Invesco

Henley Multi Asset Team

Tactical asset allocation views

31 January 2022

Synopsis

Our asset allocation is unchanged, maintaining a preference for equities over bonds and cash. We still consider equity markets expensive in absolute terms, particularly US equities, but they are supported in our view by relative valuations (versus fixed income) and recent market weakness. Having tempered our bullishness in the last quarter of 2021, we are now a little more optimistic given current equity market levels but mindful of risks, including geo-political developments in Russia.

Here you will find the Henley Multi Asset team's fundamental tactical asset allocation views, with an A-E rating for each asset class over a 1-3 year investment horizon.

These views are powered by the team's 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.

Summary

Geo-political risk has come to the fore in recent weeks with increasingly concerning rhetoric from Western leaders in recent weeks over the build-up of Russian military forces at the border with Ukraine. Naturally, this has been unhelpful for risk assets and we expect this to create some short-term volatility.

Inflation has been the more persistent theme for markets in recent months, and rates have reacted accordingly. This has had quite profound implications for both equity and bond markets. Yields have spiked dramatically as investors price in a number rate rises in the US. Growth-oriented equities, which tend to be 'longer-duration' (more interest rate sensitive), sold off markedly. Value-oriented equities experienced a less pronounced downward move. This dynamic also led US equities to underperform the rest of the world.

Another key issue that the market is seemingly grappling with is whether the global economy will roll over into recession, or whether this is just an early-to-mid cycle slowdown? Our view is that it is more likely to be the latter and hence we remain constructive on risk assets. While global PMIs have moderated somewhat, they remain above the level considered to be expansionary. Despite economic growth rates peaking, we think the outlook remains robust, with strong underlying growth. This should support a positive outlook for profits which, along with relative valuations, drive our preference for equities over bonds and cash.

In addition, the equity risk premium is at attractive levels relative to history, and equities also have high relative carry through a growing dividend yield which is attractive versus other assets. The "real asset" characteristics in a rising inflation world are also potentially helpful. We are cognisant of the potential for margins to come under pressure, and the subsequent impact on corporate earnings should that transpire. However, corporate pricing power seen in some areas of the market indicates that the improvement in margins experienced thus far may be well supported.

Despite some tightening, the policy environment remains supportive for equities, with policy makers keeping the monetary and fiscal 'taps' on.

We believe interest rates are set to remain range bound, ensuring that debt costs should be manageable. However, there is acknowledgement that interest rates remain vulnerable to both further inflation shocks and to central banks tightening policy in the next few years. Within rates markets the US is starting to offer some value given how far yields have risen.

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 31 January 2022. 1Developed Asia. *Indicates an upgrade or downgrade.

Equities

Overall — B: Overweight

We believe equities can outperform as relative valuations remain supportive, particularly when compared to government and corporate bonds. Corporate earnings have generally been beating expectations and while guidance from management teams is a bit weaker than hoped, analysts are posting more upgrades than downgrades still which, in our view, should support stocks. Margin pressures are a potential concern but pricing power appears robust. Equity valuations are not yet in bubble territory and policy should continue to be broadly supportive over our tactical timeframe, despite some tightening.

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 continue to be strong, it appears that US consumers still have cash to spend, and buybacks have increased. We remain Neutral on the market overall.

Japan equities — C: Neutral

Japanese corporate balance sheets remain strong which should provide support for dividends, and the policy framework remains helpful. 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. Domestic investors are seemingly repatriating capital from overseas, which could be supportive. However, the market has low margins and low return-on-equity when compared to other major regions. It is also an oil importer, which could be a headwind. Having downgraded to neutral in our last update, we remain so in our view.

Europe ex UK equities — B: Overweight

Valuations and policy remain supportive, and earnings surprises are strong - albeit from relatively low expectations which we highlighted as pessimistic in our last update. Sales surprises are also looking positive. The sector mix means that overseas exposure to the wealthy consumer – particularly via luxury goods and autos - may provide further support going forward. However, the proximity to ongoing Russia/Ukraine tension and sensitivity to energy supplies could be a headwind.

Emerging markets equities — C: Neutral

Emerging market equities are generally unloved and in valuation terms now appear cheap overall following pronounced market weakness. However, within emerging markets it should be noted that there has been stark performance between China and the rest. Over the past year, Chinese equities have fallen heavily given uncertainty over changed political priorities in China and are deeply 'unloved'. Over the same time frame, the emerging markets ex China has been range-bound to marginally positive but have underperformed developed market counterparts until recently. In emerging Europe, ongoing Russia/Ukraine tensions could exacerbate market volatility in the short-term.

UK equities — B: Overweight

Brexit disruption continues to be a policy drag and trade issues remain unresolved, however UK equities are notably unloved by investors and valuations versus history and other major equity markets remain attractive. The sector composition of the UK equity market means potential for a commodity-related tailwind given exposures to energy and materials sectors. Similarly, Sterling weakness may support UK large caps, which tend to be overseas earners.

Pacific ex Japan equities (Developed Asia) — B: Overweight

Valuations are reasonable, corporate margins are high and the region offers a relatively high dividend yield. Earnings remain below trend and are rising. However, while return on equity is improving, it is low relative to other major regions. 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 the region. The Royal Bank of Australia hiking less slowly than anticipated could allow for some re-rating here.

Fixed Income

Overall — D: Underweight

Fixed income remains unattractive at the asset class level with a significant proportion of the fixed income market offering limited value. Spreads on corporate bonds are still tight, particularly in investment grade where yields are extremely low, leading us to prefer higher yielding assets, where yields remain relatively attractive in a world of very low interest rates, and investors are better compensated to take risk.

Government bonds — D: Underweight

Despite rising yields, value in government bonds remains limited though we do note the emergence of some value in US Treasury bonds and UK Gilts as yields have risen notably. While government bonds can offer ballast to portfolios in declining markets, the potential for them to offer a great deal of offsetting upside, as has been the case for a couple of decades, is diminished when the starting point for yield is as low as it currently is. Nonetheless, government bonds remain an important asset in a multi-asset portfolio.

High yield bonds — C: Neutral

High yield bond spreads remain narrow but on balance we think they are likely to be supported as absolute yields remain relatively attractive in a relatively low (to history) interest rate environment. 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. 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 back up. Remain Neutral.

Investment grade credit — D: Underweight

Investment grade spreads remain tight despite recent market movements, which in our view means that the asset class offers limited risk/reward opportunities. 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. The total level of yield on offer is low and for a GBP-hedged investor, the highest yields are to be found in GBP and USD investment grade bonds.

Emerging market debt — C: Neutral

Emerging market debt valuations look attractive, and the asset class is arguably under-owned. Synchronous global growth should be supportive of investor flows into the asset class. This is one of the few areas of the rates markets where positive real yields are available. 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. We note that GBP-hedged yields are markedly lower than unhedged yields.

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 — B: Overweight

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.

Absolute return strategies — C: Neutral

In periods of increased market volatility, absolute return strategies can exploit valuation dislocations and provide potentially defensive properties for portfolios. In a potentially low return environment for government bonds and cash, these strategies provide a return potential that is lowly correlated to traditional asset classes.

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. Having upgraded to neutral in our last update, we remain so.

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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