot back to quantitative easing.
- Several central banks, including the Bank of Japan (BoJ), are being forced to tap in to reserves to defend their currencies against a persistently strong US dollar, while China continues to try to bolster growth through supportive policies as it aims to contain 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 30 September 2022

- We moderated our underweight to stocks, taking advantage of recent weakness and more attractive valuations; however, we remain broadly cautious on equities given aggressive central bank tightening and a moderating outlook for growth and earnings.
- We added to cash given continued risk of higher rates weighing on bonds, while cash offers safety and more attractive yields given the push higher in short-term policy interest rates.
- 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 remain overweight government bonds as a risk-off hedge to equities and relatively more attractive yield levels. Elsewhere in fixed income, we remain constructive on sovereign emerging market debt based on attractive yields and still supportive fundamentals.

3 Market Themes

'Pound-ed'

Markets ended the third quarter rattled by news that the UK central bank temporarily pivoted back into quantitative easing to fend off a potential disaster for the UK pension system following a spike in rates. This comes at the same time the bank has been raising policy rates and moving toward quantitative tightening to fight record-high inflation, led by shortage-driven energy prices. Worries spread quickly through the UK gilt markets—already weighed upon by threats of new supply to fund Prime Minister Liz Truss' fiscal spending plans—on concerns pensions would be forced sellers of gilts to meet margin calls. In synch with the bond sell-off, the British pound extended its slide to record-low levels against the US dollar. The chaos in financial markets and sell-off in the pound could spell disaster for the UK's central bank as it tries to rein in inflation and navigate fiscal spending, all while avoiding a collapse in UK pension system. The UK's woes are not unique in the current environment. Aggressive central bank tightening, led by the Fed, is pressuring currencies across developed and emerging markets (EMs), pushing imports inflation higher and bleeding currency reserves. Fragilities are becoming more evident as the Fed keeps on its aggressive path, leaving other markets increasingly vulnerable to getting pounded.

UK Sell-Off

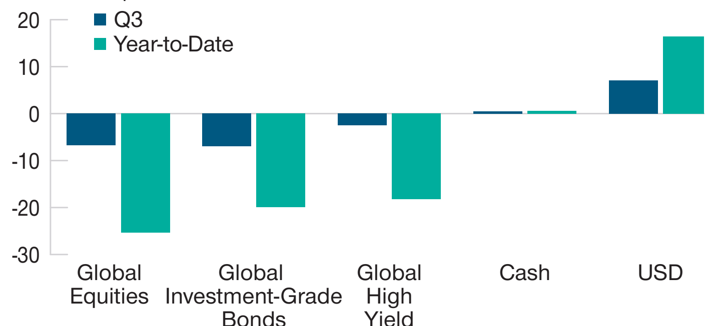
As of 30 September 2022

Anywhere to Hide?

Hopes for a continuation of the summer rally off the June lows were dashed in the back half of the third quarter. The inflection lower in risk assets coincided with Fed Chairman Jerome Powell's late-August speech in Jackson Hole, Wyoming, where he pledged a continuation of aggressive policy to beat back inflation. Market participants that had been awaiting a hint of a 'pivot' or a least a slowdown to wait and see the data were sadly disappointed. Still-strong reports on inflation and worries about collapsing currencies abroad further weighed on sentiment. Outside of cash and the US dollar, both risky and safe-haven assets steepened their declines over the quarter, leaving global equities down 25% year to date and global bonds not far behind, down nearly 20%. While there have been few places for investors to hide this year, some segments of the market are becoming more attractive. Amongst those are high yield bonds that now yield near 10%, providing a more balanced risk-to-reward entry point and with yield levels that have historically delivered attractive forward returns. While the risk of recession remains elevated and inflation has yet to be tamed, high yield fundamentals remain strong relative to history and could provide an attractive hideout and reasonable compensation for risks.

Cross-Asset Returns

As of 30 September 2022



Past performance is not a reliable indicator of future performance.
Source: Bloomberg Finance L.P. Indices: Global Equities—MSCI AC World; Global Investment-Grade Bonds—Bloomberg Global Aggregate; Global High Yield—Bloomberg Global High Yield; Cash—Bloomberg 3-Month T-Bill; USD—ICE US Dollar (DXY). See additional disclosures.

REGIONAL BACKDROP

	Positives	Negatives
Europe	▪ Fiscal spending likely to increase ▪ Very attractive equity valuations	▪ 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
United Kingdom	▪ Tax cuts and energy cap will partially offset mortgage and energy shocks to household finances ▪ The labour market remains strong ▪ Energy price cap implies a temporary return to inflation target by the end of 2023	▪ The Bank of England will raise interest rates to high levels ▪ Consumer confidence is very weak, pointing to a risk of recession with energy concerns compounding downside economic risks ▪ A recession and a house price crash next year appear likely
United States	▪ Strong corporate and consumer balance sheets ▪ Resilient labour market ▪ Supply chain issues improving rapidly	▪ Persistently high inflation ▪ Restrictive monetary policy ▪ Challenging environment for earnings

	Positives	Negatives
Japan	▪ Japanese earnings remain healthy ▪ The policy setting remains accommodative ▪ The Japanese yen is cheap, helping the export sector	▪ Leading economic indicators continue to be weak ▪ 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	▪ Bad news is seen as good news, with the economic slowdown in China implying further stimulus support ▪ 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 rising yields	▪ Risks of renewed mobility restrictions in China are increasing with the coronavirus spreading in certain provinces ▪ Investors are waiting for outcomes of the upcoming Communist Party congress for further clarity on the future economic priorities ▪ In Australia, expectations for future earnings are becoming more cautious to reflect weakening economic momentum. 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	▪ Global trade volumes are slowing ▪ Chinese housing concerns have impacted industrial activity ▪ Geopolitical risks are elevated ▪ Chinese regulatory actions are weighing on confidence

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 30 September 2022

▼ 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	Underweight	Neutral	Overweight	Overweight	
ASSET CLASSES	Equities			■				Stocks remain vulnerable amid tightening liquidity and a hawkish Fed. Earnings expectations are fading rapidly but remain too high. However, valuations have become more reasonable.
ASSET CLASSES	Fixed Income					■		The balance between central bank tightening, high inflation and deteriorating growth likely keeps rate volatility elevated. Credit sectors, such as high yield, offer attractive yields and fair spreads with supportive fundamentals.
	Region							
EQUITIES	US			■				US equities remain expensive on a relative basis. However, the less cyclical nature and stronger near-term outlook may 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. The inconsistency between fiscal and monetary policies adds to uncertainty.
EQUITIES	Japan					■		Despite cyclical concerns, Japan offers cheap valuations, relatively lower inflation, an improving outlook for the yen, an accommodative monetary and fiscal policy and improving corporate governance.
EQUITIES	Developed Asia ex-Japan*				■			Valuations are attractive relative to the US. Chinese stimulus is supportive. Export-driven economies face challenges because of global economic slowdown.
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, Chinese housing market concerns and slowing global trade could be headwinds.
	Style and Market Capitalisation							
EQUITIES	Global Growth vs. Value†			■				Relative valuations for value stocks remain attractive, and energy sector earnings could provide support. However, the more cyclical nature of value stocks makes them more vulnerable if 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 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 30 September 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	Change	Underweight	Underweight	Neutral	Overweight	Overweight	View
FIXED INCOME	Euro Government Bonds					■		The ECB should continue rate hiking. Bond supply may increase due to energy compensation. High-quality duration can mitigate some risks given the reducing likelihood of the global economy dodging a recession.
FIXED INCOME	Euro Inflation Linked				■			Inflation expectations are expected to ease.
FIXED INCOME	Euro Investment-Grade (IG) Corporates			■				Underweight credit risk in expectation of further slowing growth and widening credit spreads, particularly in Europe.
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 and the default outlook remain stable but may be challenged as economic growth continues to deteriorate. Higher yields offer reasonable compensation for risks, with spreads fairly valued and likely to remain volatile.
FIXED INCOME	EM Dollar Sovereigns					■		Attractive yield levels 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.
FIXED INCOME	EM Local Currency					■		EM yields are at attractive levels amid central bank tightening and risk-off sentiment. However, a strong US dollar continues to be a headwind.
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				■			While the euro seems cheap at present, the likelihood of the European economy slipping into recession and the safe-haven properties of the US dollar could keep prices at these levels.
CURRENCIES	EUR vs. JPY			■				The yen remains a safe-haven currency. The valuation of the yen is at an attractive level. Any hint of change of policy by the BoJ could support the yen.

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EUROPEAN INVESTMENT COMMITTEE

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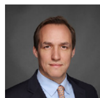

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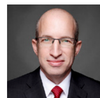

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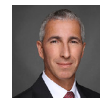

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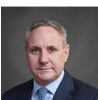

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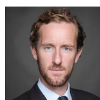

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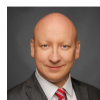

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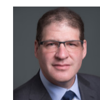

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