



## Tactical Asset Allocation

Market sentiment continues to improve, and Europe shows early signs of a rebound. We remain overweight risk relative to benchmark, via emerging and developed ex-US equities, cyclical factors, and risky credit.



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### Synopsis

- Improving risk appetite is indicative of near-term prospects for a recovery, increasing the likelihood of improving growth, led by a rebound in Europe.
- We overweight portfolio risk in the Global Tactical Asset Allocation model<sup>1</sup>, favoring emerging and developed ex-US equities, value, smaller capitalizations, and cyclical sectors. Overweight risky credit, neutral duration and underweight the US dollar.

### Macro update

Market sentiment continues to improve. Our barometer of global risk appetite posted another noticeable increase over the past month, led by outperformance in emerging market (EM) equities relative to developed markets, tightening in sovereign EM spreads and US dollar depreciation. This type of inflections in market sentiment have historically presaged an improvement in growth expectations and earnings momentum, as evidenced by the strong positive correlation – approximately 78% with a lead of 3-months - between global risk appetite and indicators of the global business cycle (**Figure 1, Figure2**). As a result, our framework confirms the increasing likelihood of a recovery in the global economy. In fact, our regional leading economic indicators suggest this recovery may be already underway in the Eurozone and the UK, in sharp contrast with market consensus and recent downward growth revisions by the European Central Bank and Bank of England. While it is premature to assume durability in this rebound, signs of stabilization in Europe provide an important signal of resilience in the region that is most vulnerable to economic and confidence shocks from the Ukraine/Russia war. Indeed, this rebound in European indicators is led by a bottoming out in consumer sentiment surveys and improving manufacturing business sentiment.

**Figure 1a: Macro framework points to a recovery in the global economy**

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

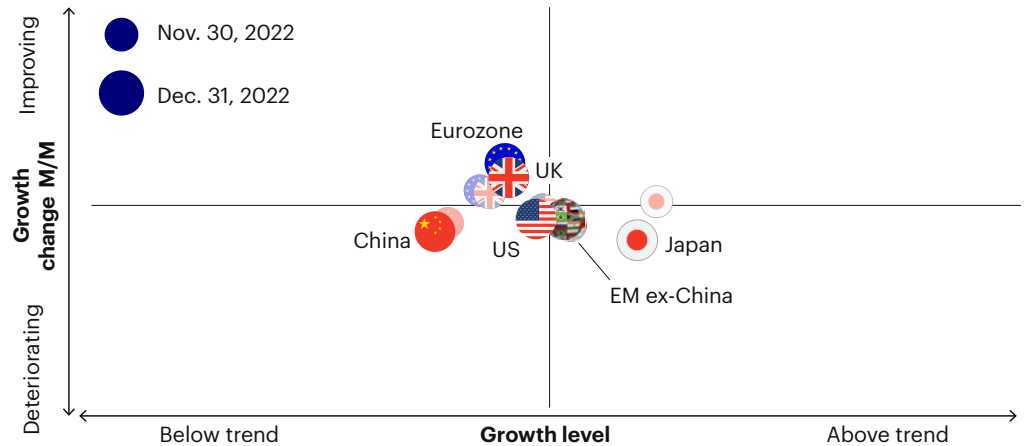
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1. Global 60/40 benchmark (60% MSCI ACWI, 40% Bloomberg Global Aggregate USD Hedged).



Our regional leading economic indicators suggest this recovery may be already underway in the Eurozone and the UK, in sharp contrast with market consensus and recent downward growth revisions by the European Central Bank and Bank of England.

**Figure 1b: Cyclical improvements in Europe, led by a rebound in consumer confidence surveys**



Sources: Bloomberg L.P., Macrobond. Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of Dec. 31, 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.



Inflections in market sentiment have historically presaged an improvement in growth expectations and earnings momentum.

**Figure 2: Market sentiment continues to improve, confirming near-term prospects of a recovery**

GRACI and the Global LEI



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Investment Solutions research and calculations, from Jan. 1, 1992 to Dec. 31, 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.



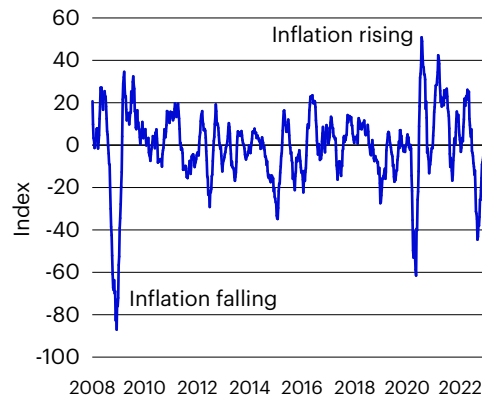
We interpret this recovery regime as a repricing of near-term recession risks in terms of timing, duration, or magnitude.

As discussed in our latest update, the expected improvement in growth is unlikely to represent the beginning of a new economic cycle given an unemployment rate near all-time lows. We interpret this recovery regime as a repricing of near-term recession risks in terms of timing, duration, or magnitude. Meaningful and persistent inversion in the yield curve is a reminder of elevated growth risks driven by tight monetary policy, and the Fed's objective to stay restrictive until inflation has converged back to 2%. On this front, the latest inflation reports in the US confirm a gradual abating of price pressures, with monthly inflation now converging towards long-term policy targets, i.e., 0.2%-0.3% month-over-month, increasing the likelihood of the Fed signaling a pause in the tightening cycle in Q1, further supporting the recent rebound in global risk appetite. Declining price pressures are also confirmed by our measure of inflation momentum across economic sectors (**Figure 3**).

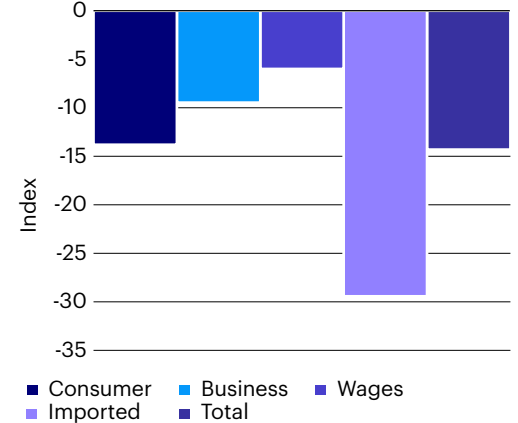


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**Figure 3a: US Inflation Momentum Indicator (IMI)**



**Figure 3b: IIS Inflation Momentum Indicator: Categories**



Sources: Bloomberg L.P. data as of Dec. 31, 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

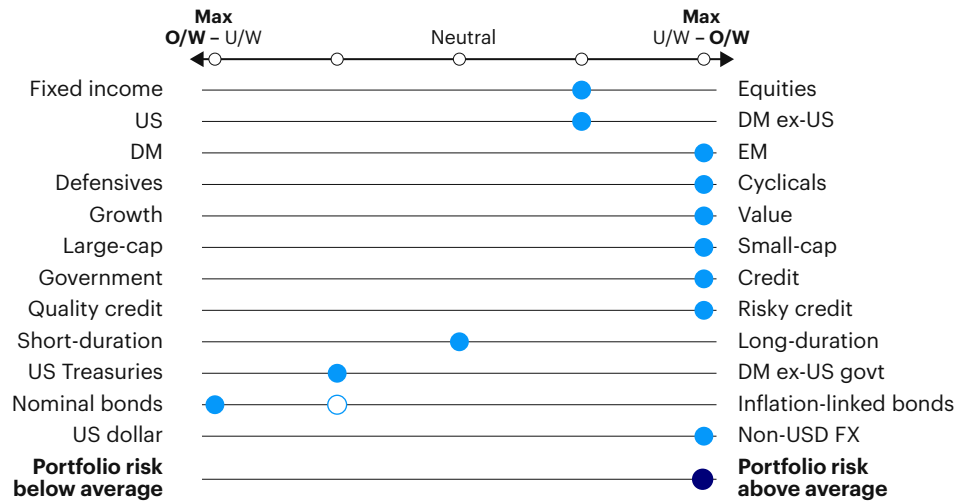
**We maintain an overweight risk stance in the Global Tactical Allocation Model relative to benchmark, favoring equities over fixed income, overweighting emerging markets, cyclical sectors, and factors (value, small/mid-caps). We overweight credit risk through high yield, loans, and emerging markets debt relative to investment grade credit, and stay neutral on duration. We remain underweight the US dollar (Figure 4, 5, 6, 7).**

In particular:

- Within **equities** we overweight cyclical factors with high operating leverage such as value and (small) size, while we underweight defensive factors as low volatility and quality. We underweight momentum as inflection points in the market cycle tend to generate reversal effects between recent winners and losers. 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 overweight emerging markets and developed ex-US equities, supported by improving risk appetite, expectations for US dollar depreciation, and confirmation of improving economic momentum in Europe.
- In **fixed income** we overweight risky credit via high yield, bank loans and emerging markets hard currency debt, given above average spreads and improving risk appetite. In this environment of below trend and improving growth, risky credit offers an attractive tactical opportunity for equity-like returns with lower volatility. The exposure is funded from investment grade and government bonds, while we maintain a neutral duration stance relative to benchmark. We expect additional compression in breakeven inflation expectations as inflation momentum continues to slow, hence favor nominal over inflation-linked bonds.
- In **currency markets** we remain underweight the US dollar, as global growth is outperforming relative to expectations and recovery regimes are typically accompanied by strong reflationary flows into non-US assets. While yield differentials still support the US dollar relative to foreign currencies, expensive valuations provide headwind to the greenback when safe-haven flows are abating. Within developed markets we favor the euro, the British pound, Norwegian kroner and Swedish krona relative to the Swiss Franc, Japanese yen, Australian and Canadian dollars. In EM we favor high yielders with attractive valuations as the Colombian peso and Brazilian real, relative to low yielding currencies as the Korean won, Taiwan dollar and Chinese renminbi.

**Figure 4: Relative tactical asset allocation positioning**

Overweight portfolio risk vs. benchmark, overweight equities, credit, emerging markets and cyclicals

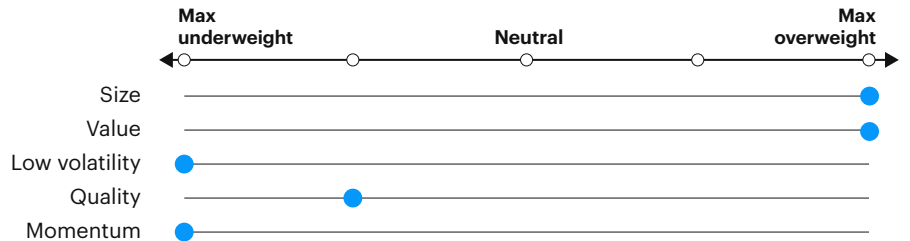


● Current positioning ○ Prior positioning

Source: Invesco Investment Solutions, Dec. 31, 2022. 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.

**Figure 5: Tactical factor positioning**

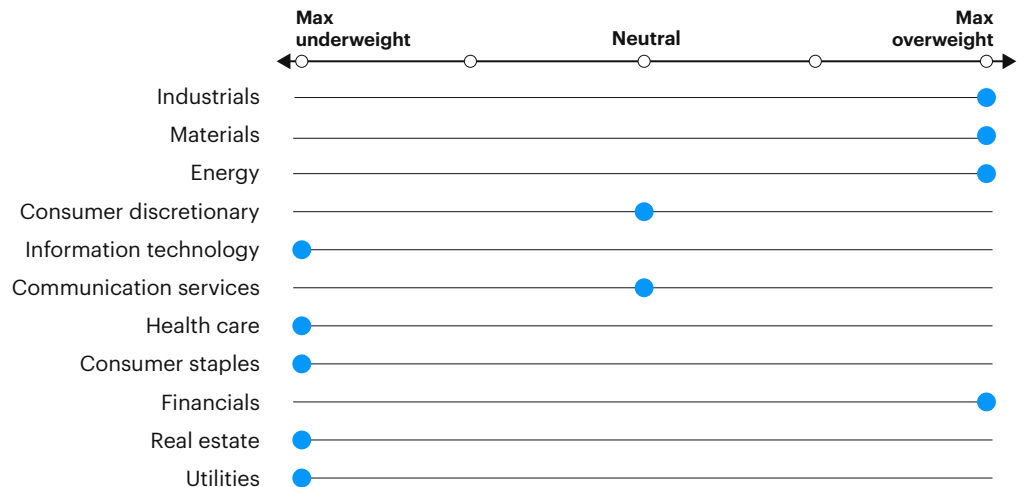
Overweight size and value



Source: Invesco Investment Solutions, Dec. 31, 2022. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

**Figure 6: Tactical sector positioning**

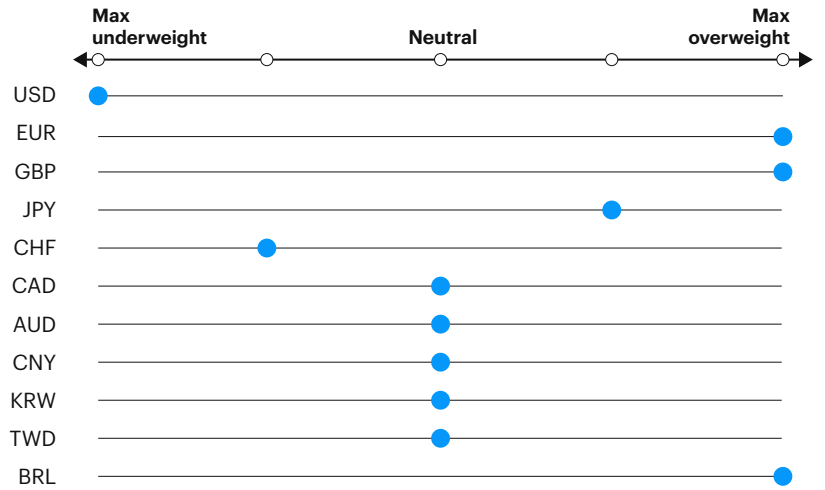
Sector exposures tilted towards cyclical sectors



Source: Invesco Investment Solutions, Dec. 31, 2022. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of November 30th, 2022, Cyclicals: energy, financials, industrials, materials; Defensives: consumer staples, health care, information technology, real estate, communication services, utilities; Neutral: consumer discretionary.

### Figure 7: Tactical currency positioning

Underweight US dollar exposure in a cyclical recovery with global growth outperforming expectations



Source: Invesco Investment Solutions, Dec. 31, 2022. 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

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