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Global Asset Allocation: The View From Europe

April 2023

1 Market Perspective

- Lagged impacts of central banks' tightening are to weigh on growth and the earnings outlook in the back half of the year, with expectations of lower inflation but still above central bank targets.
- The recent banking crisis and unexpected oil supply cuts complicate inflation and the financial stability puzzle for central banks and could keep interest rate volatility elevated.
- While consensus builds for a slower growth outlook, China reopening and resilient growth in Europe offer balance to an otherwise negative sentiment.
- Key risks to global markets include central bank missteps, resilient inflation, steeper growth decline, a broadening banking crisis and geopolitical tensions.

2 Portfolio Positioning

As of 31 March 2023

- We remain underweight equities and fixed income in favour of cash. Equities are vulnerable to the weaker growth and earnings backdrop, and still aggressive central banks could weigh on fixed income as they continue to battle inflation, while cash continues to offer safety and attractive yields.
- Within equities, we remain overweight to areas with more attractive valuation support, including small-/mid-caps, global ex-US and emerging markets.
- Within fixed income, we are underweight European government bonds but added to inflation-linked bonds. While rate volatility is to remain elevated, rates are likely to move higher from current levels. Nevertheless, duration offers ballast within our multi-asset portfolios amid a potentially choppy back half of the year and inflation-linked bonds offer some protection should inflation prove more persistent than expected.
- We have a positive view of the euro versus the US dollar. The interest rate differential between the European Union (EU) and the US is likely to narrow. The relative economic momentum of the US versus the EU may narrow because the EU has avoided a recession for now.

3 Market Themes

It's Complicated

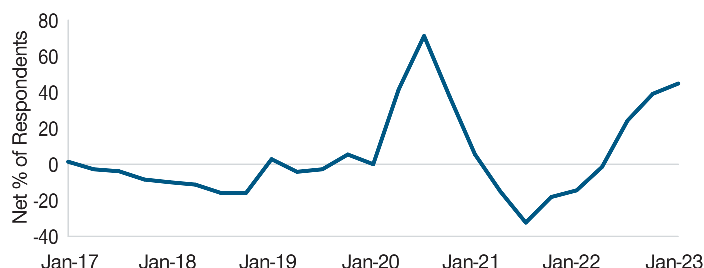
In light of the recent banking crisis, global central banks' narrow focus on combating inflation has gotten more complicated as they now face the added task of maintaining financial stability. In an effort to thread the needle in reinstating price stability while shoring up confidence in the banking system, the US Fed announced a 25bps increase at its March meeting—an apparent compromise between a 50bps hike and no move at all—while at the same time swiftly launching a new emergency lending facility, the Bank Term Funding Program. This move is not unlike the Bank of England's hurried rescue of the gilts market in October while still pursuing a tighter monetary policy. While rescue measures have seemed to quell a broader contagion for now, the immediate impact may be a further tightening of credit within the banking industry, which was already occurring prior to the crisis. This added dimension has only made central banks' mandates more complex, given the already limited visibility into the lagged impacts of their own tightening measures.

Finding the Sweet Spot

With consensus calling for an economic slowdown in the back half of the year as tighter financial conditions take hold, it is increasingly challenging to find areas of optimism amid the impending gloom. However, emerging markets are one area that has done well recently—up over 17% off October's bottom—that could continue to benefit from a lessening of headwinds. The recent outperformance was largely triggered by China's surprise reopening from COVID lockdowns last fall, and while some of the euphoria has faded, recent data continue to show momentum and China policymakers are committed to stable growth, potentially providing a further boost. And while global growth is expected to slow, this should come with an easing of inflation pressures, lower rates and further weakening of the US dollar, all of which could be supportive for emerging markets. So unless global growth surprises significantly to the downside, emerging markets could find themselves in a sweet spot as we enter a period of slower, but not 'off the rails' growth.

Banks Have Already Been Tightening Standards*

As of 31 January 2023



Positive Signals Across Emerging Markets†

Two years ended 31 March 2023

Past performance is not a reliable indicator of future performance.

*Source: Bloomberg Finance L.P. Fed Lending Conditions Survey is represented by the Net % of Respondents Tightening Standards for Commercial & Industrial Loans (Large & Middle-Market Firms).

†Sources: Bloomberg Finance L.P. and MSCI. China Services PMI represented by China Non-Manufacturing PMI Diffusion Index (see Additional Disclosures).

REGIONAL BACKDROP

	Positives	Negatives
Europe U	▪ Unusually warm winter has driven energy costs lower ▪ Fiscal spending is rising ▪ Equity valuations remain attractive	▪ Inflation remains elevated, particularly core inflation ▪ Monetary policy remains restrictive ▪ Geopolitical uncertainty is heightened due to the war in Ukraine
United Kingdom N	▪ Energy price caps continue to benefit household finances ▪ Inflation expectations have reverted to normal levels ▪ Labour market remains resilient	▪ A recession and house price declines in 2023 appear likely ▪ Bank of England is limited by financial stability concerns ▪ Brexit adjustments continue to weigh on the economy
United States U	▪ Consumer spending remains strong ▪ 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 ▪ Benefitting from uptick in inflation, particularly wages ▪ Corporate governance continues to gradually improve	▪ Earnings expectations prone for disappointment ▪ Monetary policy normalisation may surprise the market ▪ Stronger yen may weigh on the export sector
Asia Pacific ex-Japan N	▪ China's economic data are surprising on the upside, especially on the services sector. The tone of policymakers is also supportive ▪ China's earnings are beating estimates and being revised higher, boding well for future returns ▪ Australia's labour market is tight, but not yet seeing wage pressure; the economy remains surprisingly resilient, with the Reserve Bank of Australia likely to err on the dovish side to extend this cycle	▪ Some mixed signals may raise doubts about the sustainability of China's economic rebound, particularly related to exports ▪ Geopolitical risks remain with US-China tensions top of mind ▪ Australia's consumer spending is at risk with mortgage rates being reset; latest earnings results also highlight concerns on margins going forward
Emerging Markets O	▪ China reopening has been slow but supportive ▪ Economic data are surprising to the upside ▪ Equity valuations are attractive relative to the US	▪ Global trade is challenged with tighter monetary conditions ▪ Geopolitical risks remain elevated ▪ Credit formation in China remains weak

U Underweight N Neutral O Overweight

Past performance is not a reliable indicator of future performance.

Views are informed by the Asset Allocation Committee and regional investment committees (United Kingdom, Europe, Australia, Japan and Asia) and reflect the equity market.

EUROPEAN INVESTMENT COMMITTEE POSITIONING

As of 31 March 2023

▼ 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.
ASSET CLASSES	Equities			■				Financial stability concerns have added further uncertainty to the outlook, but the resilient labour market and positive developments in Europe and China are supportive. Equities remain vulnerable, and valuations are elevated.
ASSET CLASSES	Fixed Income			■				Central banks continuing to combat persistent inflation while maintaining financial stability could keep rate volatility elevated. Credit sectors continue to offer attractive valuations with broadly supportive fundamentals.
ASSET CLASSES	Cash					■		Cash currently offers attractive yields and a shorter-duration profile as rates drift higher and provides liquidity should market opportunities arise.
	Region							
EQUITIES	US			■				Despite resilient economy, the outlook remains clouded by further Fed tightening, financial stability concerns and manufacturing sector weakness. Elevated valuations make US equities unappealing given this backdrop.
EQUITIES	Europe ex-UK			■				Despite the recent rally, equity valuations are appealing. The economy remains resilient, with the purchasing managers' index (PMI) at its highest level since May 2022. However, elevated inflation means monetary policy remains restrictive and geopolitical risk is high.
EQUITIES	UK				■			Equity valuations are attractive and inflation expectations have normalised. Lower energy prices support the economy, and the labour market remains resilient, but a recession/ house price declines appear likely in 2023.
EQUITIES	Japan					■		The relative valuation of Japan's stock market, versus global peers, is attractive. However, earnings could disappoint if a global recession occurs, and a rapid appreciation of the yen would be difficult for exporters.
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 appealing, and central bank tightening may have peaked. China's medium-term outlook has improved, with economic data surprising on the upside. However, US-China tensions remain a key risk.
	Style and Market Capitalisation							
EQUITIES	Global Growth vs. Value†			■				Relative valuations for value equities remain reasonable; however, a tilt towards higher-quality businesses is important given the weakening macro backdrop.
EQUITIES	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.

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 March 2023

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.

		Change	Underweight		Neutral		Overweight	
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. Yields are expected to move higher from current levels.
	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. Core inflation may rise, and the ECB may hesitate more before hiking rates, focusing on financial stability.
	Euro Investment-Grade (IG) Corporates			■				Underweight credit risk in expectation of further slowing growth and widening credit spreads, particularly in Europe. However, good technicals and strong inflows into the asset class are supportive.
	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 emerging market (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 but reflective of cautious sentiment. The Fed slowing its pace of interest rate tightening could be supportive of EM currencies relative to a softening US dollar.
	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	▲				■		The interest rate differential between the EU and the US is likely to narrow. The relative economic momentum of the US versus the EU may narrow because the EU has avoided a recession for now.
	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 Bank of Japan could support the yen.

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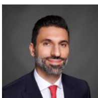
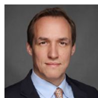
The specific securities identified and described are for informational purposes only and do not represent recommendations.

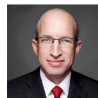
EUROPEAN INVESTMENT COMMITTEE



Elias Chrysostomou
Portfolio Analyst, Equity Division



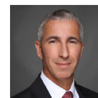
Andrew Keirle
Portfolio Manager, Emerging Markets Local Currency Bonds



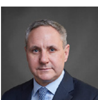
Yoram Lustig
Head of Multi-Asset Solutions, EMEA

Tobias Mueller
Portfolio Manager, Equity Division

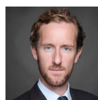
Ken Orchard
Senior Portfolio Manager, Fixed Income Division



David Stanley
Portfolio Manager, European Corporate Bonds



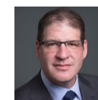
Toby Thompson
Portfolio Manager, Multi-Asset Division



Mitchell Todd
Portfolio Manager, Equity Division

Michael Walsh
Solutions Strategist, EMEA

Tomasz Wieladek
International Economist



Lowell Yura
Head of Multi-Asset Solutions, North America

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