Invesco

Henley Multi Asset Team

Tactical asset allocation views: A fine balance

30 June 2022

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Synopsis

We upgrade investment grade credit to overweight and remain overweight high yield. We downgrade equities to neutral from overweight and downgrade cash from neutral to underweight. Government bonds remain neutral overall, but only due to the yield available in the US.

Our neutral view on equities reflects our concerns that corporate earnings risks have not been fully priced in and that further rate hikes could de-rate equities further.

On a more positive note, technical factors are supportive and some sentiment surveys suggesting that the appetite for equities is as low as in 2008 makes us mindful that equities are oversold in the short term.

Within equities we downgrade US, Europe ex UK and Emerging Markets ex China, instead preferring the UK, Japan, and China. We note that the sterling (and indeed the euro and yen) investor has benefitted from currency weakness versus a stronger dollar. A reversal of this currency weakness would present a return headwind for unhedged equity investors.

Overall, our fixed income rating remains neutral, but we are increasingly positive on credit. We have upgraded investment grade credit to overweight, primarily on high absolute and relative yields. In our view the asset class offers potential value as it appears to be pricing in a default rate that is synonymous with an extremely negative economic environment – one of a magnitude that we do not see as a highly likely outcome. That said, we are wary of the adage that the credit market often leads the way.

High yield credit remains an overweight and we note the improvement in value with absolute yields at very high single digit levels. The relatively short duration of the asset class means that it may be more susceptible to rate rises at the short end of the interest rate curve. However, we feel that at these yields the asset class offers a potentially valuable 'buy and hold' option over our tactical timeframe.

We remain neutral on government bonds, driven by the US Treasury market. We are less positive on other government bonds markets such as the Eurozone, Japan and the UK given lower yields and a less advanced monetary policy profile.

Find out more about the Henley Multi Asset team's Summit Growth funds here and Summit Responsible funds here.

Macro overview

The first half of 2022 has been a sober one for most market participants, with very few assets in positive territory. Equities have been de-rated, credit spreads have widened, and government bond markets initially sold off because inflation fears became more entrenched. More recently, the focus has shifted from inflation concerns to growth and corporate earnings, and we see both inflation and growth heading lower.

On the inflation side, the sharp rise in commodity prices driven by the re-opening of economies, Covid-related supply shocks and Russia's invasion of Ukraine should lead to powerful negative base-effect adjustments. In combination with lower demand and an improvement in the supply of goods, this should ease - but not erase - the inflationary impulse seen over the last year. Indeed, there are encouraging signs that other supply chain disruptions may be easing, for example short-term data is suggesting a moderation in global container shipping costs.

On the growth side, recession and earnings risks have risen. However, deep and prolonged recessions are normally accompanied by financial crisis and – a few markets aside - consumer and corporate balance sheets are robust. The combination of excess savings and high employment, and a low perception of job risk, is leading consumers to continue spending, even as real incomes are being squeezed by inflation.

A combination of moderating inflation, more resilient growth and China ending restrictive lockdowns lend to our outlook being more optimistic (albeit cautiously so) than the market consensus. This view is supportive for equities, credit and government bonds over our three-year tactical timeframe.

Below you will find the Henley Multi Asset team's fundamental tactical asset allocation views, an A-E rating for each asset class over a 1-3 year investment horizon. These views are powered by the teams proprietary VOTE asset allocation framework - which ranks markets on **V**aluation, **O**ther (e.g. Policy) **T**echnical and **E**arnings/**E**conomics drivers. These fundamental preferences are reflected in the team's long-only portfolios.

Tactical asset allocation

		Overweight		Neutral	Underweight	
		A	B	C	D	E
Equities	**Overall**		●* →	●		
	US equities			●		
	Europe ex UK equities		●* →	●		
	UK equities		●			
	Japan equities		●			
	Emerging markets equities		●			
	Pacific ex Japan equities[1]			●		
Fixed Income	**Overall**			●		
	Government bonds			●		
	Investment grade credit		● ←	●*		
	High yield bonds		●			
	Emerging market debt		●			
Alternatives	**Overall**		●* →	●		
	Real estate			●		
	Absolute return strategies			●		
Cash	**Overall**			●* →	●	

Source: Invesco, as at 30 June 2022. [1]Developed Asia. *Indicates an upgrade or downgrade.

Equities

Overall

C: Neutral
Downgraded from B

While we have downgraded equities to neutral, we are still constructive on the asset class over our timeframe of one-to-three years, believing that equities can deliver good returns from here. However, we are mindful of the potential for shorter-term volatility and the increased relative attractiveness of some other asset classes, such as investment grade and high yield credit.
One of our key concerns is the corporate earnings outlook, with bottom-up corporate earnings expectations seemingly out of kilter with top-down expectations, which leaves scope for downward earnings revisions. In addition, the policy backdrop of further potential interest rate hikes likely means that further de-rating of valuations in the short-term is possible.
On the more positive side, equities have already fallen (and de-rated) significantly and technical factors are supportive. We also believe that the global economy is in reasonably good shape overall, which should be supportive for risk assets such as equities.

US equities

C: Neutral

US equity valuations have improved to fair value due to the recent de-rating in markets. Technical indicators suggest that the market is under-owned and unloved. The market is anticipating that interest rates start falling again within our tactical timeframe, which would be supportive of growth-oriented markets such as the US – a market with significant exposure to technology and growth industries.

Japan equities

B: Overweight

Japanese equities are among the most attractive from a valuation perspective and corporate balance sheets remain strong which should provide resilience and support for dividends. A weak yen is also supportive for the market generally and particularly for those companies with overseas earnings. The profits outlook seems to be constructive, and the policy framework also remains helpful. Less positively, Japan is an oil importer which could be a headwind at current high prices, albeit they are lower than they have been. We are also mindful that the Japanese market typically has low margins and low return-on-equity when compared to other major regions. However, we feel that current valuations compensate for these risks. Currency has been a notable headwind for unhedged sterling investors this year and there is potential for this to reverse.

Europe ex UK equities

C: Neutral
Downgraded from B

While technical indicators are supportive, the policy backdrop is less so and the region is among the most sensitive to the geo-political situation in Ukraine. Related to this is increasing concern and uncertainty over energy security and the potential for supply disruption, which could have profound implications for business activity. While we note that any improvement in this area would likely be very well received by the market, our near-term view is that we prefer to express a neutral stance given levels of uncertainty.

Emerging markets equities

B: Overweight

Our view on emerging market equities is broadly positive but nuanced in that we prefer Latin America and China to the rest of the emerging market region, where we are more neutral. From a valuation perspective, the market has de-rated significantly to the point that we think it is 'cheap' relative to its own history and relative to some other major markets. The loosening policy backdrop in China is supportive, in contrast to the rest of the emerging markets, and while China's Covid policy has been prohibitive to activity, there is potential for that to soften. Latin American equity valuations are also attractive, and corporate profits appear to be relatively robust, driven by strong commodity prices. However, we would note that sterling investors have experienced a significant currency tailwind this year.

UK equities

B: Overweight

In recent months UK equities have performed very strongly relative to most other major equity markets, largely due to a sector composition that benefits from a commodity-related tailwind - given exposures to energy and materials. Despite this, valuations have arguably become more attractive. Weak sterling and some sensitivity to commodity-related earnings should offer some support for the corporate profits outlook in the large cap space. However, we note that some sentiment surveys suggest that the UK equity markets may be 'over-owned'.

Pacific ex Japan equities (Developed Asia)

C: Neutral

The composition of the market is heavily tilted towards areas such as materials and real estate which have performed well in 2022. While the region comprises four countries, Australia accounts for just over 60% of the region and the sensitivity of earnings to commodities is high. Valuations are fair and the region offers a relatively high dividend yield – we remain neutral.

Fixed Income

Overall
C: Neutral

Our neutral view of fixed income remains, with yields much higher than they were at the start of the year meaning that the relative attractiveness of the asset class has improved. Within fixed income, we remain neutral on government bonds, and positive on high yield credit and emerging market debt. However, we now upgrade investment grade credit to overweight, primarily on high absolute and relative yields and spreads that infer a default rate that we think is unlikely to materialise.

Government bonds
C: Neutral

Our overall neutral view on government bonds masks differences between markets. Our view of US Treasuries is neutral while we are less positive on UK, Eurozone, and Japanese Government bonds. While all markets appear to be 'oversold' from a technical perspective, in than US valuations are fair with yields higher the US equity market dividend yields, and the gap versus total shareholder yield has narrowed. Valuations are less attractive in other government bond markets. A potential market shift from inflation concerns to growth concerns are supportive for the asset class.

High yield bonds
B: Overweight

We note the improvement in value in the high yield credit market with absolute yields in the very high single digits. The relatively short duration of the asset class means that it may be more susceptible to rate rises at the short end of the interest rate curve. We remain mindful that defaults could start to pick up now as the journey to policy normalisation begins and fiscal life support is reduced or removed. However, we feel that at these yields the asset class offers a potentially valuable 'buy and hold' option over our tactical timeframe.

Investment grade credit
B: Overweight
Upgraded from C

We upgrade investment grade credit to overweight with absolute yields now more attractive given the rise in government bond yields and relatively wide spreads, in the context of the last decade. While we remain mindful that defaults could start to pick up, the asset class appears to be pricing in a default rate that is synonymous with an extremely negative economic environment, which we do not see as a highly likely outcome.

Emerging market debt
B: Overweight

Emerging market bond yields appear to be discounting that we are close to the end of central bank interest rate hiking cycles, so offer good potential value. In addition, many emerging market debt issuers have benefited from rising commodity prices, which has strengthened their economies. However, a key risk is slowing economies across the emerging market region. There are rewards for those prepared to accept risk, but leverage continues to rise at the country level in emerging markets, the political backdrop is generally less stable and often idiosyncratic.

Alternatives

Overall
C: Neutral
Downgraded from B

Traditional equity and bond markets are likely to experience periods of pronounced volatility. Depending on the nature of the strategy, alternatives can help to dampen volatility and provide less correlated sources of return. There are potentially more attractive opportunities to be found elsewhere, given the falls seen in some of the more traditional asset classes.

Real estate
C: Neutral

The outlook for real estate is clouded somewhat by higher interest rates, tightening credit conditions, and concerns around economic growth. However, the asset class has the potential to offer some inflation protection through rent increases, and the diverse nature of the market means that there are opportunities within the sector and across regions. Given the rise in interest rates, global listed real estate valuations are now fair, in our view.

Absolute return strategies
C: Neutral

In periods of increased market volatility, absolute return strategies can exploit valuation dislocations and provide potentially defensive and/or diversification properties for portfolios. In an environment where traditional assets could come under pressure, lowly correlated return potential is valuable.

Cash

Overall
D: Underweight
Downgraded from C

While cash can offer the ultimate capital preservation and cash rates have risen, cash (sterling) is unattractive with inflation hampering the likely real return in the short term. Sentiment surveys suggest that investors have been increasing cash holdings noticeably, which can often be a contrarian indicator that other assets are likely to perform better in this environment.

Investment risks

The value of investments and any income will fluctuate (this may partly be the result of exchange rate fluctuations) and investors may not get back the full amount invested.

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