Invesco

Henley Multi Asset Team

Tactical asset allocation views: Help on the way?

31 December 2023

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Synopsis

Our overall view of asset classes remains unchanged from last quarter, despite the strong performance seen in the last weeks of 2023. Monetary authorities are now more able to cut interest rates as inflation rates continue to fall and economic growth rates remain generally subdued. This has started to be discounted into most asset prices, to the benefit of our funds and current positions. We still believe that we are in the early stages of the monetary easing cycle, and that as inflation continues to fall (and economic growth is relatively subdued), monetary authorities have increasing scope to cut interest rates.

While our view of equities is 'neutral' overall, there are opportunities within the asset class. While the US looks expensive (and highly concentrated) after a strong run, outside of the US most markets are much less expensive. The UK and Emerging Markets appear good value, with both markets at multi decade lows in valuation terms relative to global equities. Small and mid-cap (SMID) equities globally also offer good value in our view and have only recently started to perform after a period of relatively weak returns. While the outlook is still uncertain for listed real estate, our view is that the geographic and sector diversity of the asset class, along with a significant valuation discount to NAVs across geographies, provides good performance potential from here.

Fixed income overall remains 'overweight', with good yields still on offer across bond markets despite the year-end rally. Government bonds remain attractive sources of income, and in our view continue to offer diversification potential for multi asset investors at these yields. Elevated yields in high yield credit and emerging market debt keeps us overweight, although we note that high yield spreads have tightened, and issuance has been unusually low. Investment-grade credit still appears a relatively crowded trade and low spreads make other fixed income markets more attractive in our view, with investors likely better taking duration exposure via government bonds. We remain negative on UK cash, despite the high yields on offer, as we believe rate cuts will start within our tactical time frame. We think that other assets offer a better relative return from here, on a three-year horizon.

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 one to three-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.

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

Macro outlook

Our judgement is that we are likely still in a constructive phase of the investment cycle, with evidence of policy relief and disinflation alleviating economic growth concerns. While we acknowledge concerns around economic growth, recent evidence suggests that the global economy and corporate sector remains reasonably resilient, corporates and households are in reasonably good shape, particularly in the US, given they 'termed-out' debt at low interest rates during Covid. Many US corporates are actually beneficiaries of higher interest rates due to the high levels of cash they have on their balance sheets, and the consumer still has some excess savings and has benefitted from a strong domestic equity market. The housing market is also much less sensitive to interest rates than it was 15 years ago. With disinflation a feature across most major economies, many central banks are now expected to cut interest rates within our investment window of one-to-three years. This should be supportive for asset prices generally, barring a major recession – which is not our central case.

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		●			
Cash	**Overall**					●

Source: Invesco, as at 31 December 2023. [1]Developed Asia. *Indicates an upgrade or downgrade.

Equities

Overall — C: Neutral

The prospect of broader and more imminent rate cuts keeps our view of several equity markets positive, but we are wary of the extended valuation and concentration of the US market. The prospect of looser monetary policy in the UK, (as well as parts of EM) makes us overweight these markets and should help property REITS and global small caps continue with their nascent recovery.

We are mindful of the potential for shorter-term volatility driven across the globe by unfavourable labour market weakening, the delayed effect of high interest rates increasing bad debts in both the corporate and personal sectors, and tight credit conditions . However, the increased evidence of economic resilience along with falling interest rates will likely positively impact most asset markets and continue to drive returns.

US equities — C: Neutral

US equity valuations are fair value at best relative to history, even when excluding the tech sector. Relative to high yielding US fixed income and credit, and many other regional equity markets, US equities remain expensive. Technical indicators suggest that the market is less under-owned and unloved than it has been. New technology prospects via 'AI' could continue to drive returns but the market is now as concentrated as it has been for decades, which gives us reason to temper our enthusiasm a little. Corporate profits expectations have weakened very recently but the level of profitability and the economy have both remained relatively resilient as consumers and corporates have termed out much of their debt, lessening the impact of the higher rates environment to-date.

Japan equities — C: Neutral

Japanese equities are less attractive from a valuation perspective following recent strong performance, driven in part by a weak yen. We are mindful that the Japanese market typically has a low margin and low return-on-equity when compared to other major regions, but that does provide room for the market to catch up. Indeed, over the last decade, Japanese earnings growth compares favourably to the US market. The profits outlook continues to improve, driven in part by positive yen translation effects of overseas earnings and general Asia demand. It is worth noting strong local (yen) currency market returns this year have been experienced by sterling investors.

Europe ex UK equities — C: Neutral

China economic activity and lower energy prices in Europe generally remain a positive for the region, and the recent downward adjustment in rate expectations has helped drive strong performance. However, earnings expectations have faltered a little recently and valuations remain fair rather than compelling.

Emerging markets equities — B: Overweight

Our view on emerging market equities is positive across the board. From a valuation perspective, these markets appear cheap, but the policy environment is becoming more supportive as monetary conditions loosen in more economies as more central banks start to cut interest rates. Also, Chinese policy support may help investor sentiment and cause a positive ripple effect across the region, given the recent disappointing growth out-turn.

UK equities — B: Overweight

Reasonable valuations, earnings improvements, and the unloved nature of the market, cause us to remain overweight UK equities. Monetary policy is expected to loosen noticeably as inflation (though too high) has surprised to the downside. Market interest rates, including mortgages, are now falling which should help re-rate equity valuations. We note that small and mid-capitalisation stocks remain at historically low valuations and retain outperformance potential relative to some other markets from here over our timeframe.

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

The composition of the market is heavily tilted towards areas such as materials and real estate. While the region comprises four countries, Australia accounts for just over 60% of the region and the sensitivity of earnings to commodities is high. Valuations are still less attractive overall, even though Hong Kong remains cheap. Earning growth expectations have also moderated suggesting a corporate slowdown. We remain of a Neutral view as a result.

Fixed Income

Overall — B: Overweight

Our view of fixed income remains constructive as yields in most developed and emerging market sovereign bonds, and high yield credit, still offer good relative value compared to other asset classes, despite the rally seen in the last couple of months of 2023. Government bond yields should benefit from lower interest rates over our tactical time horizon, driven by falling inflation. While spreads have tightened, credit also remains attractive. High yield credit and emerging market debt yields have come lower but are still relatively attractive. We prefer these other asset areas compared to investment grade credit where spreads are low.

Government bonds — B: Overweight

Our overall view on government bonds remains overweight, despite the fall in yields in the US and other regions, as markets have not yet discounted the full extent of the potential rate cutting cycle in the major developed economies. UK gilts offer value as the prospect of central bank policy easing has increased as inflation falls quicker than expected. Our view of Europe is more neutral as yields are lower and we still worry about sticky inflation, despite weak growth and a less reactive ECB. Japanese government bonds (JGBs) appear vulnerable to a change in yield curve control given concerns by the authorities that inflation is too high for yields to remain anchored. A potential market shift from inflation concerns to growth concerns would be supportive for the asset class.

High yield bonds — B: Overweight

We continue to note the value on offer in high yield credit and the fact term funding by most corporates was put in place during the low yield era of the Covid pandemic. With this benign funding cycle in place, a reasonable profits outlook in many developed economies, the sector remains attractive. The relatively short duration of the asset class mean it may benefit noticeably as the short-end of the interest rate curve continues to discount central bank rate cuts. We remain mindful that defaults could start to pick up as the credit cycle remains tight, but that so far appears limited to the lowest quality names that are a minority of the sector. We feel that at these yield levels the asset class offers a potentially valuable 'buy and hold' option over our tactical timeframe.

Investment grade credit — C: Neutral

Demand for the investment grade credit remains high, with many issuances oversubscribed and by multiples in some cases. Our view of the asset class remains neutral as spreads look tight relative to the alternative return available from both emerging market and some developed market government bonds, as well as high yield credit. While investment grade credit remains a useful portfolio holding, other asset areas offer a better overall risk-reward potential going forwards in our view.

Emerging market debt — B: Overweight

Emerging market bond yields remain attractively high relative to developed market investment grade credit and offer similar yields to high yield credit. The sector will continue to benefit as more central banks in the region start to cut policy interest rates and also if US sovereign yields keep falling. . Emerging market economies also appear quite robust having benefited from a weaker dollar, but also the potential for a pick-up in trade and commerce as Asian and China economic growth continues. There are rewards for those prepared to accept risk, but leverage continues to rise at the country level in emerging markets and the political backdrop is generally less stable and often idiosyncratic.

Alternatives

Overall — C: Neutral

Traditional equity and bond markets could experience periods of volatility and corrections given the recent strong asset performance. Depending on the nature of the strategy, alternatives can help to dampen volatility and provide less correlated sources of return. However, there are potentially more attractive opportunities to be found elsewhere in traditional asset classes at present given the better value available.

Real estate — B: Overweight

The outlook for real estate equities (REITs) is likely to continue to improve as investors anticipate policy loosening over our investment time frame, despite tight credit conditions and subdued economic growth. The asset class continues to offer value given the extreme share price discount to NAVs - a typical early cycle rating. There is now an expectation that REITs earnings can start to recover slowly as some sectors within the asset class benefit from increased property demand. The asset class has the potential to offer some inflation protection through rent increases, which are now coming through across several sub-sectors. The diverse nature of the market means that there are opportunities within the sector and across regions.

Cash	Sterling Cash	E: Very Underweight

While cash rates are currently higher than they have been in quite some time, our expectation is that they are now at a peak, especially in economies like the UK, where inflation is moderating quicker than expected and domestic growth remains subdued. Our analysis suggests that even when investing in UK cash at peak interest rates, investors are typically better served over the next few years by being invested in equity and bond markets.

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

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All data in this document as at 31 December 2023 unless otherwise stated.

Views and opinions are based on current market conditions and are subject to change.

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