# Henley Multi Asset Team

# Tactical asset allocation views: A more balanced outlook, but still equity positive

**31 March 2022**

**This document is for Professional Clients only and is not for consumer use.**


**Synopsis**

Our overall preference for equities over bonds remains, as we still believe that equities are better placed than many asset classes to handle the current inflationary environment, should it persist. We are mindful that this environment is one of slowing (albeit robust) growth, high inflation that will be countered by rising central bank interest rates, and an on-going uncertain geo-political backdrop. However, we think growth is likely to remain robust enough to be supportive of risk assets over our tactical timeframe.

We upgrade our view of fixed income to neutral now that yields are significantly higher across the fixed income spectrum. As such, within fixed income we have upgraded our view of government bonds (led by US treasuries) and global investment grade credit to neutral. We also upgrade high yield credit and emerging market debt from neutral to overweight given the attractive absolute yields available.

Within the equity space we have upgraded emerging market equities on an improving policy backdrop in China and potential for an improved earnings outlook for those markets that tend to benefit from higher commodity prices. We also upgrade Japanese equities - which are seemingly unloved - to overweight given improved valuations. Currency has been a headwind for Sterling investors in Japan over the last year and that may now subside. We downgrade Pacific ex Japan equities to neutral due to a worsening policy backdrop, and also downgrade real estate to neutral.


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.

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

**Macro overview**

In recent months, markets have been driven by geo-political concerns and rampant inflation from higher energy inputs, which has led to a rise in market interest rates and volatility in equity markets. Central Banks are now potentially needing to play 'catch-up' and tighten monetary policy more aggressively than the market was pricing towards the end of 2021. An illustration of this can be found in the 2-year US treasury yield, which was 0.5% at the end of November last year and 2.4% at the end of March this year. The market is pricing more than 200bps of US interest rate hikes in quick succession. The result has been a rise in market yields to the extent that there is now more value to be found in government bonds and in credit – both investment grade and high yield. Although it should be noted that the spectre of inflation remains, which can be damaging to the value of bonds, so caution is required here.

Inflation levels are still very high, exacerbated by the conflict between Russia and Ukraine (energy prices) and the 'zero covid' policy induced lockdown in China, which has exacerbated the supply shortage issue. Additionally, much of the world's economy is still bouncing-back from various forms of lock-down, leading to pent-up demand outstripping the supply of both goods and, increasingly, services. While it is difficult to predict exactly when inflation may peak, there are reasons to believe that we may be near that point. In the US, used car prices – a significant component of the inflation measure – have begun to come down. Similarly, shipping rates have begun to ease also, and energy prices are off the highs.

Slowing economic growth is another issue that investors are grappling with, and there is increasing talk of recession with US mortgage rates at relatively high levels and concerns over corporate margins. Our view is that economic growth will likely remain robust, many corporates will benefit from pricing power in this inflationary environment driving strong sales growth, and that the likelihood of a recession this year remains low. Rather than stalling, we think the nature of the post-pandemic recovery is changing - moving from a goods-driven recovery to a services-driven one.

While many equity markets have fallen this year, they are still at high levels. However, valuations are now more attractive due to a combination of multiples compressing and earnings increasing. While this 'de-rating' may continue in the short-term, our longer-term equity risk premium suggests equities remain reasonably good value, relative to government bonds and cash.

**Tactical asset allocation**

| | | Overweight A | Overweight B | Neutral C | Underweight D | Underweight 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 31 March 2022. [1]Developed Asia. *Indicates an upgrade or downgrade.

## Equities

### Overall — B: Overweight

Our overall preference for equities over bonds remains, as we still believe that equities can outperform from here over our tactical timeframe. Valuations are more attractive due to a combination of continued earnings growth and multiple compression. We are mindful that the environment is one of slowing economic growth, potentially sustained inflation, and an uncertain geo-political backdrop. However, we think growth is likely to remain robust and that corporate revenue growth will be strong given the higher pricing power that corporates enjoy in this environment. Corporate profit growth will likely slow from recent strong levels but given the extent of downgrades seen due to the conflict in Ukraine, there is some potential for positive surprises relative to current market expectations.

### US equities — C: Neutral

US equities continue to appear expensive, both in terms of absolute valuations and relative to other equity markets. Rates are rising faster in the US than in most other regions and the growth-oriented nature of the US equity market makes it less attractive in this potential rotation away from such assets. More positively, US earnings and particularly sales growth, continues to be strong while the economy remains robust. It appears that US consumers still have cash to spend, and buybacks have increased. We remain neutral on the market overall.

### Japan equities — B: Overweight

*Upgraded from C*

We upgrade Japanese equities to overweight, driven by further improved valuations and technical factors which show the market is extremely unloved. The Japanese market is typically one of the most sensitive to global growth and is therefore well placed to benefit from the ongoing post-pandemic recovery. Corporate balance sheets remain strong which should provide support for dividends, and the policy framework remains helpful. Less positively, Japan is an oil importer which could be a headwind at current high prices, and we are mindful that the Japanese market typically has low margins and low return-on-equity when compared to other major regions, despite recent improvements. However, we feel that current valuations compensate for these risks. Currency has been a notable headwind for unhedged Sterling investors over the last year and there is potential for this to subside.

### Europe ex UK equities — B: Overweight

Valuations and technical factors are supportive of European equities, which appear unloved. Unsurprisingly, the situation in Ukraine has been the headwind for the market, but European equities are now broadly back up to pre-invasion levels. Earnings expectations have been downgraded markedly, which provides some positive revision potential. The sector mix in value sectors such as banks and energy is helpful in the current environment. Additionally, overseas exposure to the wealthy consumer – particularly via luxury goods and autos - may provide further support should global growth remain robust. Ongoing Russia/Ukraine tension and economic sensitivity to energy supplies could remain a headwind.

### Emerging markets equities — B: Overweight

*Upgraded from C*

We upgrade emerging market equities to overweight. They have significantly underperformed their developed market counterparts over the last 12 months but there are reasons to be more positive looking forward. Our view of Asia is helped by an improving (or less bad) policy backdrop in China, which appears to show a pause in market-unfriendly regulatory policy, increased investment spending and the potential for lower interest rates. Elsewhere in emerging markets, EMEA is attractive due to cheaper valuations, high commodity prices, and a resultant improving earnings outlook. Valuations in Latin America have improved also.

### 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. There is potential for this to continue. Despite this strong performance, UK equities are still generally unloved by investors and valuations versus history and other major equity markets remain attractive. Brexit disruption continues to be a policy drag and trade issues remain unresolved. We prefer UK large caps to UK small- and mid-caps.

### Pacific ex Japan equities (Developed Asia) — C: Neutral

*Downgraded from B*

The composition of the market is heavily tilted towards areas such as financials, materials and real estate which are potential beneficiaries of an inflationary environment. While the region comprises four countries, Australia accounts for just over 60% of it. Recent performance has therefore unsurprisingly been very strong relative to many other regions. Following this strong performance valuations are now neutral, with policy less supportive. We downgrade to neutral.

## Fixed Income

**Overall** — **C: Neutral**
Upgraded from D

We upgrade our view of fixed income to neutral now that yields are significantly higher across the fixed income spectrum. As such, within fixed income we have upgraded our view of government bonds (led by US treasuries) and global investment grade credit to neutral. We also upgrade high yield and emerging market debt from neutral to overweight given the attractive absolute yields available.

### Government bonds — C: Neutral
*Upgraded from D*

The emergence of value in US Treasury bonds and UK Gilts has continued as yields have risen further. Yields in the US are now higher than the US equity market dividend yields, and comparable to total shareholder yield, which also includes buybacks. Government bonds now offer better diversification potential for multi asset investors; however, we are mindful of the risk of rising rate/inflationary environment, particularly for longer duration investors. For Sterling-hedged investors, US Treasury yields are attractive.

### High yield bonds — B: Overweight
*Upgraded from C*

A combination of relatively high government bond yields and wide spreads means that absolute yields for this asset class are attractive in a world of still relatively low yields. The high yield market is typically shorter duration in nature than government bonds or investment grade credit and is therefore potentially less susceptible to weakness from a rising rate/inflationary environment. We remain mindful that defaults could start to pick up as the growth environment slows and policy is normalised, though net issuance is very low at present. Corporates are typically increasingly levered, but the corporate earnings recovery means value can be found in this market as returns can still be positive even if yields continue to rise.

### Investment grade credit — C: Neutral
*Upgraded from D*

Absolute yields in investment grade are now more attractive given the rise in government bond yields and credit spreads. While the risk/reward opportunity is not compelling, it has improved markedly. 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, the continuation of the robust economic recovery should be supportive, and many corporates have long term funding in place.

### Emerging market debt — B: Overweight
*Upgraded from C*

We upgrade emerging market debt to overweight. Many emerging economies are closer to the end of their interest rate hiking cycles, which when combined with very high absolute yields, means that in this part of the fixed income universe valuations now look attractive. In addition, many emerging market debt issuers have benefited from rising commodity prices, which has strengthened their economies. However, elections in areas like Brazil and South Africa may lead to some volatility. 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** — **B: Overweight**

Traditional equity and bond markets are at elevated levels despite recent weakness. Depending on the nature of the strategy, alternatives can help to dampen volatility and provide less correlated sources of return. We have a positive view on the broad asset class given that there is less reliance on traditional markets.

### Real estate — C: Neutral
*Downgraded from B*

The global listed real estate sector has the potential to offer some inflation protection, and in our view valuation remains supportive. In some regards, the uncertain outlook for the sector is abating as a more 'normal' world of property use can be envisaged in the medium-term. The diverse nature of the market means that there are opportunities within the sector and across regions. However, we are mindful of the potential impact of a rising rate environment on this area of the asset class hence we have moderated our rating to neutral.

### 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** — **C: Neutral**

Cash also offers the ultimate capital protection which is valuable when equity and bond levels are high or if there is another economic downturn. Yields have yet to rise to the level of government bonds, but this could happen within a year or so on current forecasts.

## 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.

## Important information

This document is for Professional Clients only and is not for consumer use.

All data in this document as at 31 March 2022 unless otherwise stated.

Where individuals or the business have expressed opinions, they are based on current market conditions, they may differ from those of other investment professionals and are subject to change without notice.

This document is marketing material and is not intended as a recommendation to invest in any particular asset class, security or strategy. Regulatory requirements that require impartiality of investment/investment strategy recommendations are therefore not applicable nor are any prohibitions to trade before publication.

Issued by Invesco Fund Managers Limited
Perpetual Park, Perpetual Park Drive, Henley-on-Thames, Oxfordshire RG9 1HH, UK
Authorised and regulated by the Financial Conduct Authority

EMEA2022/2165475