Invesco

Tactical Asset Allocation

Our macro framework dismisses recession risks and remains in an expansionary regime. We are overweight risk relative to benchmark, via equities, emerging markets, cyclicals, and value.

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Head of Tactical Asset Allocation,
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Synopsis

- Despite turbulent financial markets and the broad-based deterioration in leading economic indicators over the past month, our macro regime framework continues to dismiss recession risks at this stage, pointing to an expansionary regime ahead.
- We maintain an overweight risk stance relative to benchmark in the Global Tactical Asset Allocation model[1], overweighting equities relative to fixed income, primarily via emerging market equities, and tilting in favor of cyclical sectors and factors. We are neutral credit and underweight duration.

Macro update

Equity, credit, and government bond markets around the world experienced meaningful underperformance over the past month, hit by a confluence of adverse developments.

- First, central banks continue to increase their hawkish tone in response to stubbornly high and rising price pressures, with inflation statistics still printing well above market consensus. Markets are now pricing a slightly restrictive policy stance in the US and the UK, and a normalization of policy in the Eurozone back to positive deposit rates by year end[2]. The era of unconventional, ultra-accommodative monetary policy has effectively come to an end.
- Second, China continues to battle the spread of COVID-19 with renewed selective lockdown measures, which inevitably provide downside risks to growth and upside risks to inflation given their likely impact on local and global supply chains, transportation, and production channels.
- Finally, the conflict between Russia and Ukraine continues to impact market confidence, as the threat of energy supply shocks to the European continent skews future outcomes toward the poisonous mix of additional downside growth and upside inflation risks.

Our leading economic indicators declined noticeably over the past month, especially for the Eurozone, UK, and China. Unsurprisingly, consumer confidence, manufacturing surveys, and global trade were hard hit across European countries following the start of the conflict. In China, real estate surveys and housing indicators still point to weakness, which has led the People's Bank of China to ease policy.

Despite turbulent financial markets and the broad-based deterioration in leading economic indicators over the past month, **our macro regime framework continues to dismiss recession risks at this stage. On the contrary, it suggests growth expectations are likely to improve from here, anticipating an expansionary environment in developed markets and a recovery in emerging markets following a decline to below-trend growth rates** (**Figure 1 and Figure 2**).

1. Global 60/40 benchmark (60% MSCI ACWI / 40% Bloomberg Barclays Global Agg USD hedged)
2. Market pricing as of May 2, 2022 in Fed Funds futures and OIS markets.

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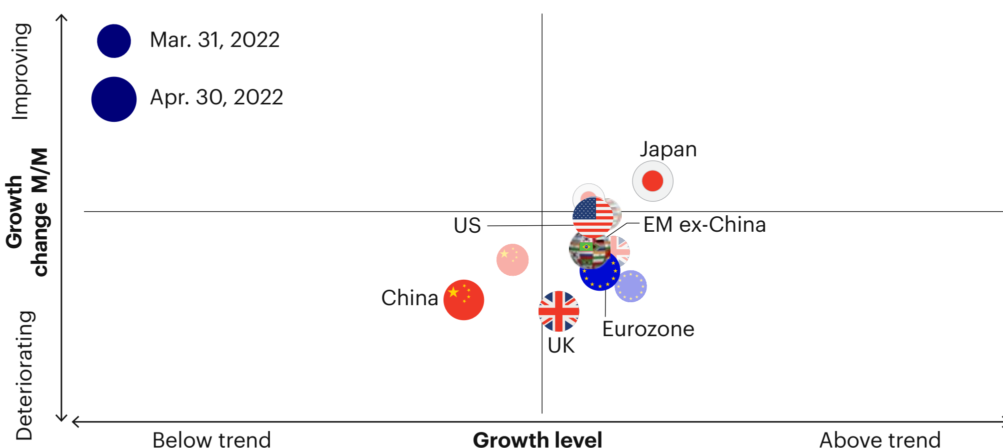
Growth expectations are likely to improve from here, anticipating an expansionary environment in developed markets and a recovery in emerging markets.

Figure 1a: Macro framework points to an Expansion regime

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

Figure 1b: Leading economic indicators declining, noticeably in Europe and China

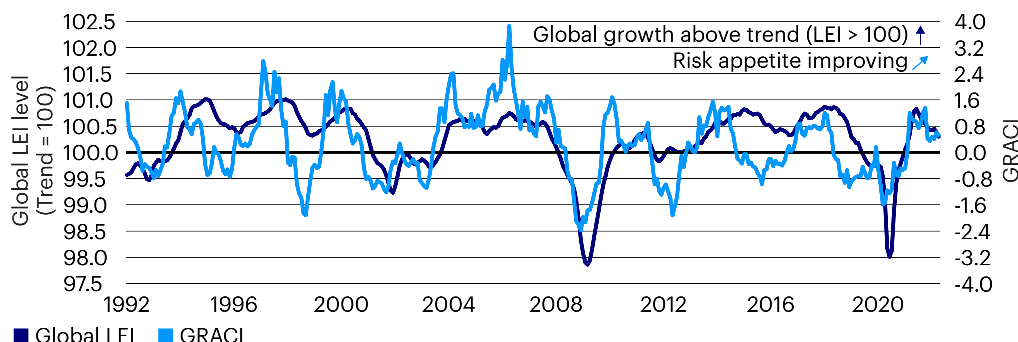


Sources: Bloomberg L.P., Macrobond. Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of Apr. 30, 2022. The Leading Economic Indicators (LEIs) are proprietary, forward-looking measures of the level of economic growth. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment.

The violent repricing of higher discount yields has not led to a repricing of lower growth expectations via lower equity or credit excess returns, which are directly related to growth risk in the economy.

Figure 2: Global risk appetite is accelerating, signaling improving growth expectations

GRACI and the global LEI



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Investment Solutions research and calculations, from Jan. 1, 1992 to Apr. 30, 2022. 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.

We discussed the drivers of this seemingly counterintuitive conclusion in our last note, and those considerations remain in place today. The violent repricing of higher discount yields has not led to a repricing of lower growth expectations via lower equity or credit excess returns, which are directly related to growth risk in the economy. Over the past month, for example, global equity markets and government bond markets have both posted large negative returns but performed roughly in-line, suggesting that, at least at this stage, the repricing in risky assets is largely due to a repricing in bond yields rather than deteriorating growth. Inflation remains the primary driver of markets, and we continue to register upside risks to inflation in the near term (**Figure 3**). In our opinion, downside surprises in inflation statistics may represent the most powerful catalyst for a rebound in markets, alleviating risks of excessively restrictive monetary policy.

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Figure 3a: US Inflation Momentum Indicator (IMI)

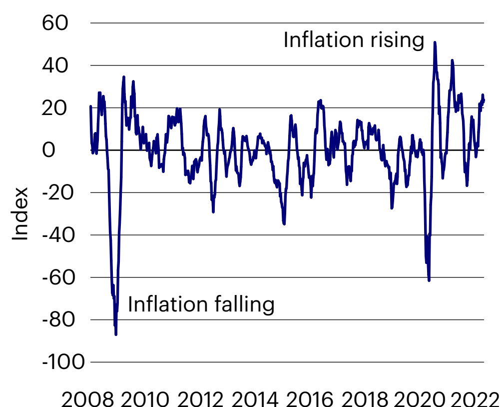
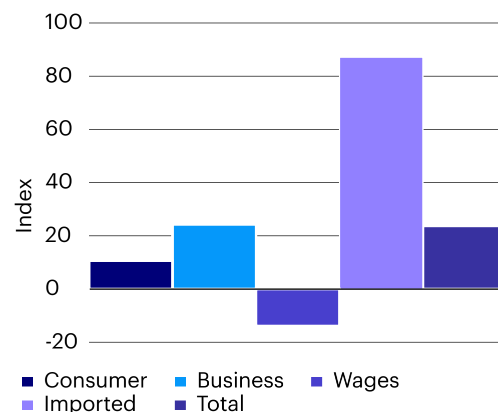


Figure 3b: IIS Inflation Momentum Indicator: Categories



Sources: Bloomberg L.P. data as of Apr. 30, 2022, Invesco Investment 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.

Investment positioning

We have implemented no changes in our portfolio over the past month and maintain an overweight risk stance relative to benchmark in the Global Tactical Asset Allocation model.[1] We are overweighting equities relative to fixed income, primarily via emerging market equities, and tilting in favor of cyclical sectors and factors. We maintain a neutral posture in credit risk[2], with a higher allocation to short and intermediate credit maturities, and remain underweight duration risk in aggregate while maintaining a flattening yield curve bias. **(Figure 4, 5, 6).** In particular:

- Within **equities** we overweight cyclical factors like (small) size, value, and momentum and favor cyclical sectors such as financials, industrials, materials, and energy at the expense of information technology, communication services, and other defensive sectors (Figure 6). From a regional perspective, we overweight emerging markets relative to developed markets as improving risk appetite and attractive valuations tend to benefit the asset class.
- In **fixed income** we remain overweight inflation-linked bonds relative to nominal Treasuries and concentrate our credit exposure in short-dated high yield and bank loans, with no exposure to emerging markets debt, seeking to harvest higher income per unit of risk rather than capital appreciation. We reduced the overweight in US Treasuries over other developed government bond markets given the reduced yield advantage on a hedged basis.
- In **currency markets** we remain underweight the US dollar, favoring the euro, Japanese yen, Canadian dollar, Singapore dollar, Norwegian kroner, and Swedish krona within developed markets. In EM we favor high yielders with attractive valuations such as Indonesian rupiah, Colombian peso, and Brazilian real. We underweight the British pound, Swiss franc, Australian dollar and Korean won.

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

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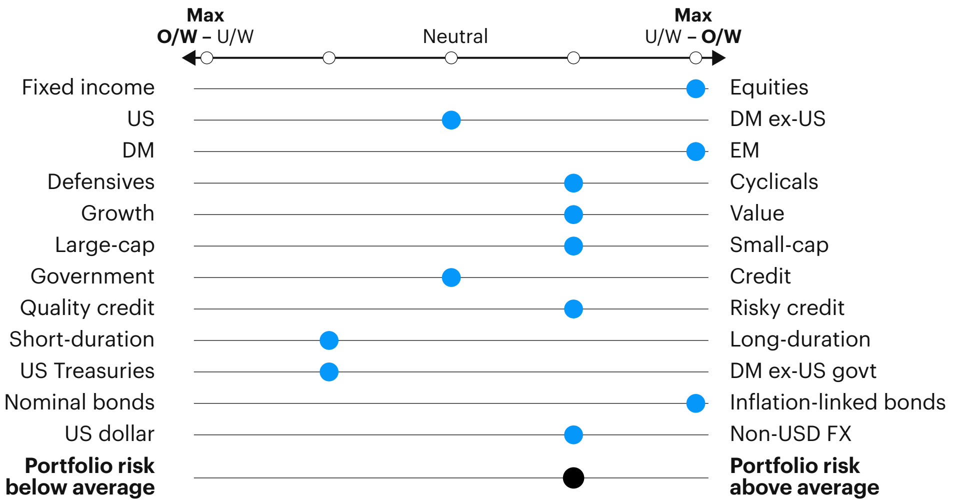
Figure 4: Relative tactical asset allocation positioning

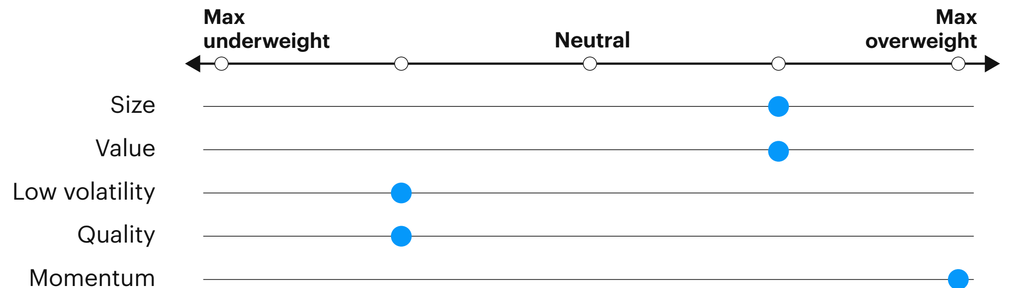
Positioning remains above average portfolio risk with an overweight to EM equities, cyclical factors and credit risk.



Source: Invesco Investment Solutions, Apr. 30, 2022. DM = developed markets. EM = emerging markets. FX = foreign exchange. For illustrative purposes only.

Figure 5: Tactical factor positioning

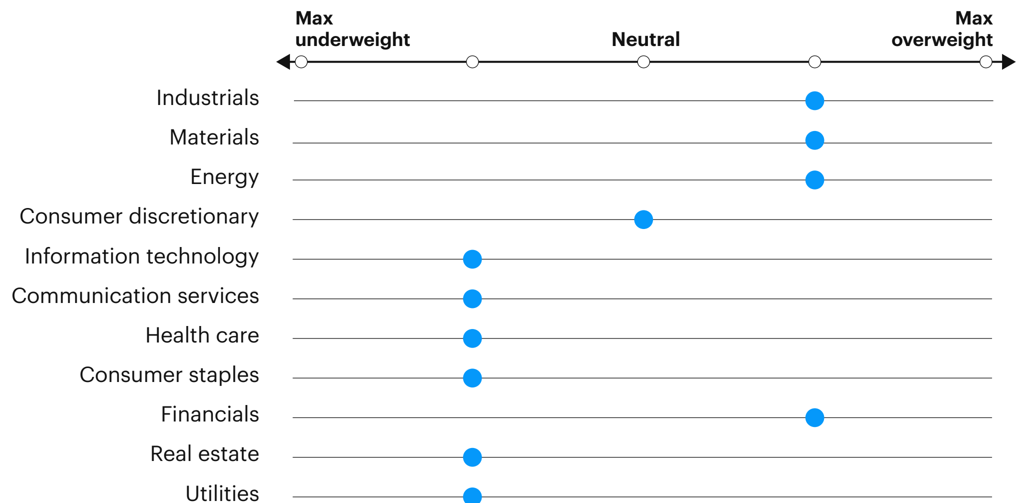
Factor tilts within the expansion regime are toward size, value and momentum



Source: Invesco Investment Solutions, Apr. 30, 2022. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

Figure 6: Tactical sector positioning

In an expansionary regime, sector tilts favor cyclicals relative to defensives.



Source: Invesco Investment Solutions, Apr. 30, 2022. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of April 2022, Cyclicals: energy, financials, industrials, materials; Defensives: consumer staples, health care, information technology, real estate, communication services, utilities; Neutral: consumer discretionary.

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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All information as of April 30, 2022, in USD, unless stated otherwise.

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