

Tactical Asset Allocation

Invesco Investment Solutions



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September 2020 Update



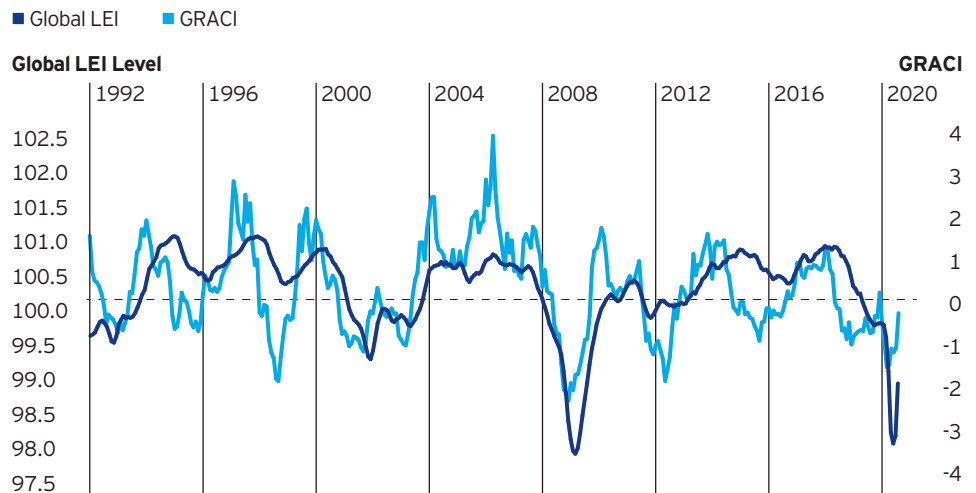
Synopsis:

- Based on our macro regime framework, we expect the global business cycle to remain in a **recovery** regime, with growth below trend and expected to improve over the next few months as the economic recovery strengthens in depth and breadth.
- Risk appetite has increased remarkably throughout the summer months despite a record contraction in GDP and sputtering fiscal stimulus in the United States. The world outside of the US has led this recovery in terms of economic and health policy, producing favorable cyclical conditions which we expect to be the catalyst for risk assets to outperform as local valuations are cheaper and the US dollar is expensive.
- We maintain a **higher risk posture** than our benchmark¹ in our Global Tactical Allocation model, sourced through an overweight to equities, tilting towards (small) size and value stocks, and credit, at the expense of government bonds.

The global economy is healing, and we expect its upward growth trajectory to continue for the remainder of the year. Based on our macro regime framework, the global business cycle remains solidly in a **recovery regime**, with growth below trend and expected to improve over the next few months. The recovery is strengthening in its depth and breadth. Our leading economic indicators suggest growth is gaining momentum. Trade activity within Emerging Asia is rebounding strongly, providing further evidence the global manufacturing cycle is normalizing, supported by rebounding orders and demand in the developed world.

Global market sentiment continues to improve, as evidenced by broad-based outperformance of risky assets over defensive assets in both equity and fixed income markets. Improving risk appetite tends to correlate strongly with improving growth expectations, suggesting market participants expect the recovery to continue for the remainder of the year.

Figure 1: The recovery should continue into year-end, as growth expectations and market sentiment continue to improve.



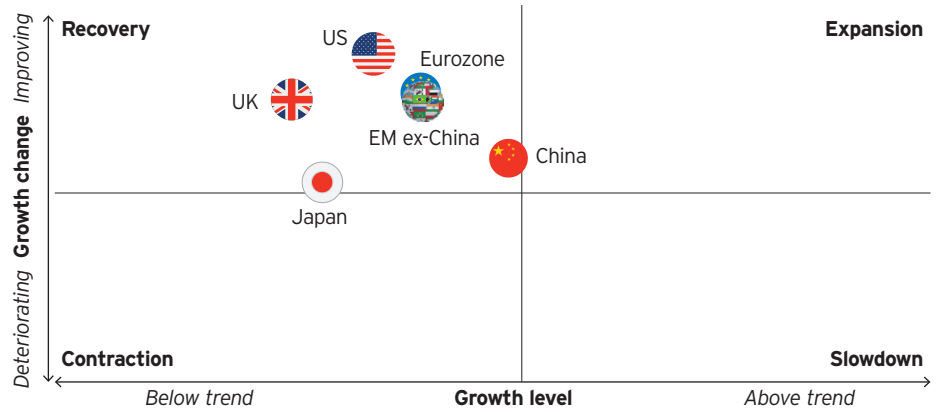
Source: Bloomberg L.P., MSCI, Citi, Barclays, JPMorgan, Invesco Investment Solutions research and calculations, from January 1992 to August 2020. The Global Leading Economic Indicator (LEI) is a proprietary, forward-looking measure of the macroeconomic trend level. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment. A level above (below) 100 on the Global LEI signals growth above (below) a long term average trend, while a GRACI number above (below) zero suggests above (below) trend risk sentiment.

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¹ Global 60/40 benchmark (60% MSCI ACWI / 40% Bloomberg Barclays Global Agg USD Hedged).

Figure 2: Leading economic indicators suggest the recovery is strengthening and is now shared across regions around the world.

Current Leading Economic Indicators (LEIs) - Aug. 31, 2020



Source: Invesco Investment Solutions team proprietary research, Aug. 31, 2020.

Region	(a) Current level of growth (LEIs)	(b) Change in global growth expectations (GRACI)	(c) Expected macro regimes
Global	Below Trend	& Growth Expectation Improving =	Recovery
United States	Below Trend		Recovery
Developed Markets ex-USA	Below Trend		Recovery
Europe	Below Trend		Recovery
United Kingdom	Below Trend		Recovery
Japan	Below Trend		Recovery
Emerging Markets	Below Trend		Recovery
China	Below Trend		Recovery
Emerging Markets ex-China	Below Trend		Recovery

Source: Invesco Investment Solutions. Macro regime data as of Aug. 31, 2020. 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 impressive rebound in global equity markets has been extraordinary, despite record a contraction in gross domestic product (GDP) and rising COVID-19 contagion rates during the summer months. We attribute this steady improvement in risk appetite to a few key developments and risk factors:

- **Vaccine research:** While the discovery, production and distribution of a vaccine is still a few months away and subject to uncertainty, market participants have responded positively to preliminary results from multiple vaccine studies around the world (Oxford, Moderna, etc.). In other words, markets are discounting a high probability that COVID-19 is actually a good candidate for a vaccine, despite the uncertainty on the timeline, and that some form of meaningful positive development is to be expected.
- **Declining mortality rates:** COVID-19 contagions have increased around the world, a well-understood price to be paid for the reopening of economies. However, mortality rates have declined meaningfully compared to the first half of 2020, suggesting that a combination of more prudent social behavior (distancing, masks, etc.), and a better prepared healthcare system will likely reduce the need for a new round of lockdowns, therefore reducing the risk of another severe contraction in global GDP.
- **Monetary policy support:** Lower policy rates, sizable asset purchases from major central banks and expectations of low long-term bond yields in the future (i.e. forward guidance) contributed to a steep decline in discount rates for future cash flows, boosting prices, valuation and market sentiment.
- **Fiscal policy support:** After the initial rounds of fiscal support in the first quarter, market sentiment has been boosted by additional policy initiatives around the world. In particular, the creation of a European Recovery Fund was of utmost importance to eliminate the threat of a new European debt crisis and the re-emerge of Euro break-up risk. On the other hand, the market is currently digesting the loss of fiscal impulse in the United States, caused by the expiration of the first round of benefits and the impasse in Congress on a new round of fiscal support, which we expect to eventually materialize at around \$1.5-2.0 trillion.

Investment Positioning

We believe this remains a very constructive environment for risk assets. We maintain a **higher risk posture** than the benchmark¹ in our Global Tactical Asset Allocation model, sourced through an overweight exposure to equities and credit at the expense of government bonds. In particular:

- Within **equities** we hold large tilts in favor of developed markets outside the US and emerging markets, driven by more favorable cyclical conditions, attractive local asset valuations and an expensive US dollar which, in our opinion, is in the early stages of a long-term depreciation cycle. The confluence of these medium and short-term drivers increases the potential for long-term capital inflows in non-US equity markets. As a result, we hold a large underweight to US equities, especially in quality and momentum stocks, given our tilts in favor of value and (small) size factors. The underperformance of small and mid-cap value stocks versus large cap quality and momentum stocks continues to be one of the most prominent and surprising features of this market recovery. Rational economic explanations for such a divergence can be found in the technology-driven nature of the COVID-19 recovery, as well as the declining interest rate environment, both favoring quality and momentum stocks over value and small/mid-cap companies. However, even a modest recovery in the global earnings cycle for small and mid-cap value companies can lead to a large positive impact on prices, given high operating leverage and attractive valuations. Hence, we maintain our factor exposure tilted towards value and size.
- In **fixed income**, we maintain an overweight exposure to US high yield credit, emerging markets sovereign dollar debt, and event-linked bonds at the expense of investment grade corporate credit and government bonds, particularly in developed markets outside the US, given the negative yield environment. Overall, we are overweight credit risk and neutral duration² versus the benchmark.
- In **currency markets**, we maintain an overweight exposure to foreign currencies, positioning for long-term US dollar depreciation. Focusing on a combination of attractive valuations, cyclical conditions and yield, within developed markets we favor the Euro, the Canadian dollar and the Norwegian kroner. In emerging markets, we favor the Indian rupee, Indonesian rupiah and Russian ruble.

² Credit risk defined as DTS (duration times spread).

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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