



Global Asset Allocation: The View From the UK

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 rate tightening commitment 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. The Bank of England (BoE) may hike rates less than expected due to a potential UK house price driven recession.
- Moderating pressures from higher rates and a stronger US dollar continue to benefit emerging market (EM) economies, taking pressure off their central banks. While uncertainty remains, China sentiment has improved. An end to stringent zero-COVID policies provides 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.

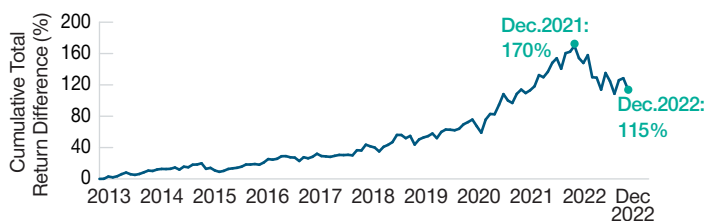
3 Market Themes

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 World¹

10 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.

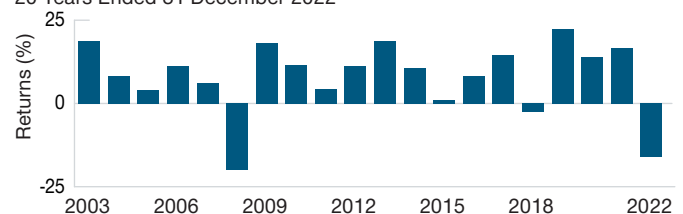
² Source: Bloomberg Finance L.P. References the S&P 500 and Bloomberg U.S. Aggregate Bond Indices. Figures shown in US dollars. Please see Additional Disclosures for more information about this sourcing information.

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 Portfolio²

20 Years Ended 31 December 2022





REGIONAL BACKDROP

Positives

Negatives

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

Developed 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 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

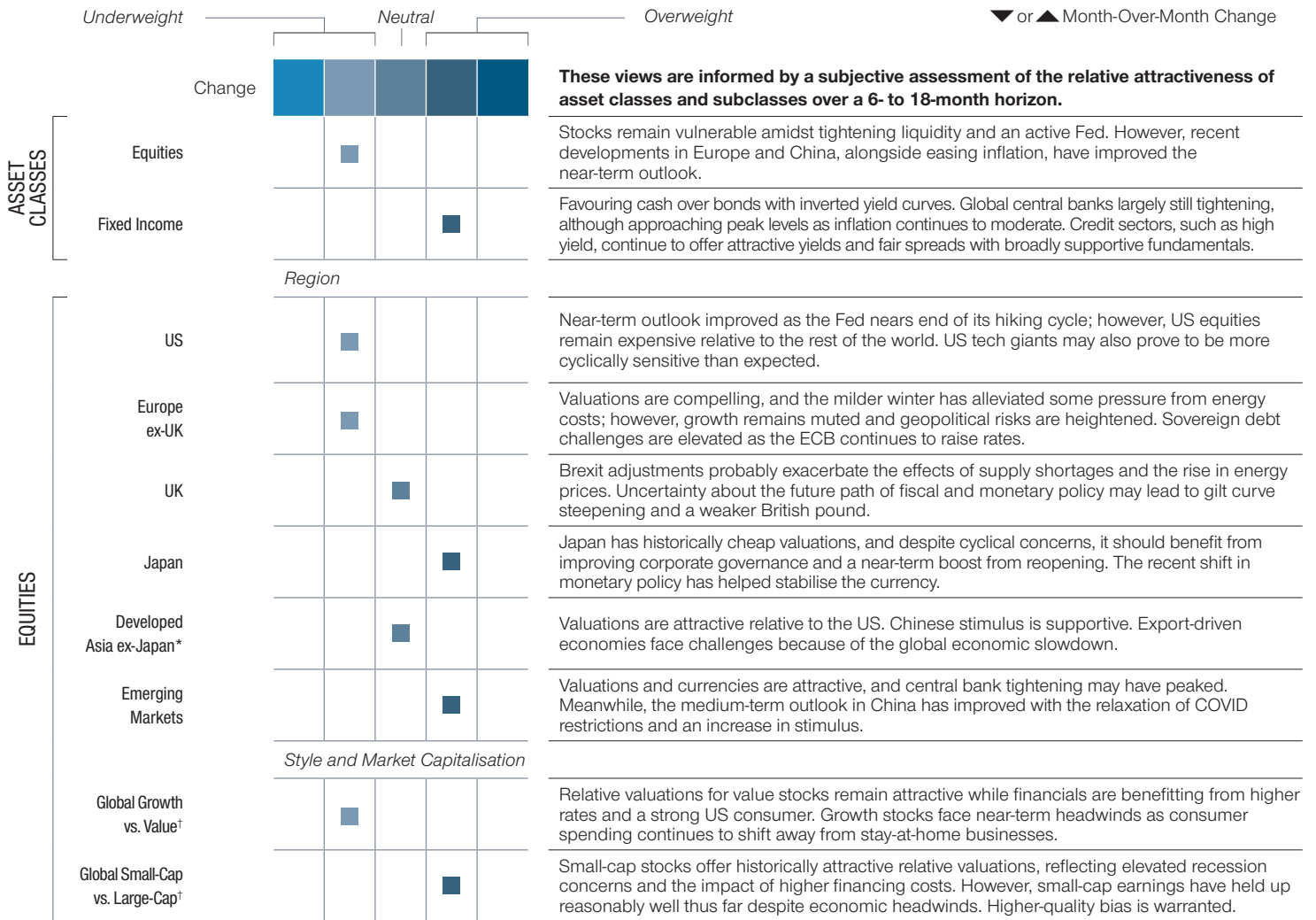
- Earnings expectations may be prone to disappointment if a global recession takes place
- A disorderly exit of the Bank of Japan's yield curve control policy would spark financial system volatility
- A rapid appreciation of the Japanese yen would pose difficulties for the export sector

- 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



* Includes Australia.

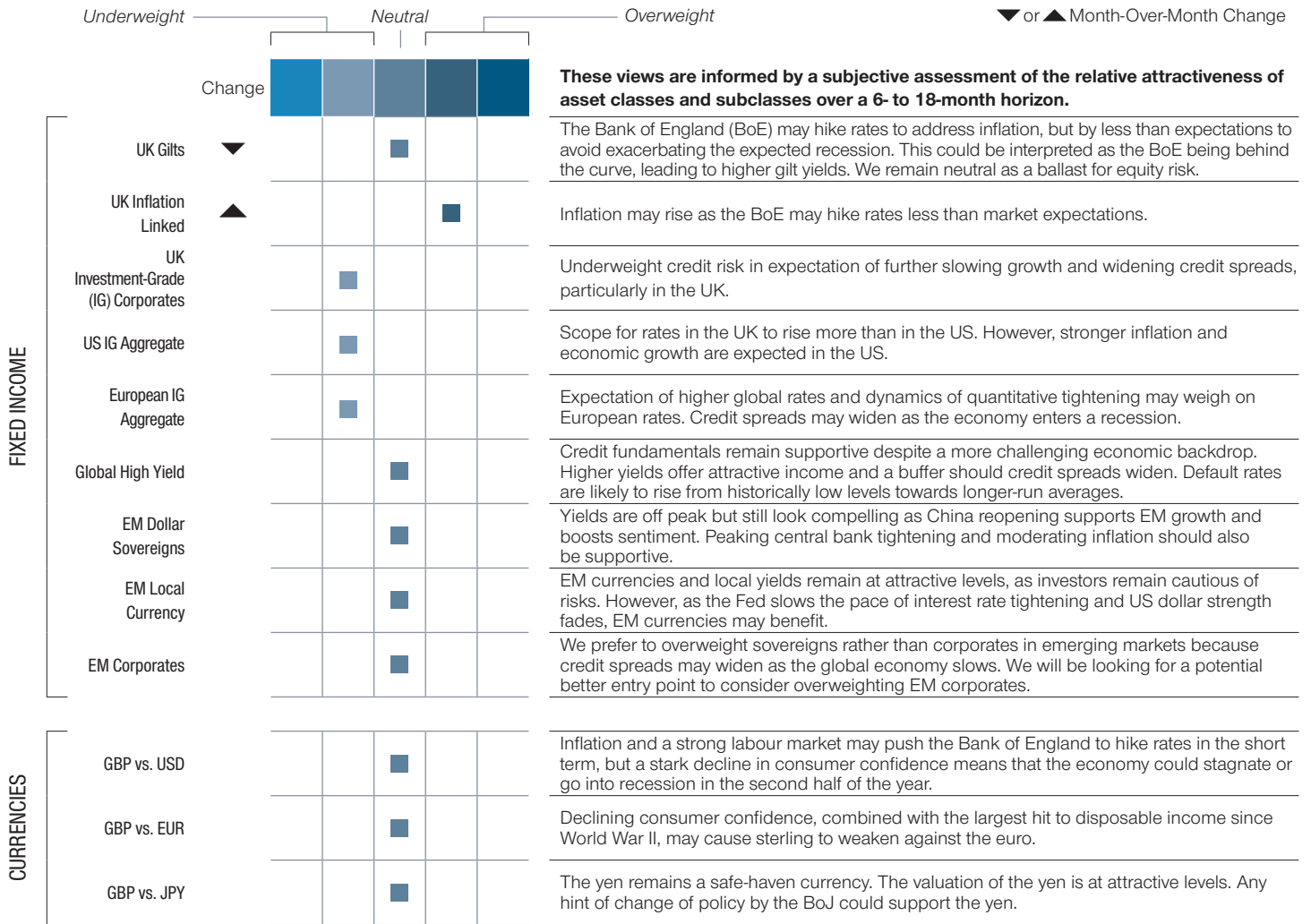
† For pairwise decisions in style and market capitalisation, positioning within boxes represents positioning in the first-mentioned asset class relative to the second asset class.

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.



UK INVESTMENT COMMITTEE POSITIONING

As of 31 January 2023



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



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