



# Global Asset Allocation: The View From Europe

May 2022

## 1 Market Perspective



- Global growth estimates are trending lower on heightened geopolitical risk, and COVID-19 lockdowns in China are weighing on supply chains and potentially exacerbating already elevated inflation.
- Despite moderating growth expectations, developed market central banks are expected to advance tightening policies to combat decades-high inflation, with the US Federal Reserve leading with the most aggressive plans, followed by the Bank of England. The European Central Bank (ECB) accelerates ending asset purchases and considers future rate hikes, while the Bank of Japan remains steadfast on its policy of yield curve control.
- Emerging market central banks remain biased towards tightening to fend off inflation and defend currencies, while China policies continue moving in the opposite direction to stimulate the economy to help catch up to growth targets following COVID-19 lockdowns.
- Key risks to global markets include central bank missteps, commodity impact of the Russia-Ukraine conflict, lingering inflation and China balancing growth amid COVID-19 lockdowns.

## 2 Portfolio Positioning

As of 30 April 2022



- Despite lower valuations amid recent declines, we remain underweight equities given a moderating growth and earnings outlook with a hawkish Fed battling high inflation. Within fixed income, we remain underweight bonds and overweight cash.
- Within equities, we continue to overweight value and underweight growth to provide a hedge should inflationary pressures persist longer than expected.
- Within fixed income, we continue to favour inflation-protected securities and shorter-duration and higher-yielding sectors through overweights to emerging market debt and high yield bonds supported by still solid fundamentals while keeping a cautious eye on liquidity and volatility.
- To provide some defence against growing market risks, we further moderated our underweight to European government bonds following recent moves higher in rates.

## 3 Market Themes

### Where to Hide?

War, inflation and lingering COVID-19 impacts have set the stage for a challenging start to 2022 for investors, with both stocks and bonds down over 9% in response. While dynamic, stocks and bonds on average have a low correlation with each other, and their correlation can move sharply negative during risk-off periods. However, this time is quite unique, with runaway inflation sparking aggressive central bank tightening all while growth is moderating amid a world full of rising risks. These concerns of rising rates and inflation are contributing to a retreat in bonds. At the same time, rising rates and slowing growth are weighing on equity markets in a period where valuations are already above average. This unfortunate rise in stock-to-bond correlation is weighing on even the most conservative of investors. While it's hard to gauge the path forward given the unprecedented confluence of issues facing global markets, a cautious approach is warranted, especially to mitigate more extreme tail events, including more persistent inflation or a hard landing in the economy.

### Stock and Bond Correlations on the Rise<sup>1</sup>

As of 30 April 2022



**Past performance is not a reliable indicator of future performance.**

<sup>1</sup> Chart represents rolling 2-year correlation of monthly price changes of the S&P 500 Index and U.S. 10-Year Treasury Futures.

<sup>2</sup> Chart shows China Manufacturing PMI Index and China Non-Manufacturing PMI Index (representing Services PMI).

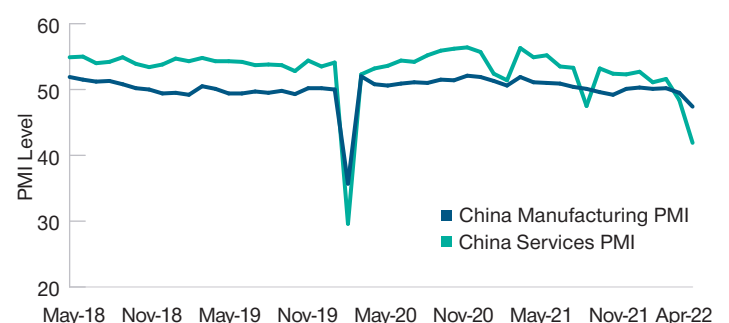
Sources: Bloomberg Finance L.P. and S&P (see Additional Disclosures).

### Walking a Tightrope

As the rest of the world is seeing fewer outbreaks and learning to cope with COVID-19, China, on the other hand, has faced a new wave of outbreaks, forcing it to enact 'zero-COVID' lockdown policies, which are taking a toll on the nation's growth and potentially spilling over to the rest of the world. The stringent lockdowns in Shanghai, an export hub, and most recently in Beijing are weighing on the ability to transport goods, further impacting already fractured global supply chains. The market increasingly expects China to further ease monetary and fiscal policy in response to the recent weakness. However, as they do, they will not want to reflate speculative bubbles that they burst last year, most notably the housing sector. With the presidential election approaching and President Xi Jinping up for an unprecedented third term, he seems determined to reach China's lofty 5.5% gross domestic product target that is severely challenged by COVID-19 lockdowns. This leaves policymakers walking a tightrope should they seek to maintain the aggressive lockdowns and reach growth targets while providing just enough stimulus not to overheat some sectors of the market.

### China's Manufacturing and Services Data Take a Hit<sup>2</sup>

As of 30 April 2022





## REGIONAL BACKDROP

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### Positives

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- Europe**
- Fiscal stimulus is increasing
  - Equity valuations are attractive relative to the US
  - European Union unity is strengthening

### Negatives

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- Ukraine conflict has driven energy prices sharply higher
- Industrial production dampened by supply chain challenges
- Limited long-term catalysts for earnings growth

- United Kingdom**
- Purchasing managers' surveys remain firm
  - The labour market is historically very strong
  - Energy resilience has improved with the sourcing of liquefied petroleum gas supplies that are not dependent on Russia

- The Bank of England is raising interest rates and may need to do much more if its forecast that inflation will roll over does not transpire
- Consumer confidence has fallen to very low levels, reflecting high energy costs, and this seems likely to drive a slowdown in economic growth with recessionary risks rising over time
- Very tight labour market means higher wage growth, and the prospect of second-round effects could lead to more persistent inflation

- United States**
- Strong corporate and consumer balance sheets
  - Pent-up demand for services and capex

- The Fed is tightening at a rapid pace
  - Elevated stock inflation
  - Supply chain issues are limiting economic activity
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## Positives

- Japan**
- Earning expectations remain solid
  - Domestic fiscal stimulus and easy monetary policy support the economic recovery
  - A weak yen has historically been positive for equity markets, assuming contained commodity prices

**Asia Pacific  
ex-Japan**

- Chinese policymakers will have to implement larger stimulus measures to hit their set growth target
- A tight Australian labour market supports the ongoing recovery in consumer spending
- Depressed sentiment and positioning make Chinese stocks an interesting contrarian, medium-term investment amidst appealing valuations
- Australian assets proved to be more resilient to current geopolitical risks than the rest of the world, benefiting from its relative isolation

**Emerging  
Markets**

- Chinese authorities are easing policies
- Equity valuations attractive relative to the US

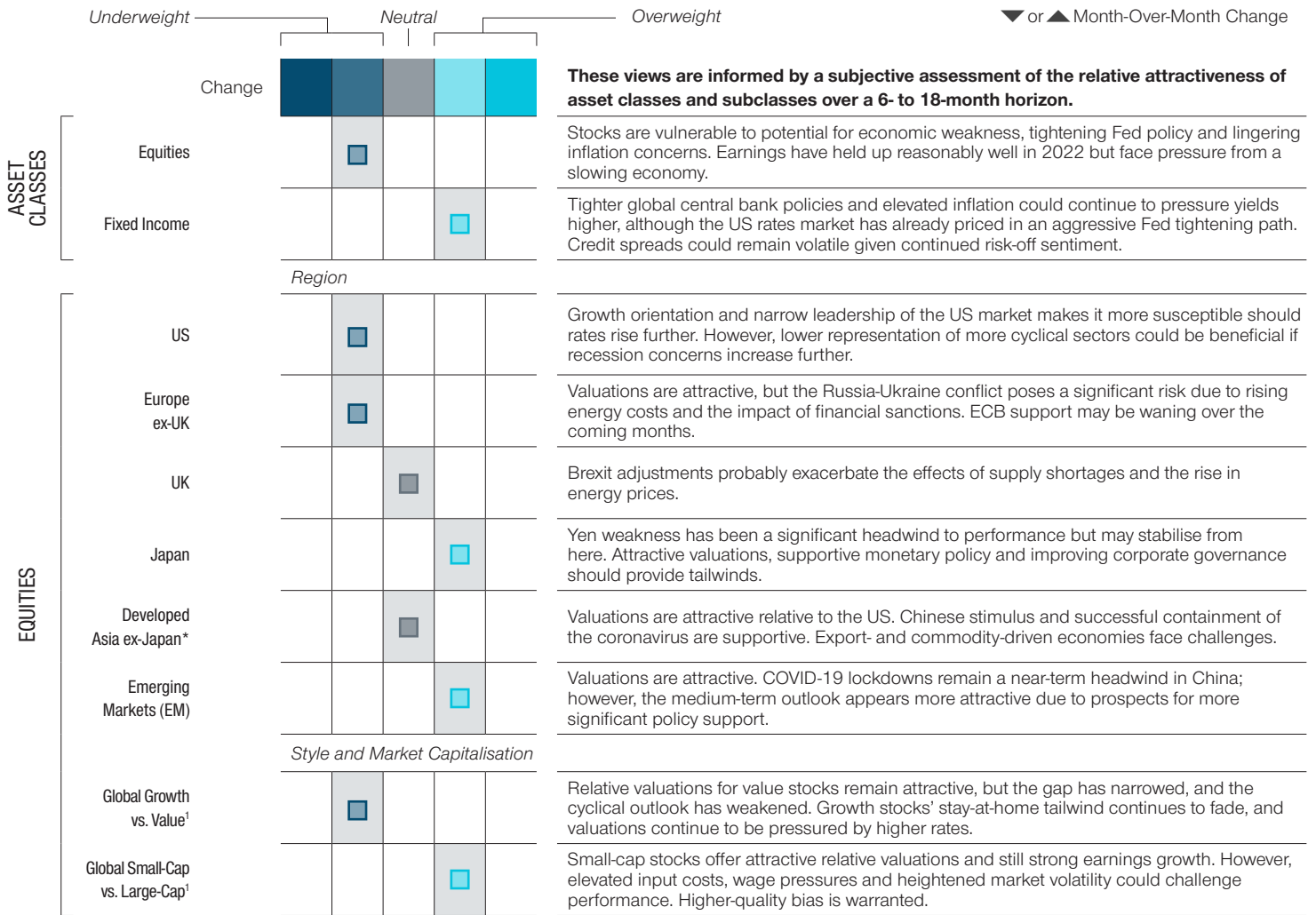
## Negatives

- Leading economic indicators continue to be weak due to supply shortages and rising input prices
- The Japanese yen is reaching levels that may prove a headwind to domestic activity
- The changing correlation between currency, bonds and equity contributes to greater uncertainties

- Chinese COVID-19 outbreaks are challenging the dynamic clearance policy, severely impacting mobility indicators
- Australian business and consumer confidence indices deteriorate on the back of rapid price increases
- Earnings momentum in China hasn't yet bottomed given the uncertain environment
- Rising yields on the horizon raise concerns over a hot Australian property market

- COVID-19 lockdowns have impacted economic activity
- Chinese regulatory actions have impacted investor confidence
- Global trade remains impacted by supply chain issues, geopolitical uncertainty and COVID-19 restrictions
- Central bank accommodation is fading

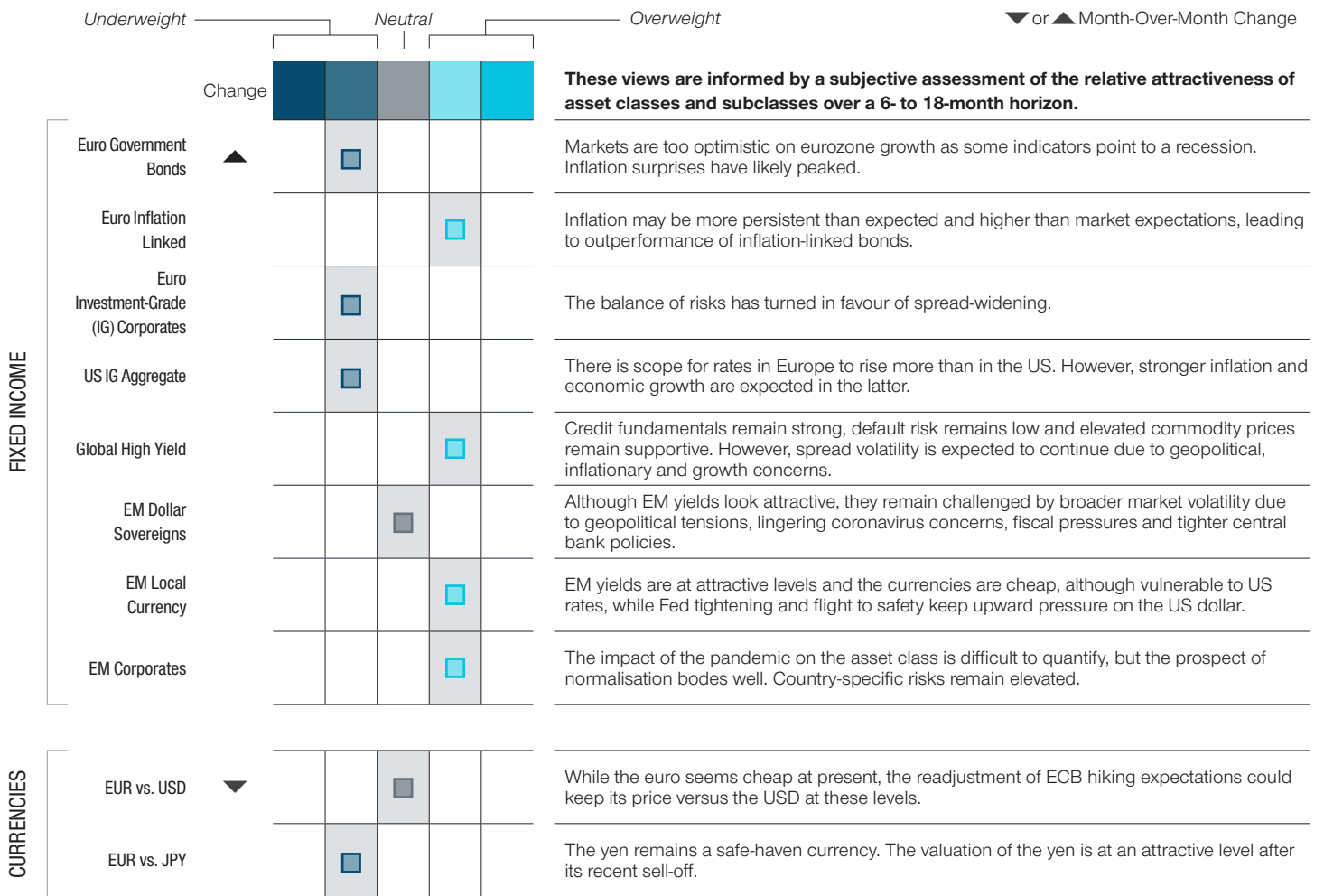
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\*Includes Australia.

<sup>1</sup> 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.



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