Invesco

Tactical Asset Allocation

Overweight risk assets, cyclicals, and non-US equities. With good news largely priced in, we reflect on possible scenarios for 2024.

Our macro process drives tactical asset allocation decisions over a time horizon between six months and three years, on average, seeking to harvest relative value and return opportunities between asset classes (e.g., equity, credit, government bonds, and alternatives), regions, factors, and risk premia.

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Senior Portfolio Manager,
Head of Investments,
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Synopsis

- We remain positioned for a recovery in the global cycle and cyclical divergence in favor of non-US equities. However, global risk appetite is peaking, increasing the likelihood of mean reversion in the relative performance between asset classes unless economic data validate rosy market expectations.
- We remain overweight portfolio risk in the Global Tactical Asset Allocation model,[1] favoring equities relative to fixed income, non-US equity markets, value, and smaller capitalizations. Overweight risky credit, neutral duration, and underweight the US dollar.

Macro update

After the strong cyclical rebound in risk assets in Q4 2023, markets experienced mixed performance in the first month of 2024. In our last update, we highlighted the possibility of a pullback in market pricing, as good news on falling inflation, stable growth, strong labor markets, and rate cut expectations seemed largely priced. The price action in January broadly confirmed, in our opinion, these dynamics. While global equities and fixed income markets were largely flat and in line, the relative performance between equity sectors, styles, and regions has shown some indication of a defensive shift in market sentiment, more consistent with a decelerating growth environment. Defensive sectors with quality and low volatility characteristics, such as communication services, information technology, health care, and consumer staples, led the performance table in January. Conversely, value-oriented and lower capitalization sectors, such as industrials, materials, and real estate, underperformed.

Our barometer of global risk appetite has moderately decelerated over the past month. While short of flagging a clear rollover in market sentiment as of now, it is highlighting the risk of a near-term peak in the market cycle and global growth expectations. At this stage, our rules-based macro framework continues to suggest a recovery regime for the global economy, i.e., growth below trend and improving (**Figure 1**). However, the growing gap between market-implied growth expectations and global leading economic indicators, or earnings expectations, begs the question (**Figure 2, Figure 3**): Will the economy and the earnings cycle rebound, validating market expectations, or are we likely to see mean reversion in the performance of risk assets? While our macro indicators will adjust to the incoming information, we outline two plausible scenarios over the next few months and their potential catalysts based on the current macro backdrop.

1 Global 60/40 benchmark (60% MSCI ACWI, 40% Bloomberg Global Aggregate USD Hedged).

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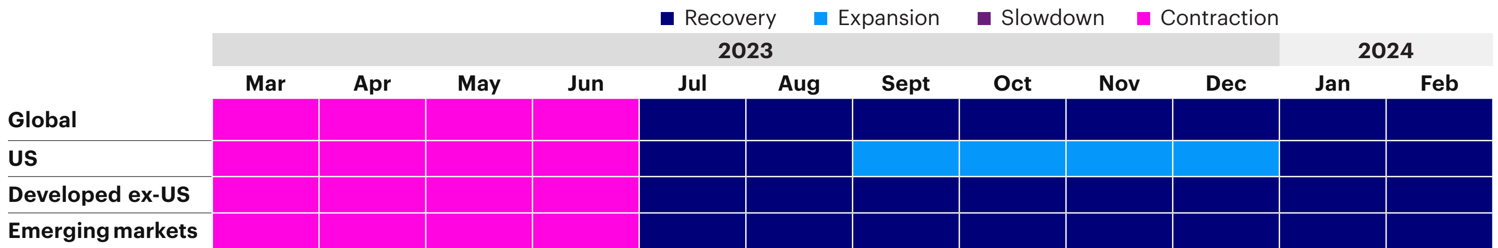
Figure 1a: Global macro framework remains in a recovery regime
Regional regime signals and components

Region	LEIs Current level of growth	&	Global risk appetite Change in global growth expectations	=	Expected macro regimes
Global	**Below Trend**	&	**Growth expectation improving**	=	**Recovery**
United States	**Below Trend**				**Recovery**
Developed markets ex-USA	**Below Trend**				**Recovery**
Europe	Below Trend				Recovery
United Kingdom	Below Trend				Recovery
Japan	Above Trend				Expansion
Emerging markets	**Below Trend**				**Recovery**
China	Below Trend				Recovery
Emerging markets ex-China	Above Trend				Expansion

Sources: Bloomberg L.P., Macrobond. Invesco Solutions research and calculations. Proprietary leading economic indicators of Invesco Solutions. Macro regime data as of January 31, 2024. The Leading Economic Indicators (LEIs) are proprietary, forward-looking measures of the level of economic growth. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment. Developed markets ex-USA include the eurozone, UK, Japan, Switzerland, Canada, Sweden, Australia. Emerging markets include Brazil, Mexico, Russia, South Africa, Taiwan, China, South Korea, India.

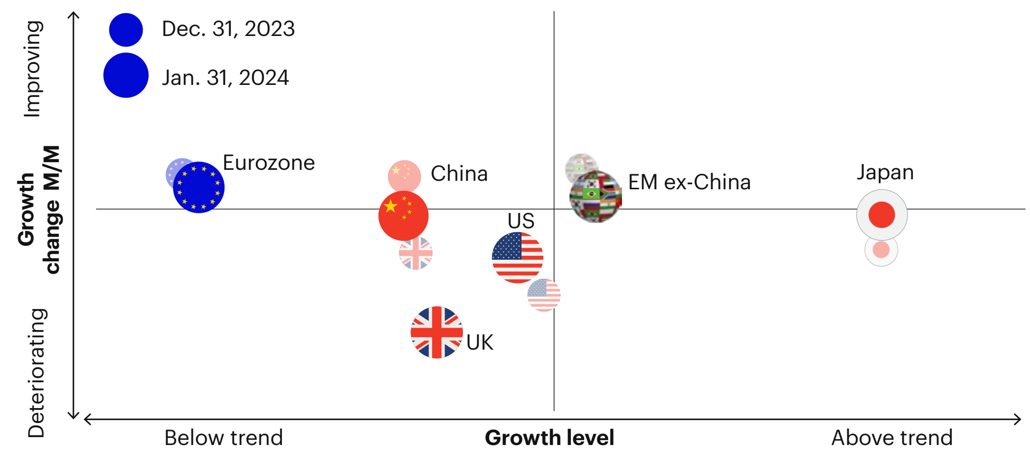
Figure 1b: Trailing 12-month regime history by region
US in a recovery phase as LEIs continue to decline below the long-term trend



Source: Invesco Solutions as of January 31, 2024.

Will the economy and the earnings cycle rebound, validating market expectations, or are we likely to see mean reversion in the performance of risk assets?

Figure 1c: Cyclical divergence between the US and the rest of the world, with improving momentum in Europe and emerging markets



Sources: Bloomberg L.P., Macrobond. Invesco Solutions research and calculations. Proprietary leading economic indicators of Invesco Solutions. Macro regime data as of January 31, 2024. The Leading Economic Indicators (LEIs) are proprietary, forward-looking measures of the level of economic growth. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment.

Recovery scenario, with a rebound in earnings and stable inflation

Historical analysis of past cycles suggests market expectations tend to lead inflection points in the cycle, with earnings and other cyclical indicators validating financial markets. **Figure 2** illustrates how global risk appetite tends to presage peaks and troughs in leading economic indicators by a few months. Today, evidence of this scenario would require a meaningful improvement in earnings growth, likely supported by strong labor markets and a rebound outside the US, mainly Europe and Asia, where growth has lagged. Given peak conditions in market sentiment, however, further outperformance in risk assets is likely to require additional support from lower inflation and lower interest rates, creating a very favorable backdrop for cyclicals, value, smaller capitalizations, and non-US assets. Recent signs of a trough in European and Asian manufacturing indicators, improvements in US consumer sentiment, and stable credit spreads provide some support to this scenario.

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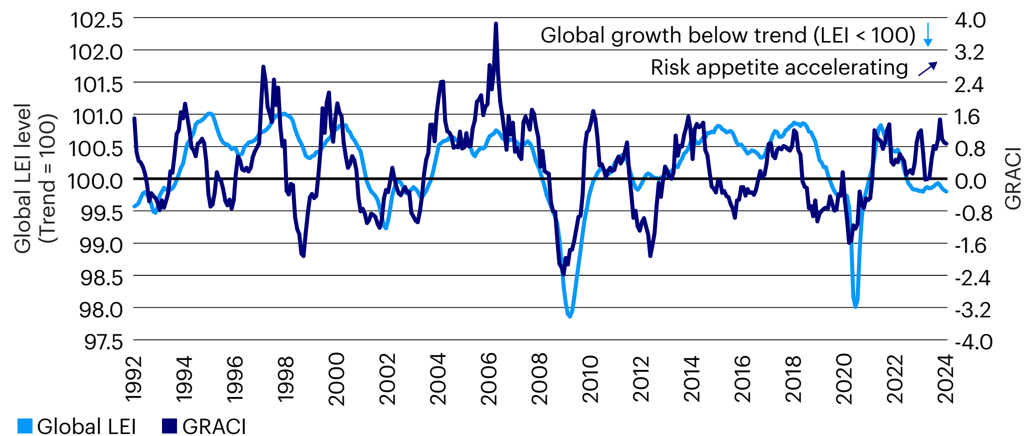
Figure 2: Global risk appetite peaking while leading indicators still below their long-term trend

GRACI and Global LEI



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Solutions research and calculations, from Jan. 1, 1992 to Jan. 31, 2024. The Global Leading Economic Indicator (LEI) is a proprietary, forward-looking measure of the growth level in the economy. A reading above (below) 100 on the Global LEI signals growth above (below) a long-term average. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment. A reading above (below) zero signals a positive (negative) compensation for risk-taking in global capital markets in the recent past. **Past performance does not guarantee future results.**

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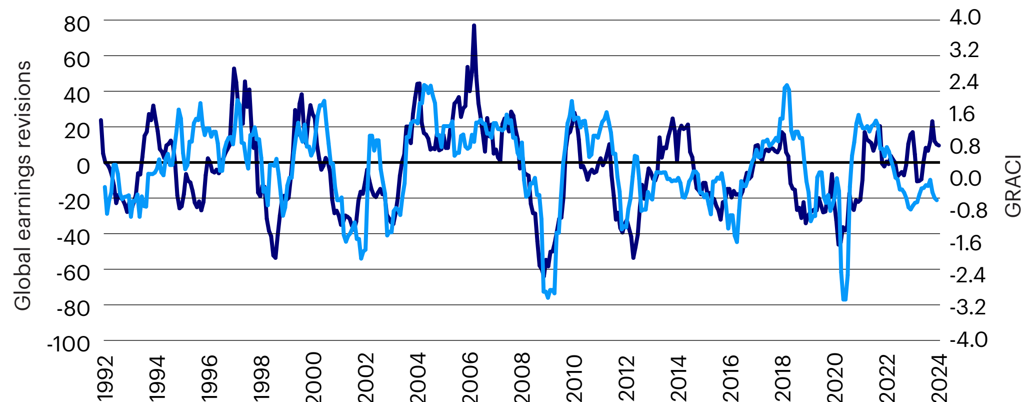
Figure 3: Forward earnings expectations yet to catch up with market expectations of improving growth



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Investment Solutions research and calculations, from January 1992 to January 31, 2024. Global Earnings Revisions measure the net percentage of positive / negative revisions in 12-month forward earnings estimates. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment. A reading above (below) zero signals a positive (negative) compensation for risk-taking in global capital markets in the recent past. **Past performance does not guarantee future results.**

While markets celebrated the end of the tightening cycle and priced-in multiple rate cuts for 2024 and beyond, we should not lose sight of the fact this tightening cycle was one of the most aggressive in history.

While every cycle is different, historical evidence over multiple cycles reminds us it can take up to two years for markets and the economy to fully incorporate the impact of monetary policy.

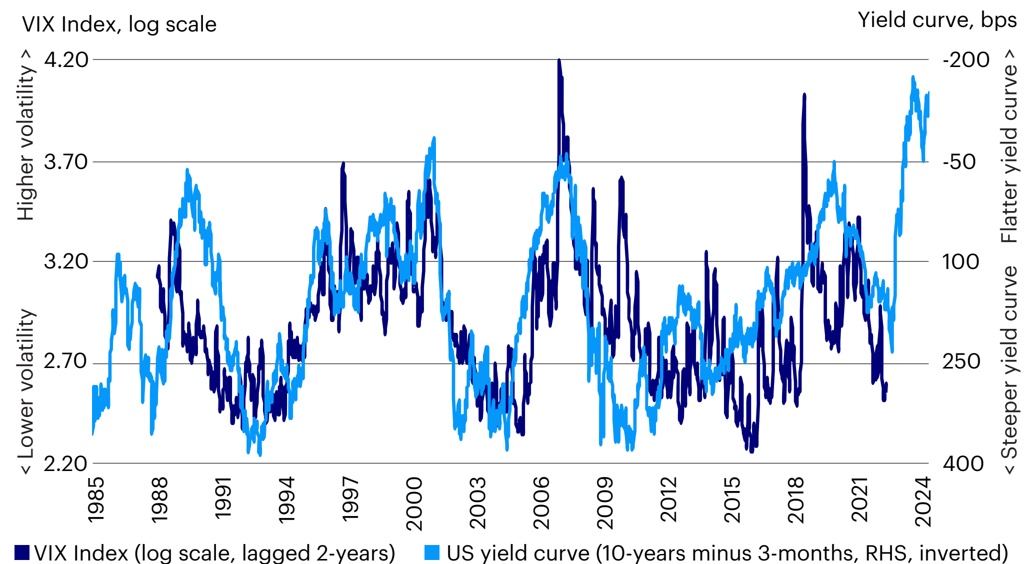
Given peak conditions in market sentiment, however, further outperformance in risk assets is likely to require additional support from lower inflation and lower interest rates.

Contraction scenario: Below-trend and decelerating growth due to lagged impact of policy tightening

While markets celebrated the end of the tightening cycle and priced-in multiple rate cuts for 2024 and beyond, we should not lose sight of the fact this tightening cycle was one of the most aggressive in history, both in magnitude and speed, and that its lagged effects are still making their way into the economy and financial system. While every cycle is different, historical evidence over multiple cycles reminds us it can take up to two years for markets and the economy to fully incorporate the impact of monetary policy (**Figure 4**). Therefore, it would not be surprising to see growth below trend and decelerate over the next few quarters. This scenario does not necessarily mean a recession but would most likely see earnings and leading indicators fail to catch up with rosy market expectations. Mean reversion in asset prices would likely bring a convergence in performance between risky and safer asset classes, with fixed income likely to perform well and defensive sectors, quality, and low volatility equities to outperform the market.

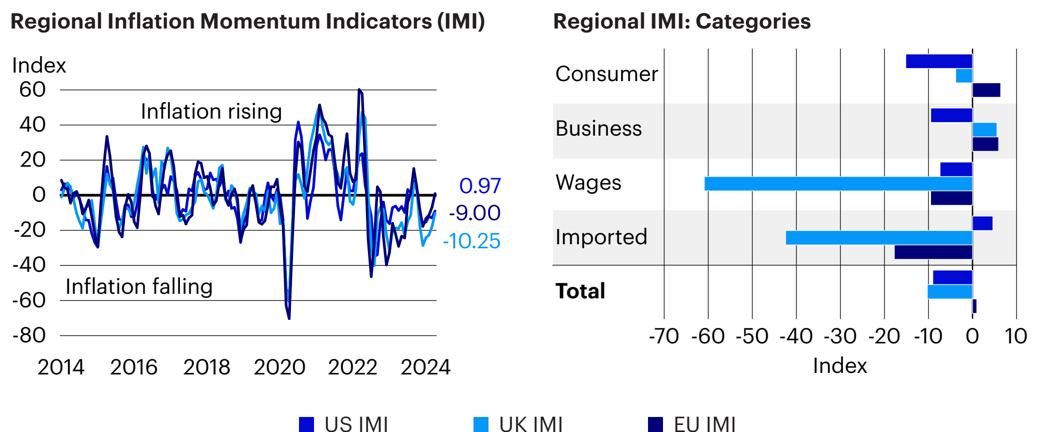
Overall, our rules-based process continues to suggest a recovery scenario for markets at this stage. We maintain a portfolio positioning consistent with this scenario while waiting for incoming information to adjust course as needed.

Figure 4: Monetary policy cycles affect market volatility with long lags, suggesting medium-term risks still skewed toward higher volatility



Sources: Bloomberg L.P., Invesco Investment Solutions research and calculations, from January 1985 to January 2024. **Past performance does not guarantee future results.**

Figure 5: Inflation continues to decline in the US and UK, while stabilizing in Europe



Sources: Bloomberg L.P. data as of January 31, 2024, Invesco Solutions calculations. The US Inflation Momentum Indicator (IMI) measures the change in inflation statistics on a trailing three-month basis, covering indicators across consumer and producer prices, inflation expectation surveys, import prices, wages, and energy prices. A positive (negative) reading indicates inflation has been rising (falling) on average over the past three months.

Within equities, we overweight cyclical factors with high operating leverage and a higher sensitivity to a rebound in growth expectations, such as value and smaller capitalizations.

In fixed income, we remain overweight in risky credit via high yield, bank loans and emerging markets hard currency debt.

In currency markets, we underweight the US dollar, as regimes of cyclical recoveries are typically accompanied by strong reflationary flows into non-US assets.

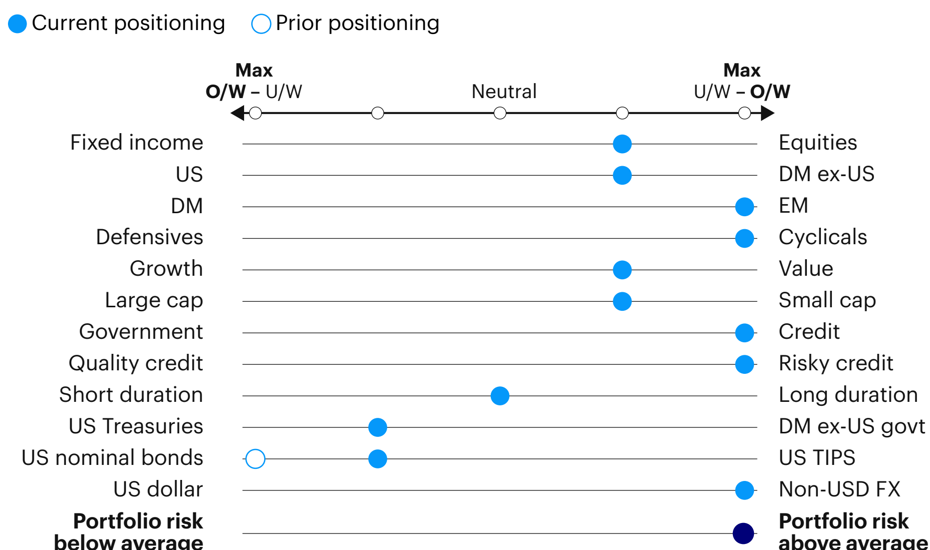
Investment positioning

We remain overweight risk relative to the benchmark in the Global Tactical Allocation Model, overweight equities over fixed income, favoring developed ex-US equities and emerging markets at the expense of US equities, and remain underweight the US dollar. We overweight cyclical sectors, value, and smaller capitalizations. In fixed income, we remain overweight credit[2] risk via lower quality sectors, maintaining a neutral duration posture. (Figures 6 to 9). In particular:

- Within **equities,** we overweight cyclical factors with high operating leverage and a higher sensitivity to a rebound in growth expectations, such as value and smaller capitalizations, while we underweight defensive factors, such as low volatility, quality, and larger capitalizations. Similarly, we favor exposures to cyclical sectors such as financials, industrials, materials, and energy at the expense of health care, staples, utilities, and technology. From a regional perspective, we remain overweight emerging markets, supported by improving risk appetite and expectations for US dollar depreciation, as well as developed ex-US equities, driven by cyclical divergence in leading economic indicators between the US and other developed markets.
- In **fixed income,** we remain overweight in risky credit via high yield, bank loans and emerging markets hard currency debt. Credit spreads have tightened further, now hovering around historical lows in most sectors. However, we expect volatility to remain subdued and credit markets to offer stable yields in a stable macro backdrop. The case for credit assets remains limited to their income advantage over government bonds rather than capital appreciation. In sovereigns, we favor duration in nominal bonds across developed markets, driven by negative inflation momentum (**Figure 5**).
- In **currency markets,** we underweight the US dollar, as regimes of cyclical recoveries are typically accompanied by strong reflationary flows into non-US assets. Within developed markets, we favor the euro, the British pound, Norwegian kroner, Swedish krona, and Singapore dollar relative to the Swiss Franc, Japanese yen, and Australian and Canadian dollars. In EM, we favor high yielders with attractive valuations, such as the Colombian peso, Brazilian real, South African rand, and Indonesian rupiah, relative to low yielding and more expensive currencies, such as the Korean won, Chilean peso, Thai baht, and Chinese renminbi, but still expect these currencies to do well in a US dollar depreciation scenario.

Figure 6: Relative tactical asset allocation positioning

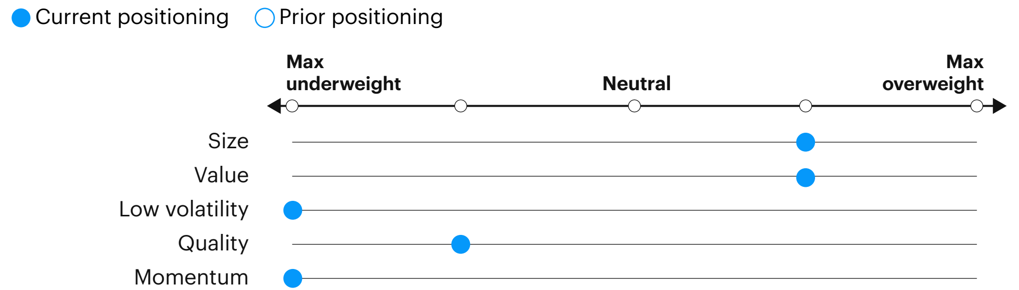
Overweight portfolio risk vs. benchmark via non-US equities, credit, and cyclicals



Source: Invesco Solutions, February 1, 2024. DM = developed markets. EM = emerging markets. Non-USD FX refers to foreign exchange exposure as represented by the currency composition of the MSCI ACWI Index.
For illustrative purposes only.

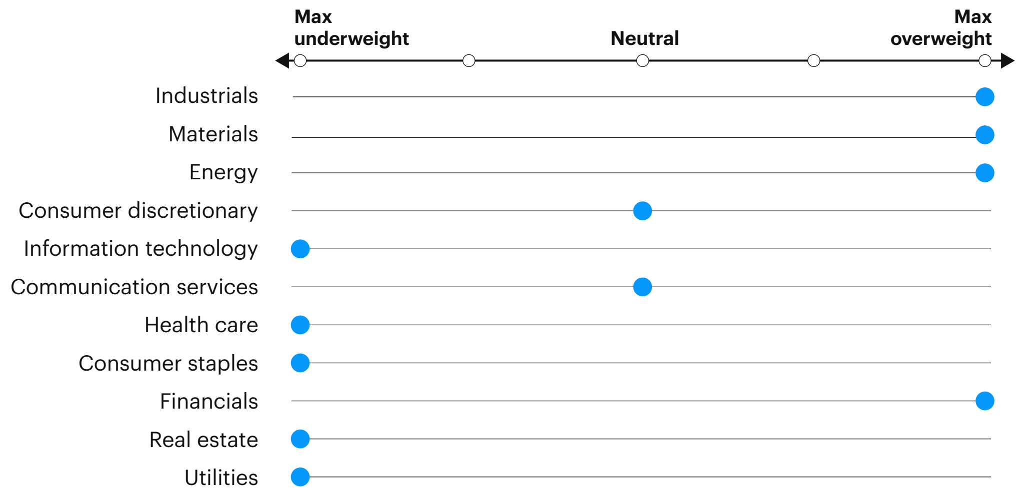
2 Credit risk defined as duration times spread (DTS).

Figure 7: Tactical factor positioning
Overweight value and small size; underweight quality, low volatility, and momentum



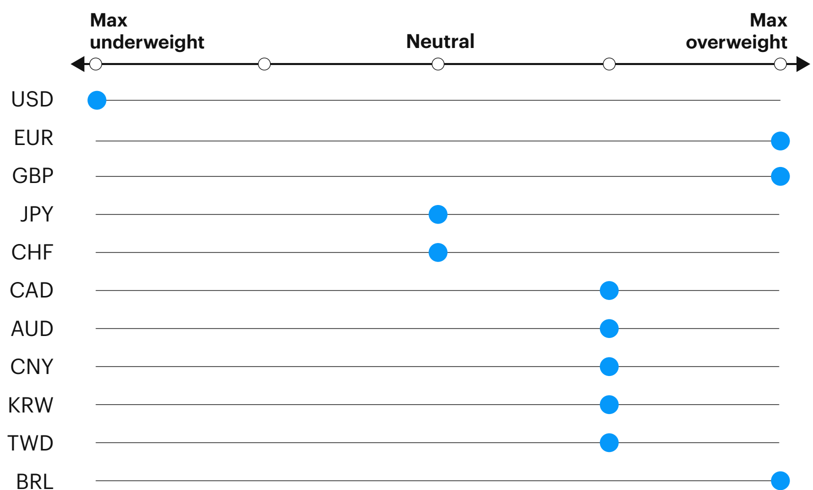
Source: Invesco Solutions, February 1, 2024. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

Figure 8: Tactical sector positioning
Sector exposures favoring cyclicals



Source: Invesco Solutions, February 1, 2024. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of December 2023, Cyclicals: energy, financials, industrials, materials; Defensives: consumer staples, health care, information technology, real estate, utilities; Neutral: Consumer discretionary and communication services.

Figure 9: Tactical currency positioning
Underweight the US dollar, favoring the euro and British pound within developed markets



Source: Invesco Solutions, February 1, 2024. For illustrative purposes only. Currency allocation process considers four drivers of foreign exchange markets: 1) US monetary policy relative to the rest of the world, 2) global growth relative to consensus expectations, 3) currency yields (i.e., carry), 4) currency long-term valuations.

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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