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Global Asset Allocation Viewpoints

August 2022

1 Market Perspective

As of 31 July 2022

- Central banks and investors continue to contend with higher inflation while global growth is slowing amid continued supply disruptions, geopolitical challenges and reduction of liquidity, setting the stage for a challenging second half of the year.
- The US Federal Reserve (Fed) remains committed to its tightening policy, having already raised rates by 225 basis points this year and hinting at a continued aggressive path forward to combat inflation. The European Central Bank (ECB) made its first rate hike in more than a decade despite a fragile macro backdrop, while the Bank of Japan (BoJ) remains steadfast on its policy of yield curve control.
- While most emerging market (EM) central banks continue to tighten policy in response to heightened inflation and weak currencies, China policies remain supportive to help bolster growth as the country continues to try and contain the spread of COVID.
- Key risks to global markets include central bank missteps, persistent inflation, impacts of the Russia-Ukraine conflict, potential for a sharper slowdown in global growth and China's balance between containing COVID and growth.

2 Portfolio Positioning

As of 31 July 2022

- Despite more attractive valuations following recent declines, we remain cautious on the earnings outlook and inflationary impacts on margins supporting our modest underweight to equities. Within fixed income, we remain underweight bonds and overweight cash.
- We further reduced our overweight to value stocks globally and favor core strategies to moderate the cyclical exposure of our equity allocation amid a backdrop of slowing economic growth.
- Within fixed income, we increased our allocation to high yield bonds as spreads have reached attractive levels and as we remain constructive on fundamentals.
- We trimmed our position in short-term Treasury inflation protected securities as inflation expectations appear to have peaked amid aggressive Fed tightening and evidence of slowing growth.

3 Market Themes

As of 31 July 2022

Whatever It Takes 2.0

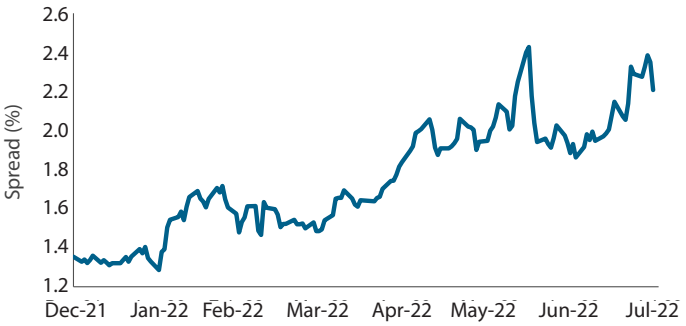
While recent reports showed better-than-expected second-quarter economic growth in the region, Europe faces a growing list of headwinds. At its most recent meeting this month, the ECB delivered a larger-than-expected half-point rate increase, its first in more than a decade, to fight decades of high inflation. Despite concerns over slowing growth, risk of Russia cutting off gas supplies to the region and rising political instability, ECB President Christine Lagarde signaled that more rate hikes will be needed to rein in inflation. At the same time, the ECB introduced a new plan, the Transmission Protection Instrument, which would provide flexibility to buy the government debt of troubled member nations to stave off a potential borrowing crisis. The new tool may come in handy soon, as political uncertainty following the resignation of Prime Minister Mario Draghi sent Italian bond spreads higher. With fall around the corner and bringing colder weather amid energy shortages threatening even higher inflation and uncertainty around Italian elections in September, Lagarde may find herself reinventing "whatever it takes" to save the region this time around.

Keep on Smiling

There seems to be little that can break the US dollar's climb; it reached its highest level since the early 2000s and continues to cause broad-based pain from EM-facing dollar-denominated debt obligations to US companies reporting weaker exports and lower revenues due to the dollar's unrelenting rise. Among the forces behind the US dollar's runup have been the relative strength of the US economy compared with other regions, the Fed's aggressive rate tightening relative to other major central banks and elevated geopolitical challenges increasing the bid for the relative safety of the US dollar. The "dollar smile" theory holds that the currency does well at each end of the global growth continuum, benefitting when relative US growth and rates are higher as well as from being a "safe haven" when global growth is declining—both of which are happening today. At this point, it appears the only thing that could slow the dollar is a pivot by the Fed, which would likely only come amid signs of much weaker growth in the US or stronger evidence of receding inflation, so for now it looks like the dollar will keep on smiling.

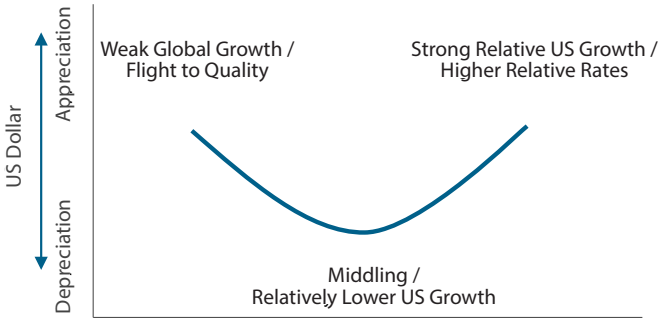
Italian 10 Year Government Bond Spread

As of 31 July 2022



US Dollar Smile

As of 31 July 2022



Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Finance L.P.

4 Regional Backdrop

As of 31 July 2022

	Positives	Negatives
United States	▪ Strong corporate and consumer balance sheets ▪ Resilient demand for services and capex ▪ Still-tight labor market	▪ Fed tightening at a rapid pace ▪ Significantly elevated inflation ▪ Fiscal stimulus has peaked ▪ Sharp slowdown in the housing market
Europe	▪ Fiscal spending likely to increase ▪ Equity valuations attractive relative to the US ▪ European Union unity is strengthening	▪ Ukraine conflict has impacted supply chains ▪ Industrial production could be dampened by energy shortages ▪ Limited long-term catalysts for earnings growth ▪ ECB is tightening ▪ Debt costs rising
Developed Asia/Pacific	▪ Very attractive equity valuations ▪ Improving corporate governance ▪ Monetary policy remains accommodative	▪ Limited long-term catalysts for earnings growth ▪ Global trade remains challenged by supply chain issues, geopolitical uncertainty and COVID concerns ▪ Uptick in inflation is leading to tighter monetary conditions
Emerging Markets	▪ Chinese authorities are easing monetary, regulatory and credit conditions ▪ Equity valuations attractive relative to the US ▪ COVID concerns have decreased	▪ Chinese regulatory actions have impacted investor confidence ▪ Global trade remains challenged by supply chain issues, geopolitical uncertainty and COVID restrictions

5 Asset Allocation Committee Positioning

As of 31 July 2022

Underweight | Neutral | Overweight

▼ 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 CLASS	Equities		■				Despite a recent bounce, stocks remain vulnerable to further weakness amid tightening liquidity. Earnings expectations are beginning to be pressured by slowing economic growth and rising input costs.
ASSET CLASS	Bonds				■		Tighter global central bank policies and still-elevated inflation could keep upward pressure on yields, although US rates appear to be approaching a ceiling. Credit spreads remain compelling, but default risks likely to increase.
EQUITIES	*Regions*						
EQUITIES	U.S.		■				US equities remain expensive on a relative basis. However, the less cyclical nature of the US economy should provide some support as global growth weakens.
EQUITIES	Global Ex-U.S.				■		Global growth outlook may benefit from potential stabilization in China. However, inflation concerns, tighter central bank policy and a protracted conflict between Russia and Ukraine could weigh on the global economy.
EQUITIES	Europe		■				Valuations are compelling, but elevated energy costs and weakening manufacturing activity remain significant concerns. Meanwhile, ECB support has faded with inflation concerns rising.
EQUITIES	Japan				■		Cyclical concerns continue to weigh on Japanese equities; however, improved valuations, relatively lower inflation, accommodative monetary policy and improving corporate governance should provide long-term tailwinds.
EQUITIES	Emerging Markets (EM)				■		Valuations and currencies are attractive. Medium-term outlook in China appears attractive due to prospects for significant policy support and less stringent COVID lockdowns; however, further outbreaks remain a risk.
EQUITIES	*Style & Market Capitalization*						
EQUITIES	U.S. Growth vs. Value[1] ▲		■				Relative valuations for value stocks remain attractive, but the gap has narrowed. Value stocks could weaken as inflation concerns give way to increasing recession risks. Mega-cap technology earnings have thus far proven to be less cyclically sensitive.
EQUITIES	Global Ex-U.S. Growth vs. Value[1] ▲			■			Value stocks offer attractive valuations. However, earnings could face significant pressure as cyclical risks are rising and amid a challenging geopolitical backdrop.
EQUITIES	U.S. Small vs. Large-Cap[1]				■		Small-cap stocks offer historically attractive relative valuations, more fully pricing in the slowing earnings growth environment. However, elevated input costs, wage pressures and heightened market volatility could challenge performance. Higher-quality bias is warranted.
EQUITIES	Global Ex-U.S. Small vs. Large-Cap[1]			■			Small-caps balance idiosyncratic opportunities with significant global growth concerns. Additionally, caution is warranted due to US dollar strength and a potential flight to quality that could favor large-caps.
EQUITIES	*Inflation-Sensitive*						
EQUITIES	Real Assets Equities			■			Commodity prices have weakened somewhat recently due to economic concerns and waning demand, balancing this economic sensitivity with real assets' role as an attractive hedge to a sustained period of elevated inflation.
BONDS	U.S. Investment Grade (IG)	■					Moderating growth and impacts of geopolitical conflict are offsetting the upward pressure on interest rates from continued Fed tightening and elevated inflation.
BONDS	Developed Ex-U.S. IG (Hedged)		■				Rates biased higher as developed market central banks, outside the BoJ, remain hawkish as they continue to combat high inflation. The US dollar remains supported by the Fed's tightening and safe-haven trade.
BONDS	U.S. Treasury Long			■			Upward move in longer rates appears to have paused as current pace of Fed tightening is largely priced in. The sector provides portfolio ballast in a risk-off scenario but remains vulnerable should elevated inflation persist.
BONDS	Inflation-Linked ▼			■			Most of the upward move in inflation has been priced in, although the sector could offer a buffer if Fed tightening fails to bring inflation down.
BONDS	Global High Yield ▲				■		Credit fundamentals remain strong, default risk increasing but remains low and yields at attractive levels. However, spread volatility is expected to continue due to geopolitical, inflationary and growth concerns.
BONDS	Floating Rate Loans				■		Loans' short duration profile is attractive for a rising rate regime, but that benefit may be waning. Solid fundamentals and demand for yield remain supportive, but liquidity remains a risk.
BONDS	EM Dollar Sovereigns				■		Select EMs look attractive and are supported by a prospective improvement in China's outlook as well as still-elevated commodity prices. However, geopolitical tensions and fiscal pressures remain risks.
BONDS	EM Local Currency				■		EM yields are at attractive levels amid central bank tightening and risk-off environment. EM currencies are cheap but have had to contend with a stronger US dollar.

[1] For pairwise decisions in style & market capitalization, positioning within boxes represent 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 & market capitalization asset classes are represented as pairwise decisions as part of our tactical asset allocation framework.

ADDITIONAL DISCLOSURES:

Certain numbers in this report may not equal stated totals due to rounding.
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Key risks –The following risks are materially relevant to the information highlighted in this material:
Even if the asset allocation is exposed to different asset classes in order to diversify the risks, a part of these assets is exposed to specific key risks.
Equity risk – in general, equities involve higher risks than bonds or money market instruments.
ESG and Sustainability risk – May result in a material negative impact on the value of an investment and performance of the portfolio.
Credit risk – a bond or money market security could lose value if the issuer's financial health deteriorates.
Currency risk – changes in currency exchange rates could reduce investment gains or increase investment losses.
Default risk – the issuers of certain bonds could become unable to make payments on their bonds.
Emerging markets risk – emerging markets are less established than developed markets and, therefore, involve higher risks.
Foreign investing risk – investing in foreign countries other than the country of domicile can be riskier due to the adverse effects of currency exchange rates; differences in market structure and liquidity, as well as specific country, regional, and economic developments.
Interest rate risk – when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.
Real estate investments risk – real estate and related investments can be hurt by any factor that makes an area or individual property less valuable.
Small- and mid-cap risk – stocks of small and mid-size companies can be more volatile than stocks of larger companies.
Style risk – different investment styles typically go in and out of favour depending on market conditions and investor sentiment.

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