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INVEST WITH CONFIDENCE

Global Asset Allocation: The View From Europe

August 2023

1 Market Perspective

- Despite expectations for slowing global growth in the back half of the year, some regions are proving more resilient in the face of tighter financial conditions, bolstered by strong household and corporate balance sheets.
- The US economy has been more robust than expected, while Europe has navigated a mild recession in Germany and continues to combat inflationary pressures. Chinese growth has disappointed, while Japan continues to benefit from an uptick in domestic demand.
- While global central banks are likely near peak tightening, they remain vigilant on inflation as it is proving stickier in some regions, such as Europe and the UK, and are at the ready to take further steps towards tightening depending on trends in the data.
- Key risks to global markets include a deeper-than-expected decline in growth, central bank missteps, reacceleration in inflation, tight credit conditions and geopolitical tensions.

2 Portfolio Positioning

As of 31 July 2023

- We modestly trimmed our underweight to equities; however, we maintain a cautious stance as valuations remain elevated despite expectations for the global economy to slow in the back half of the year. Within fixed income, we increased cash holdings as bonds remain vulnerable to further central bank tightening, while cash offers liquidity in an uncertain environment and still-attractive yields.
- Within equities, we remain overweight in areas of the market with more attractive valuation support, such as small-caps and emerging markets, which could benefit from broader equity participation in the recent rally.
- Within fixed income, we now hold reduced overweight positions in return-seeking sectors such as high yield and emerging market sovereign and local currency bonds. We also favour inflation linked over fixed interest government bonds.

3 Market Themes

Insensitive

Despite the Federal Reserve's ('Fed') funds rate reaching its highest level in over 20 years, the US economy has proven more insensitive to higher interest rates than many would have expected so far. Typically, as rates move higher the economy slows, leading to weakness in the labour market, which then flows through to the consumer. However, labour market tightness has supported real income gains amid moderating inflation, and excess savings have kept consumer balance sheets strong, ultimately buoying the broader economy. Additionally, with fixed rate mortgages making up most of the US home loan market, higher rates have not had the same impact that they have had in other regions dominated by floating rate mortgages. Corporations have also proven less sensitive to higher rates given that they previously refunded debt at low rates and that capital expenditure funding was supplemented by fiscal stimulus programmes rather than from loans at high interest rates. While so far it appears the economy may be less sensitive to higher rates than in previous cycles, it is also possible that policy has not been restrictive for long enough to have its desired effects on the economy.

Taking Shelter

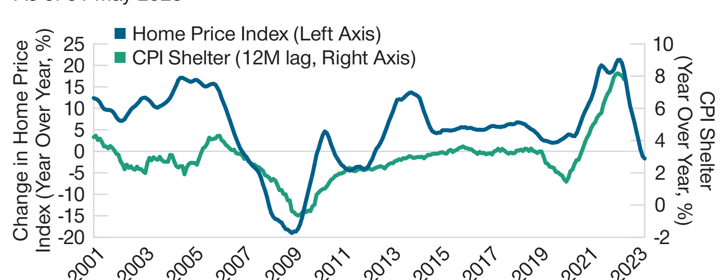
Shelter inflation, which includes rent of primary residences and owners' equivalent rent of residences (OER), is coming off its recent highs. OER closely tracks home prices, which have shown declines year over year. Given the two components make up nearly one-third of US consumer price index (CPI) and have a lagged impact on CPI, hopes are for softening data to start to pull down overall inflation in the coming months. While this would be a welcomed sign for the Fed, recent data showing resilience in the US economy are starting to raise concerns of inflation stagnating or possibly inflecting higher. With a backdrop of a still-tight labour market, a strong services sector, consumers still holding excess savings and a recent spike in energy and food prices, there are plenty of reasons for the Fed to remain cautious. Investors and the Fed, alike, will be eyeing details as the decline in shelter inflation may be masking a move higher in other underlying components if the economy continues to surprise to the upside.

Resilient Economic Growth Despite Higher Rates*

As of 31 July 2023

Shelter Inflation Expected to Fall†

As of 31 May 2023



Past performance is not a reliable indicator of future performance.

*GDP Growth Barometer represented by NY Fed Weekly Y/Y GDP Barometer, on a 12-month lag.

† Home Price Index represented by S&P Corelogic Case-Shiller Home Price Index (Y/Y%). See Additional Disclosure.

Source: Bloomberg Finance L.P.

REGIONAL BACKDROP

Region	View	Positives	Negatives
Europe	U	▪ Inflation showing signs of cooling ▪ European Central Bank ('ECB') close to peak tightening ▪ Equity valuations remain attractive	▪ Inflation remains elevated, particularly core inflation ▪ Economic growth is slowing ▪ Geopolitical uncertainty remains a concern
United Kingdom	N	▪ Inflation has begun to moderate ▪ Labour market remains strong ▪ Economy has proven more resilient	▪ Wage inflation is very elevated ▪ The Bank of England may be forced to hike rates further ▪ Fiscal consolidation may need to be accelerated
United States	N	▪ Consumer spending remains strong ▪ Labour market has been resilient ▪ Earnings expectations may have bottomed ▪ Artificial intelligence-related spending is a powerful tailwind	▪ Monetary policy remains very tight ▪ Banking sector concerns will impact credit availability ▪ Equity valuations are elevated
Japan	O	▪ Uptick in inflation catalyst for increase in wages ▪ Inflows from foreign investors are likely to continue ▪ Corporate governance continues to gradually improve	▪ A stronger Japanese yen may weigh on the export sector ▪ Earnings expectations may need to be revised lower
Asia Pacific ex-Japan	N	▪ China economic activity is expected to pick up in the second half, especially as policymakers appear willing to provide additional support ▪ Cheap valuations and positive earnings growth are also supportive of equities ▪ In Australia, the jobs market remains bright, while housing prices are resilient amid higher rates	▪ Growth in China remains muted, and consumer and business confidence are fragile ▪ Saving in China is being prioritized over spending ▪ Australian consumers are starting to feel the effects of tightening, and more hikes may be needed amid accelerating wage growth data
Emerging Markets	O	▪ Monetary tightening in most emerging markets (EM) has peaked ▪ Equity valuations are attractive relative to the US ▪ Further Chinese stimulus is expected	▪ Global trade could suffer with slowing global growth ▪ China's reopening has been underwhelming ▪ Geopolitical risks remain elevated

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 31 July 2023

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.**
ASSET CLASSES	Equities			■				Outlook is improving but remains uncertain due to elevated valuations and tight monetary policy. However, a resilient labour market, fiscal stimulus and positive sentiment about artificial intelligence (AI) are providing support.
ASSET CLASSES	Fixed Income					■		Central banks continue to balance lingering inflation and growth concerns, which could keep rates volatile. Credit sectors continue to offer reasonable valuations with broadly supportive fundamentals.
ASSET CLASSES	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 expensive valuations, earnings expectations appear to be improving, economic activity is stabilising, market breadth has widened and technology innovation remains a key differentiator.
EQUITIES	Europe ex-UK			■				European equity valuations remain appealing, inflation has notably cooled and the economy is showing signs of slowing, easing pressure to hike rates much further. That said, core inflation remains elevated, and the European Central Bank (ECB) policy bias is restrictive.
EQUITIES	UK				■			Equity valuations are attractive relative to history and versus major peers. The jobs market is strong, and headline inflation in June fell below 8% (7.9%) for the first time since March 2022. However, wage inflation means the Bank of England may need to keep hiking.
EQUITIES	Japan					■		Japanese stocks remain a favourite due to the reflationary story, governance improvements and the Bank of Japan's confirmed dovish stance. Earnings could disappoint if a global recession occurs, and a rising yen, from very cheap levels, would be a headwind for large exporters.
EQUITIES	Developed Asia ex-Japan*				■			China economic activity should improve as policymakers seem willing to provide additional stimulus. Cheap valuations and positive earnings growth provide further support. However, consumer and business confidence are fragile, and saving is being prioritized over spending.
EQUITIES	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							
EQUITIES	Global Growth vs. Value†	▼			■			A tilt towards higher-quality businesses is warranted given elevated valuations and lingering economic concerns. Momentum surrounding AI could provide a structural tailwind to growth.
EQUITIES	Global Small-Cap vs. Large-Cap†					■		Small-caps offer attractive upside potential having already priced in a negative economic scenario with attractive relative valuations. Given heightened economic uncertainty, 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 July 2023

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 continues to hike rates and to engage in quantitative tightening, despite difficult economic fundamentals. High-quality duration can mitigate some risks if the global economy dodges a recession.
	Euro Inflation Linked					■		Inflation is expected to ease as the impact of tighter ECB policy continues to be felt. The labour market, however, remains tight. Energy prices have also moved upwards in recent weeks.
	Euro Investment-Grade (IG) Corporates					■		Euro investment-grade credit offers good value over the short term.
	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 and higher yields remain supportive. Default rates are rising from historically low levels but are not likely to spike.
	EM Dollar Sovereigns					■		Yields are still attractive, while peaking central bank tightening cycles and moderating inflation are supportive. China's reopening enthusiasm has faded, but modest policy support is expected.
	EM Local Currency					■		EM local yields are at fair values, reflective of cautious sentiment. A weaker US dollar would also be supportive of EM currencies.
	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 and the ECB keeps hiking.
	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 Bank of Japan could support the yen.

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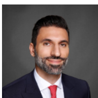
The specific securities identified and described are for informational purposes only and do not represent recommendations.

EUROPEAN INVESTMENT COMMITTEE



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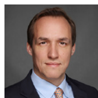

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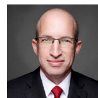

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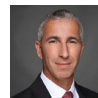

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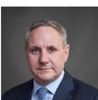

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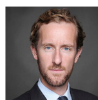

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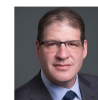

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ID0006207 (08/2023)
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