Global Asset Allocation: The View From Europe

February 2023

1 Market Perspective

- While evidence of slowing inflation and moderating central bank tightening have reduced the probability of a hard economic landing, global growth is still expected to slow as tighter financial conditions flow through the global economy.
- The US Federal Reserve struck a dovish tone as they acknowledged that inflationary pressures have eased but remain elevated, warranting a data-dependent approach in determining the extent of future rate increases.
- The European Central Bank (ECB) reaffirmed its commitment to its rate tightening path until inflation moves towards its 2% target. After the surprise move of easing yield curve control, the Bank of Japan (BoJ) defied speculation for another policy adjustment amidst decades-high inflation levels.
- Moderating pressures from higher rates and a stronger US dollar continue to benefit emerging market (EM) economies and offer a reprieve for their central banks. While uncertainty remains, sentiment towards China has improved as the country rapidly shifts away from its stringent zero-COVID policies, providing a boost to the global economy.
- Key risks to global markets include central bank missteps, resilient inflation, steeper growth decline resulting in a hard landing and geopolitical tensions.

2 Portfolio Positioning

As of 31 January 2023

- We trimmed our underweight to stocks on a more balanced outlook following evidence of improving trends, including lower inflation, the easing pace of central bank tightening, China reopening and Europe staving off an energy crisis. While risks have moderated, valuations remain challenged by expectations for slowing economic and earnings growth ahead.
- We remain modestly overweight cash relative to bonds, earning attractive yields and providing liquidity should market opportunities arise.
- Within equities, we are overweight Japan and emerging markets on attractive relative valuations, improving sentiment surrounding China reopening and an outlook for a softer US dollar. While the outlook for Europe has improved with the continent dodging higher energy prices due to a mild winter, we remain underweight the region after the strong rebound since October.
- Within fixed income, we remain overweight emerging market debt, where yields still offer reasonable compensation for risks, despite recent outperformance. We remain underweight investment grade corporate bonds and neutral high yield, waiting for a potential better entry point when the economy slows further.

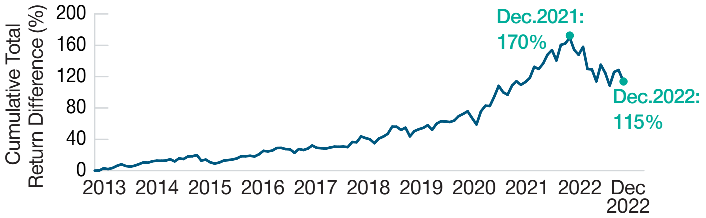
3 Market Themes

Two in a Row?

After outpacing the rest of the world by more than 170% over the past nine years between 2013 and 2021, US equity markets notably lagged the rest of the world last year. Despite deeply negative returns across global markets in 2022, markets outside the US broadly outperformed in both local currency and US dollars, even with a persistently strong US dollar. Perhaps this was not unsurprising as some positive tailwinds appeared on the horizon late in the year, including growing evidence of slowing inflation pressures leading some central banks to hint at moderating their pace of interest rate hikes. In Asia, China surprised the world in early December with reopening from COVID lockdowns, while at the same time Europe seemed to avert an energy crisis by benefitting from warmer weather and aggressive steps to control energy usage. Lower yields in the US on the back of falling inflation are also contributing to a lower dollar, providing further support for markets outside the US, particularly emerging markets. While much uncertainty remains around the trajectory of global growth for 2023, markets outside the US could be up for a second year of outperformance as they are supported by still attractive relative valuations, higher dividend yields and more cyclical exposures that could benefit from China's reopening and a less dire outlook for Europe.

US Equity Performance vs. the Rest of the World[1]

10 Years Ended 31 December 2022

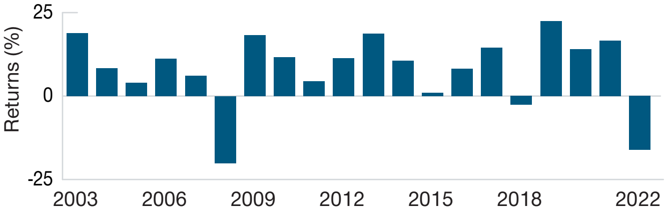


I'm Back!

In a rare year with both equity and bond markets down by double digits, much noise was made about the death of the US traditional 60/40 balanced portfolio and the need to include allocations to less correlated sources of return. Last year's high inflation and rising interest rates led to increased correlations between stocks and bonds as both fell in unison, leaving bonds unable to fulfill their typical role of providing ballast, particularly during risk-off periods. Despite correlations between stocks and bonds remaining elevated, noise around the death of the 60/40 portfolio has been silenced as strong returns in both stocks and bonds have led to a more than 5% return for the 60/40 in just the first month of the year. The rally in both asset classes has been supported by evidence of falling inflation and lower rates. Our analysis has shown that, in historical periods like today when inflation is declining from elevated levels, correlation between stocks and bonds can remain elevated. While perhaps still not providing diversification, if the disinflationary trend continues, the two asset classes could perform well, bringing back the 60/40 portfolio from one of its worst years ever.

Annual Returns of a Hypothetical 60 US Equity/40 US Fixed Income Portfolio[2]

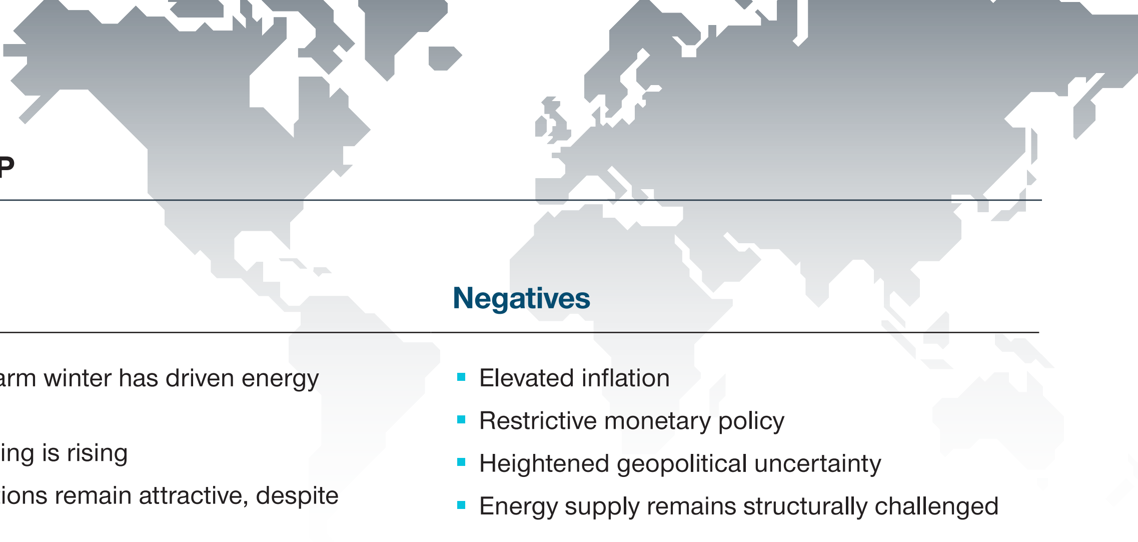
20 Years Ended 31 December 2022



Past performance and hypothetical performance are not reliable indicators of future performance. Actual performance will vary, perhaps materially, from the performance shown. The performance of the hypothetical portfolio does not include fees or costs. If these fees were deducted from the returns shown, the returns would be lower.

[1] Source: FactSet. References the MSCI U.S. and MSCI All Country World ex U.S. Indices. Figures shown in local currency.

[2] Source: Bloomberg Finance L.P. References the S&P 500 and Bloomberg U.S. Aggregate Bond Indices. Figures shown in US dollars. Please see Additional Disclosures for more information about this sourcing information.



REGIONAL BACKDROP

	Positives	Negatives
Europe	▪ Unusually warm winter has driven energy costs lower ▪ Fiscal spending is rising ▪ Equity valuations remain attractive, despite recent rally ▪ ECB providing support to periphery nations	▪ Elevated inflation ▪ Restrictive monetary policy ▪ Heightened geopolitical uncertainty ▪ Energy supply remains structurally challenged
United Kingdom	▪ Energy cap will partially offset mortgage and energy shocks to household finances ▪ Inflation expectations decreasing to target ▪ Lower gas prices mean a shallower recession ▪ The UK labour market remains resilient	▪ The Bank of England may raise interest rates to 4.25% ▪ Fiscal consolidation will further weigh on demand in 2023 ▪ A recession and sharp house price declines in 2023 appear likely
United States	▪ Strong corporate and consumer balance sheets ▪ Resilient labour market ▪ Monetary tightening close to peak	▪ Recession risk remains elevated ▪ Still elevated inflation, driven by services ▪ Labour supply shortages ▪ Deteriorating corporate margins

	Positives	Negatives
Japan	▪ The relative valuation of the Japanese stock market versus global peers is very attractive ▪ The reflationary story is spreading throughout the economy ▪ Lower commodity prices and a normalised Japanese yen are lowering the inflation impulse	▪ Earnings expectations may be prone to disappointment if a global recession takes place ▪ A disorderly exit of the Bank of Japan's yield curve control policy would spark financial system volatility ▪ A rapid appreciation of the Japanese yen would pose difficulties for the export sector
Asia Pacific ex-Japan	▪ China's post-COVID reopening will boost economic activity throughout 2023 ▪ Company valuations also remain undemanding, with solid earnings growth forecast over the next 12 months ▪ In Australia, consensus expectations are for the Reserve Bank to moderate the pace of tightening going forward, reducing the pressure on yields rising	▪ In China, risk appetite may cool in the short term as investors digest the sharp rebound since October ▪ Foreign investors remain cautious towards Chinese assets due to geopolitical risks ▪ Australia may avoid an economic recession, but an earnings recession is likely in 2023; the inflation picture also remains mixed, dampening expectations for a clear pivot in policy setting
Emerging Markets	▪ China reopening should provide a strong boost to growth in emerging markets ▪ Equity valuations are attractive relative to the US ▪ Central banks tightening is likely to have peaked	▪ Exports to developed markets are weakening as global growth is slowing ▪ Chinese housing concerns remain a structural headwind ▪ Geopolitical uncertainty remains elevated

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 January 2023

▼ or ▲ Month-Over-Month Change

			Underweight		Neutral	Overweight		
		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			■				Stocks remain vulnerable amidst tightening liquidity and an active Fed. However, recent developments in Europe and China, alongside easing inflation, have improved the near-term outlook.
	Fixed Income					■		Favouring cash over bonds with inverted yield curves. Global central banks largely still tightening, although approaching peak levels as inflation continues to moderate. Credit sectors, such as high yield, continue to offer attractive yields and fair spreads with broadly supportive fundamentals.
			Region					
EQUITIES	US			■				Near-term outlook improved as the Fed nears end of its hiking cycle; however, US equities remain expensive relative to the rest of the world. US tech giants may also prove to be more cyclically sensitive than expected.
	Europe ex-UK			■				Valuations are compelling, and the milder winter has alleviated some pressure from energy costs; however, growth remains muted and geopolitical risks are heightened. Sovereign debt challenges are elevated as the ECB continues to raise rates.
	UK				■			Brexit adjustments probably exacerbate the effects of supply shortages and the rise in energy prices. Uncertainty about the future path of fiscal and monetary policy may lead to gilt curve steepening and a weaker British pound.
	Japan					■		Japan has historically cheap valuations, and despite cyclical concerns, it should benefit from improving corporate governance and a near-term boost from reopening. The recent shift in monetary policy has helped stabilise the currency.
	Developed Asia ex-Japan*				■			Valuations are attractive relative to the US. Chinese stimulus is supportive. Export-driven economies face challenges because of the global economic slowdown.
	Emerging Markets					■		Valuations and currencies are attractive, and central bank tightening may have peaked. Meanwhile, the medium-term outlook in China has improved with the relaxation of COVID restrictions and an increase in stimulus.
			Style and Market Capitalisation					
	Global Growth vs. Value†			■				Relative valuations for value stocks remain attractive while financials are benefitting from higher rates and a strong US consumer. Growth stocks face near-term headwinds as consumer spending continues to shift away from stay-at-home businesses.
	Global Small-Cap vs. Large-Cap†					■		Small-cap stocks offer historically attractive relative valuations, reflecting elevated recession concerns and the impact of higher financing costs. However, small-cap earnings have held up reasonably well thus far despite economic headwinds. Higher-quality bias is warranted.

Past performance is not a reliable indicator of future performance.

*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.

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 January 2023

▼ or ▲ Month-Over-Month Change

		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.**
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 decreasing likelihood of the global economy dodging a recession.
	Euro Inflation Linked				■			Inflation is expected to ease with healing supply chains, lower energy prices and a committed ECB. The labour market, however, remains tight and China reopening may be inflationary.
	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 remain supportive despite a more challenging economic backdrop. Higher yields offer attractive income and a buffer should credit spreads widen. Default rates are likely to rise from historically low levels towards longer-run averages.
	EM Dollar Sovereigns					■		Yields are off peak but still look compelling as China reopening supports EM growth and boosts sentiment. Peaking central bank tightening and moderating inflation should also be supportive.
	EM Local Currency					■		EM currencies and local yields remain at attractive levels, as investors remain cautious of risks. However, as the Fed slows the pace of interest rate tightening and US dollar strength fades, EM currencies may benefit.
	EM Corporates				■			We prefer to overweight sovereigns rather than corporates in emerging markets because credit spreads may widen as the global economy slows. We will be looking for a potential better entry point to consider overweighting EM corporates.
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.
	EUR vs. JPY			■				The yen remains a safe-haven currency. The valuation of the yen is at an attractive level. Any further changes of policy by the BoJ could support the yen.

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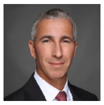

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