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Global Asset Allocation: The View From Europe

March 2023

1 Market Perspective

- Global growth is proving resilient in the face of tighter monetary policies; however, impacts of central banks' tightening are still expected to weigh on the economic growth and earnings outlook in the back half of the year.
- Despite declining goods inflation, services inflation remains sticky on the back of higher wages, keeping the US Federal Reserve and other central banks hawkish.
- While uncertainty remains, optimism surrounding China's reopening and resilient growth in Europe, supported by declining energy costs, could help buoy 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 28 February 2023

- We remain underweight equities and bonds in favour of cash. Equity valuations remain extended in the face of tightening liquidity and slowing growth. Bond yields are likely to remain volatile amid mixed economic data and central bank policy shifts, while cash offers attractive yields and stability.
- Within equities, we are overweight areas with more attractive valuation support such small-/mid-caps, Japan and emerging markets (EM). We also maintain a broad balance between value and growth—with a modest overweight to value—to reduce exposure to extreme interest rate sensitivity and cyclicality.
- Within fixed income, we remain overweight emerging market bonds, where yields still offer reasonable compensation for risks despite persistent market volatility.

3 Market Themes

Too Hot to Handle

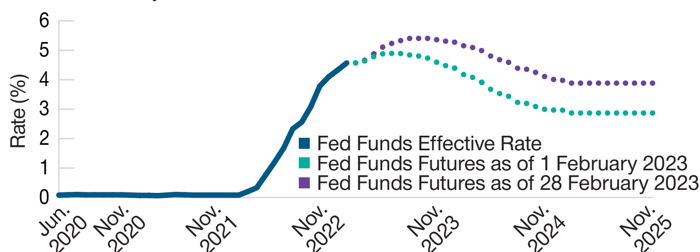
Recent good news on consumer spending, sentiment and employment has been bad news for the US Fed as they are not seeing evidence that aggressive rate hikes are having the intended impacts in slowing growth and reining in inflation. Markets had started the year positively on signs of peaking central bank tightening; however, the positive sentiment quickly faded as expectations for the path of future rate hikes jumped in response to the hotter data. Over the course of February, the futures market went from projecting the fed funds rate to peak at 4.90% in June to a projected peak of 5.41% in October. Having already raised rates by 450 basis points over the past year, the Fed is hopeful that the lagged effects will help them reach their inflation target of close to 2%, but if the economic data keep coming in strong, the Fed may find it too hot to handle and need to step up the tightening. The months ahead are likely to be volatile as every bit of data will be scrutinised by investors hoping for just enough bad economic data to please Fed officials, yet not bad enough to signal that a hard landing is imminent.

Last One Standing

Bank of Japan (BoJ) Governor Haruhiko Kuroda is set to step down in early April after a decade in office, with markets speculating that ultra-easy monetary policies he oversaw may be ending. The bank had already surprised markets when it eased yield curve controls at the end of last year, allowing rates to rise more. With inflation running near 4.3%, a 40-year high, the BoJ has been the last major central bank standing firm with ultra-easy policy, while almost all others pivoted to aggressive rate hikes to fend off high inflation. With his expected replacement, Kazuo Ueda, coming into office amid high inflation, it is likely Mr Ueda will begin to take further steps to unwind ultra-easy policy. While stocks and bonds have broadly declined in the face of higher inflation and rates, Japanese markets may benefit as assets are repatriated back home, where they are now able to earn higher yields. For investors outside of Japan, a stronger yen supported by higher yields could provide a further boost to Japanese market returns. Although inflation has not been a friend to investors elsewhere, the Japanese market may be one area where investors welcome it.

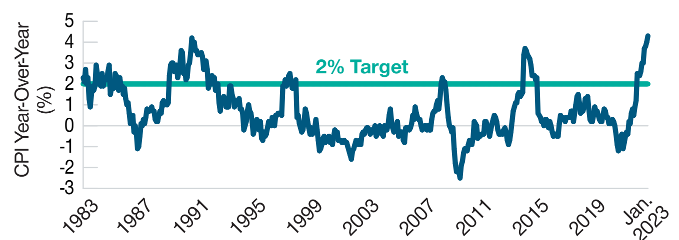
Fed Funds Rate Expectations Have Adjusted Higher

As of 28 February 2023



Japan Seeing Decades-High Inflation

40 Years Ended 31 January 2023



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.

Figures shown in USD.

Source: Bloomberg Finance L.P.

REGIONAL BACKDROP

Region	Rating	Positives	Negatives
Europe	U	▪ Unusually warm winter has driven energy costs lower ▪ Fiscal spending is rising ▪ Equity valuations remain attractive, despite recent rally	▪ Inflation remains elevated, particularly core inflation ▪ Monetary policy remains restrictive ▪ Heightened geopolitical uncertainty due to the war in Ukraine
United Kingdom	N	▪ Energy cap benefitting household finances ▪ Inflation expectations have reverted to normal ▪ The UK labour market remains resilient	▪ The Bank of England may be forced to hike more than expected ▪ Fiscal consolidation may weigh further on demand in 2023 ▪ A recession and house price declines in 2023 appear likely
United States	U	▪ Corporate and consumer balance sheets remain strong ▪ The labour market has been extremely resilient ▪ Services sector remains remarkably strong	▪ Recession risk remains elevated ▪ Inflation has proven more persistent than expected ▪ Labour supply remains scarce
Japan	O	▪ Equity valuations remain very attractive ▪ Gradual monetary policy normalisation ▪ Lower commodity prices and a stronger yen are lowering the inflation impulse	▪ Expectations in earnings are prone for disappointment ▪ Accelerating wage growth is making gradual monetary policy normalisation difficult ▪ A stronger yen may weigh on the export sector
Asia Pacific ex-Japan	N	▪ China's reopening proved faster than anticipated ▪ Equity valuations are undemanding, relative to the US ▪ In Australia, China's reopening has boosted earnings expectations; the economy remains broadly resilient	▪ Given the strength of the reopening thus far, Chinese policy may become less supportive ▪ Geopolitical risks remain elevated ▪ Australia consumer spending is at risk with mortgage rates being reset. The Reserve Bank of Australia remains hawkish
Emerging Markets	O	▪ China's 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

U Underweight N Neutral O Overweight

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EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 28 February 2023

▼ 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		■				Near-term outlook has improved given the resilient labour market and positive developments in Europe and China. However, stocks remain vulnerable over the medium term amid tightening liquidity and an active Fed.
	Fixed Income		■				Persistently elevated inflation should keep global central banks in tightening mode. Credit sectors, such as high yield, continue to offer attractive yields and fair spreads with broadly supportive fundamentals.
	Cash				■		Cash currently offers attractive yields and a shorter-duration profile as rates drift higher and provides liquidity should market opportunities arise.
EQUITIES	*Region*						
	US		■				Near-term outlook improved given US consumer strength and the resilient labour market. However, US equities remain expensive relative to the rest of the world. US tech giants may 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. Meanwhile, growth stocks remain vulnerable to rising rates.
	Global Small-Cap vs. Large-Cap†				■		Small-cap earnings have held up reasonably well thus far despite economic headwinds, alongside historically attractive relative valuations. 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.

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 28 February 2023

▼ or ▲ Month-Over-Month Change

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		Change	*Underweight*	*Underweight*	*Neutral*	*Overweight*	*Overweight*	
FIXED INCOME	Euro Government Bonds				■			The European Central Bank (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's 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 economic growth is expected in the latter.
	Global High Yield				■			Credit fundamentals remain supportive; however, default rates may rise from historically low levels given a challenging economic backdrop. Higher yields offer attractive income and a buffer should credit spreads widen.
	EM Dollar Sovereigns					■		Yields still look compelling as China's reopening supports EM growth and boosts sentiment. Potentially 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. The sector may also benefit from further US dollar weakness.
	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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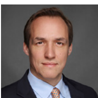

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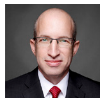

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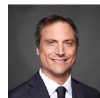

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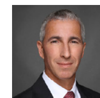

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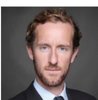

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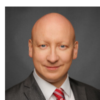

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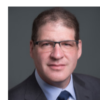

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