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Global Asset Allocation: The View From Europe

May 2023

1 Market Perspective

- Slowing economic growth, lingering inflation and declining liquidity keep us cautious, while a still resilient labour market, solid consumer and corporate balance sheets and China reopening remain positives against otherwise negative sentiment.
- A widening gap in monetary policy is likely ahead as the Federal Reserve (Fed) is expected to pause after May and the Bank of Canada remains on hold, while the European Central Bank and Bank of England remain hawkish. Meanwhile, increased uncertainty around the Bank of Japan persists under new leadership as they evaluate yield curve control policy.
- Key risks to global markets include a sharp decline in growth, central bank missteps, persistent inflation, liquidity shock and geopolitical tensions.

2 Portfolio Positioning

As of 30 April 2023

- We maintain a cautious stance with an underweight to equities and government bonds in favour of cash. Equities remain vulnerable to a slowing economy and weaker earnings backdrop, while central banks' bias, albeit moderating, toward inflation fighting remains a potential headwind to bonds. Cash offers liquidity in an uncertain environment and still attractive yields.
- Within equities, we remain overweight areas of the market that offer attractive valuation support, including small-/mid-cap stocks, Japan and emerging markets.
- Within fixed income, we added to global high income given attractive yields and emerging market (EM) local currency bonds given appealing yields levels and relatively cheap EM currencies that may appreciate because of a weaker US dollar against narrowing growth and interest rate differentials as the Fed nears its anticipated terminal rate.

3 Market Themes

Looking for Direction

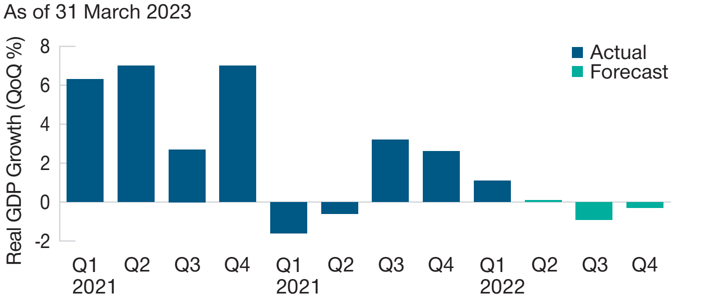
While the market narrative is that a recession is inevitable, especially in the US, economic data continue to be mixed with seemingly sufficient evidence to support both bulls and bears outlooks for the markets. Bulls continue to lean on evidence of a still robust labour market, strong consumer and corporate balance sheets, a better-than-expected earnings season and signs of moderating inflation supporting a pause in central banks' tightening. Meanwhile, bears cite lagging impacts of central bank tightening, regional banking turmoil, contractionary manufacturing data, still high inflation and a deeply inverted yield curve as top reasons why a deeper recession is coming. While we agree that the data remain mixed, the trend will likely continue to be negative into the back half of the year with employment softening and economic growth contracting. However, at this point, it is difficult to gauge the potential depth and duration of the contraction, leaving us broadly cautious as we keep an eye on data, looking for more direction.

Fissures Forming

Despite slowing economic growth amid an aggressive tightening campaign by the Fed, the labour market has remained resilient, especially with the unemployment rate anchored near 3.5%, but some fissures appear to be forming. Looking below the surface, peaking wage growth, declining job openings and mixed continuing claims data are telling us that the employment picture may be finally softening. Headlines of recent layoffs also indicate labour market weakness, although most of them have been concentrated in the higher-earning technology and financials sectors, while the lower-income and service-related job market remains tight. This is an unusual trend and a result of the lag in reopening from COVID, which has created a lack of supply in labour as services demand has returned. Despite this still positive undercurrent, we are expecting further softening in the labour market evidenced in our research of staffing companies seeing significant weakness in demand, usually an early sign of pending deterioration. This should be a welcome sign for the Fed as a softening labour market will surely ease wage pressures and ultimately help on the disinflation front.

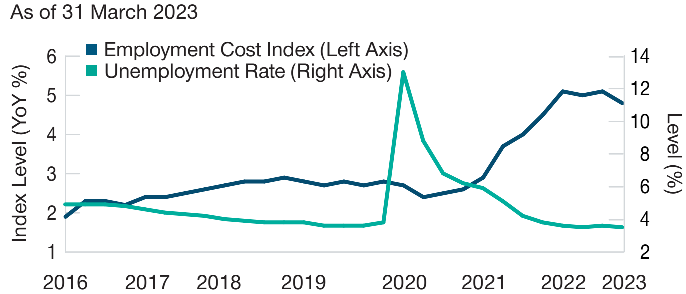
Economic Growth Forecasts Indicate a Recession Coming*

As of 31 March 2023



Wage Growth Peaking With Still Low Unemployment†

As of 31 March 2023



Data provided are for illustrative and informational purposes only. There is no guarantee that any forecasts made will come to pass. Actual results may vary.

*Real gross domestic product (GDP) is represented by the GDP US Chained Index (QoQ).

† Employment Cost Index is represented by the Bureau of Labor Statistics Employment Cost Civilian Workers Index (YoY%). Unemployment Rate is represented by the US Unemployment Rate Total in Labor Force Seasonally Adjusted.

Source: Bloomberg Finance L.P.

REGIONAL BACKDROP

		Positives	Negatives
Europe	U	▪ Lower energy costs ▪ Fiscal spending is rising ▪ Equity valuations remain attractive ▪ Manufacturing Purchasing Managers' Indexes (PMIs) are improving	▪ Inflation remains elevated, particularly core inflation ▪ Monetary policy remains restrictive ▪ Geopolitical uncertainty is heightened
United Kingdom	N	▪ Pressure from gas and oil prices has decreased ▪ Manufacturing PMIs are improving ▪ Inflation expectations have decreased	▪ Inflation remains elevated ▪ Fiscal consolidation and tighter financial conditions may weigh ▪ House price declines in 2023 appear likely ▪ Brexit adjustments continue to weigh on the economy
United States	U	▪ Consumer spending remains strong ▪ Labour market has been resilient ▪ Services sector remains robust ▪ Yields may have peaked	▪ Banking sector concerns impact on credit availability ▪ Inflation more persistent than expected ▪ Labour supply remains scarce ▪ Debt ceiling standoff creates additional uncertainty
Japan	O	▪ Equity valuations remain attractive ▪ Uptick in inflation, particularly increase in wages ▪ Inflows to the stock market from foreign investors ▪ Corporate governance continues to gradually improve	▪ Earnings expectations could be revised lower ▪ Monetary policy normalisation may surprise the market ▪ A stronger yen may weigh on the export sector
Asia Pacific ex-Japan	N	▪ China's economic recovery is ongoing, with solid data from the services sector. The tone of policymakers is also supportive ▪ China market valuations are undemanding, while earnings could surprise on the upside ▪ Australia's labour market is tight but not yet seeing wage pressure. The economy remains surprisingly resilient, with some signs of bottoming house prices	▪ 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 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 proven to be faster than expected ▪ Economic data are surprising to the upside ▪ Equity valuations are attractive relative to the US ▪ Chinese regulatory policy is more supportive	▪ Global trade could weaken with tighter monetary conditions ▪ Geopolitical risks remain elevated ▪ Credit formation in China remains weak ▪ Brazilian politics are becoming less business friendly

U Underweight N Neutral O Overweight

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 30 April 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.
ASSET CLASSES	Equities			■				Outlook remains uncertain due to lagged impacts of Fed tightening amid a slowing economy. However, resilient labour market and positive developments in Europe and China are supportive. Stocks remain vulnerable due to elevated valuations.
	Fixed Income					■		Rate volatility could remain elevated as central banks continue to balance persistent inflation and growth concerns. Credit sectors continue to offer attractive valuations with broadly supportive fundamentals.
	Cash					■		Cash currently offers attractive yields and a shorter-duration profile (if rates drift higher) and provides liquidity should market opportunities arise.
	Region							
EQUITIES	US			■				Despite a resilient economy, the outlook remains clouded by lagged impacts of Fed tightening, manufacturing sector weakness and early signs of labour market softness. Elevated valuations make US equities unappealing given this backdrop.
	Europe ex-UK			■				Despite the recent rally, equity valuations are appealing. The economy remains resilient, with the Purchasing Managers' Index at its highest level since May 2022. However, high inflation means monetary policy remains restrictive and geopolitical risk is high.
	UK				■			Equity valuations are reasonable, and despite high inflation prints, expectations have decreased. Lower energy prices support the economy, and the labour market remains resilient, but a recession/house price decline appears likely in 2023.
	Japan					■		Japan's market valuation looks appealing relative to global peers, and the reflation story is real, as evidenced by recent wage negotiations. However, earnings could disappoint if a global recession occurs, and a rapid appreciation of the yen would be problematic for exporters.
	Developed Asia ex-Japan*				■			China's recovery is ongoing, and the supportive tone of policymakers is encouraging business and investor confidence alike. In Australia, valuations are similarly reasonable, despite some headwinds, while the economy remains surprisingly resilient.
	Emerging Markets					■		Valuations and currencies are attractive, and central bank tightening may have peaked. Meanwhile, the medium-term outlook in China has improved with reopening and an easing regulatory environment.
	Style and Market Capitalisation							
	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 and banking concerns.
	Global Small-Cap vs. Large-Cap†					■		Small-caps offer attractive upside potential, having already priced in a dire economic scenario with historically attractive relative valuations. Higher-quality bias and selective exposure to regional banks 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 30 April 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		Neutral		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 attractive as China reopening continues to support 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 are 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 US dollar may continue to weaken against narrowing growth and interest rate differentials as the Fed nears its anticipated terminal rate while the ECB keeps hiking.
	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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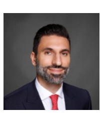
The specific securities identified and described are for informational purposes only and do not represent recommendations.

EUROPEAN INVESTMENT COMMITTEE



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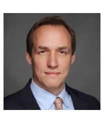

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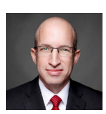

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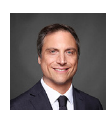

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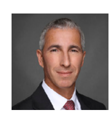

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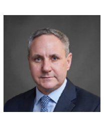

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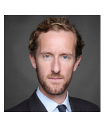

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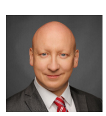

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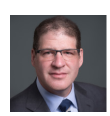

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