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Global Asset Allocation: The View From Europe

January 2023

1 Market Perspective

- Volatility likely to remain elevated in the new year as central bank policy expectations diverge amid evidence of slowing growth and moderating inflation.
- While slowing the pace of tightening, the US Federal Reserve reinforced its commitment to taming inflation, signalling that policy rates may need to stay higher for longer despite the negative impacts on growth and employment.
- The European Central Bank (ECB) struck a hawkish tone amid its battle against inflation despite acknowledging the likelihood of a near-term recession. The Bank of Japan (BoJ) made a surprise move towards policy normalisation by adjusting its yield curve controls to provide flexibility for yields to move higher. The Bank of England (BoE) may hike rates less than expected because of a potential UK house price driven recession.
- Moderating pressures from higher US rates and a strong US dollar could become tailwinds for emerging market economies and a reprieve for their central banks. While uncertainty remains, sentiment towards China could improve following easing of zero-COVID restrictions along with signalling from policymakers that more stimulus measures are on the way.
- 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 December 2022

- We remain underweight stocks. Earnings estimates remain too optimistic, not yet reflecting the potential for weaker demand and higher input prices weighing on profit margins.
- We remain modestly overweight cash relative to bonds, reducing portfolio duration while earning attractive yields and providing liquidity should market opportunities arise.
- 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 valuations offer reasonable compensation for risks. While fundamentals remain generally supportive, we maintain a cautious positioning on investment grade corporate bonds because default rates are expected to rise from historically low levels towards longer-run averages. We also hold a modest overweight to long-term US Treasuries as a risk-off ballast to equities and other risk assets.

3 Market Themes

Reopen for Business

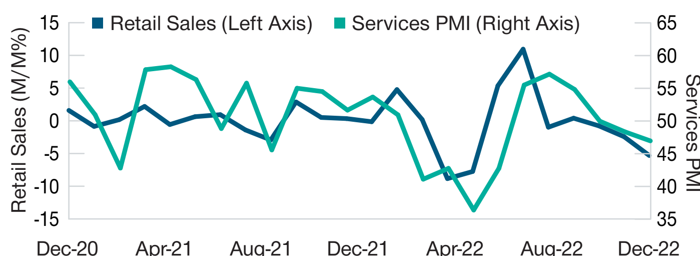
In early December, Chinese policymakers surprised markets by announcing a pivot away from strict zero-Covid policies. The measures had been effective in containing the coronavirus through targeted lockdowns, testing and quarantines but at high economic and social costs. The reopening announcement partially removed virus testing requirements, restrictions on domestic travel and production stoppages. The news was welcomed by those impacted and championed by the markets as the world has been awaiting China's reopening to provide a lift to global growth. Unfortunately, the reopening has been met with a wave of infections across the country, resulting in the population being cautious to reengage in outside contact and travel. While China's reopening should ultimately be a positive for growth in 2023, it is likely to unfold over the balance of the year. As more of the population reengages, it will provide a boost for domestic growth, fuelled by pent-up demand and savings accumulated over the shutdown. Additionally, a re-emergent Chinese economy should be supportive for broader emerging markets and commodities as growth and trade rebound. As investors happily leave 2022 behind, China's success this year in reopening its economy, stabilising growth and addressing risk in its property sector could be a positive catalyst that helps turn market sentiment around.

No Quick Fix

While there has been a growing number of companies announcing layoffs and hiring freezes over recent months—notably across technology and financial services sectors—the unemployment rate remains anchored near historically low levels with millions of job openings still in the economy. Consumer demand remains strong across services sectors of the economy, including transportation and leisure. However, employers are dealing with a shortage of workers, resulting in the need to offer higher wages to attract and retain talent. On the labour supply front, the pandemic resulted in an increased amount of people exiting the workforce, particularly in sectors that were shut down entirely over the course of the pandemic. Workers have also been more willing to quit jobs in search of higher wages and better benefits, including flexibility to work remotely. The tightness of the labour market and rising wages have the Fed's attention, and while the decline in goods inflation amid improving supply chains has been a welcomed sign, services inflation is likely to be more of a challenge. Unfortunately for the Fed, there is no quick fix for improving the labour supply chain, leaving them more likely to keep policy tighter for longer until they see a cooling in demand for jobs.

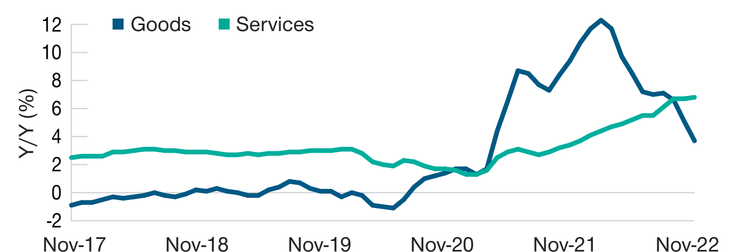
China: Awaiting Turnaround in Domestic Growth

31 December 2020 to 31 December 2022



US: Goods vs. Services Inflation

Last Five Years Ended 30 November 2022



Sources: Haver Analytics/China National Bureau of Statistics, Caixin/S&P Global. Haver Analytics/Bureau of Labor Statistics (see Additional Disclosures).

REGIONAL BACKDROP

	Positives	Negatives
Europe	▪ Fiscal spending is likely to increase ▪ Attractive equity valuations ▪ ECB bond-buying backstop ▪ Historically warm winter has eased energy costs	▪ Recession risk is very high ▪ Industrial production will be curtailed by energy shortages ▪ ECB remains hawkish ▪ Sovereign debt risks are rising ▪ Limited long-term catalysts for earnings growth
United Kingdom	▪ Energy cap will partially offset mortgage and energy shocks to household finances ▪ Inflation expectations at high levels, but slowly decreasing	▪ 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 are highly likely
United States	▪ Strong corporate and consumer balance sheets ▪ Resilient labour market ▪ Supply chain issues are improving rapidly ▪ Persistent demand for services	▪ Stubbornly high inflation ▪ Restrictive monetary policy ▪ Labour supply shortages ▪ Deteriorating corporate margins

	Positives	Negatives
Japan	▪ Earnings outlook remains healthy relative to other regions ▪ The reflationary story is spreading throughout the economy ▪ Lower commodity prices and a normalised Japanese yen are lowering the inflation impulse	▪ Expectations in earnings are prone to disappointment if a global recession takes place ▪ A disorderly exit of the Bank of Japan's yield curve control policy would spark volatility in the financial system ▪ A rapid appreciation of the Japanese yen would be difficult to navigate for the export sector
Asia Pacific ex-Japan	▪ China's reopening, post-COVID, will boost economic activity throughout 2023 ▪ Company valuations also 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. The labour market also remains healthy, which should extend consumer spending	▪ In the very short term, China's exit from its zero-COVID policy will be challenging, limiting the recovery ▪ 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. Inflationary pressures also remain, dampening expectations for a clear pivot in policy setting
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 have been loosened	▪ High likelihood of near-term COVID disruptions in China ▪ Global trade volumes are slowing ▪ Chinese housing concerns have impacted industrial activity ▪ Geopolitical risks are elevated

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 December 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.

		Underweight		Neutral		Overweight	
	Change						
ASSET CLASSES	Equities		■				Stocks remain vulnerable amid tightening liquidity and a hawkish Fed. Earnings expectations have begun to fade but remain optimistic against a growing likelihood of recession.
ASSET CLASSES	Fixed Income				■		The balance between central bank tightening, high inflation and deteriorating growth has kept rate volatility elevated. Credit sectors, such as high yield, offer attractive yields and fair spreads with broadly supportive fundamentals.
	Region						
EQUITIES	US		■				US equities remain expensive on a relative basis. The US economy appears to be on stronger footing than the rest of the world, though US tech giants may prove to be more cyclically sensitive than expected.
EQUITIES	Europe ex-UK		■				Valuations are compelling, but elevated energy costs and weakening manufacturing activity have made a recession highly likely. Sovereign debt challenges are also elevated within the European periphery as the ECB continues to raise rates.
EQUITIES	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.
EQUITIES	Japan				■		Despite cyclical concerns, Japan offers historically cheap valuations, accommodative fiscal policy and improving corporate governance. While a weaker yen should benefit corporate competitiveness, the recent shift in monetary policy has helped stabilise the currency.
EQUITIES	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.
EQUITIES	Emerging Markets				■		Valuations and currencies are attractive. Central bank tightening may have peaked. Meanwhile, the medium-term outlook in China has improved with the relaxation of COVID restrictions and the promise of more stimulus.
	Style and Market Capitalisation						
EQUITIES	Global Growth vs. Value†		■				Relative valuations for value stocks remain attractive while energy sector earnings could provide support. Growth stocks face near-term headwinds as consumer spending continues to shift away from stay-at-home businesses.
EQUITIES	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.

*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 December 2022

Underweight — *Neutral* — *Overweight*   ▼ or ▲ Month-Over-Month Change

		Change	Underweight	Underweight	Neutral	Overweight	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 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 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					■		Yield levels look attractive as EM growth prospects benefit from China moving towards reopening. Peaking central bank tightening and moderating inflation should also be supportive.
	EM Local Currency					■		EM currencies and local yields are at attractive levels, reflecting cautious sentiment. As the Fed slows the pace of interest rate tightening and US dollar strength fades, EM currencies may benefit.
	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, 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 attractive levels. Any further changes of policy by the BoJ could support the yen.

The specific securities identified and described are for informational purposes only and do not represent recommendations.

EUROPEAN INVESTMENT COMMITTEE

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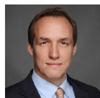

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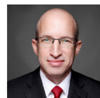

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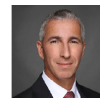

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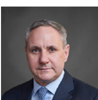

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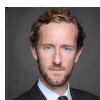

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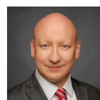

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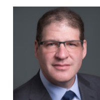

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