Tactical Asset Allocation

Invesco Investment Solutions

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October 2020 Update

Assessing the near-term impact of the US election on markets, while the global recovery continues.

Synopsis:

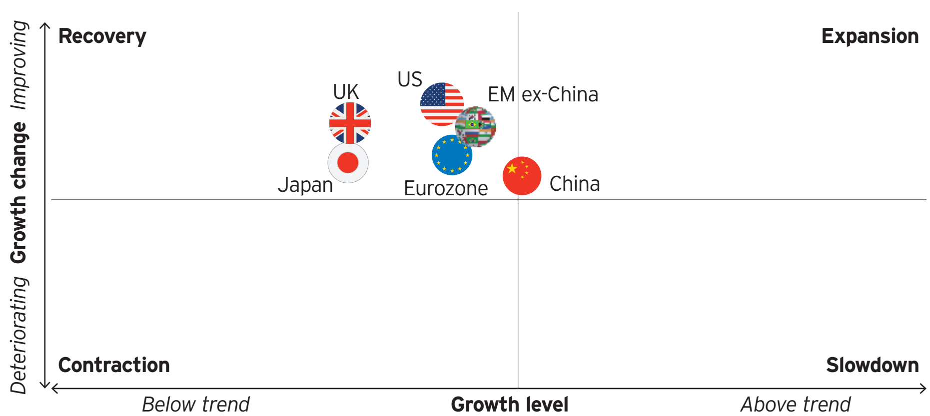
- Based on our macro regime framework, the global business cycle remains solidly in a **recovery regime**, with growth below trend and expected to improve over the next few months. The recovery is strengthening in its depth and breadth, as our leading economic indicators suggest growth is broadening across regions.
- We maintain a **higher risk posture** than the benchmark in our Global Tactical Asset Allocation model[1], sourced through an overweight exposure to equities, particularly Developed Markets (DM) ex-US and EM (Emerging Markets), and credit, both High Yield (HY) and EM, at the expense of government bonds. Further we hold an overweight to foreign currencies, positioning for long-term US dollar depreciation.
- Our investment process does not explicitly consider, or position for, the expected outcome of the US election. While it is important to outline the potential impact of these alternative developments, we do not position for either outcome ahead of the election and follow our macro-driven investment process.

Macro update

The global economy continues to improve and we expect its upward trajectory to persist for the rest 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, as our leading economic indicators suggest growth is broadening across regions. While global equity and credit markets experienced declines over the past month, our measures of global risk appetite remain in an improving trend, indicative of improving growth expectations **(Figure 1).**

Figure 1: Leading economic indicators and market sentiment suggest the global economic recovery continues across all regions.

Current Leading Economic Indicators (LEIs)



Source: Invesco Investment Solutions team proprietary research, Sept. 30, 2020.

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

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

Sources: Bloomberg L.P., Macrobond. Invesco Investment Solutions research and calculations as of Sept. 30, 2020. Proprietary leading economic indicators of Invesco Investment Solutions.

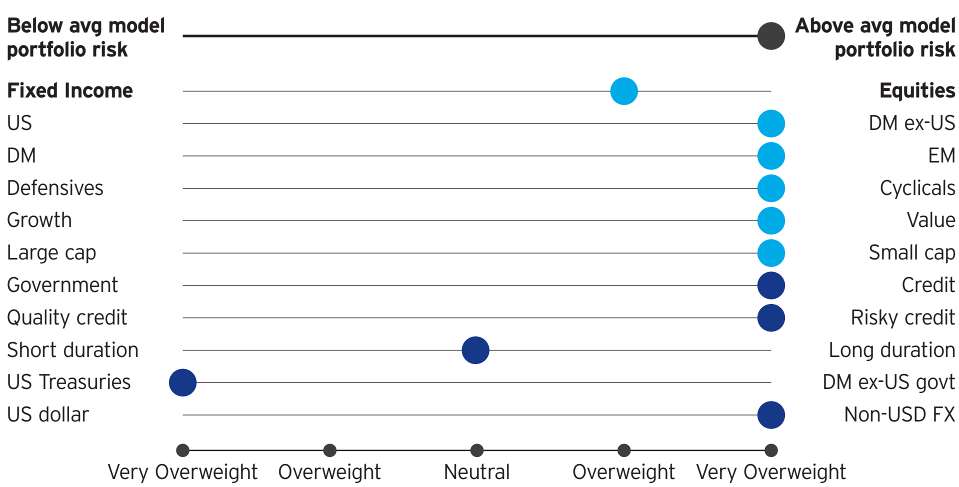
Investment Positioning

We have not implemented any change in our model portfolio over the past month **(Figure 2)**. We maintain a higher risk posture than the benchmark in our Global Tactical Asset Allocation model[1], sourced through an overweight exposure to equities and credit at the expense of government bonds. In particular:

We hold a large underweight position in US equities, especially in quality and momentum stocks, given our tilts in favor of value and (small) size factors, which we belive should eventually benefit from higher operating leverage and a recovery in the global earnings cycle.

- 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. 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 position in US equities, especially in quality and momentum stocks, given our tilts in favor of value and (small) size factors, which we belive should eventually benefit from higher operating leverage and a recovery in the global earnings cycle.
- 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. Overall, we are overweight credit risk and neutral duration[2] versus the benchmark.
- In **currency markets** we maintain an overweight exposure to foreign currencies, positioning for long-term US dollar depreciation. 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.

Figure 2: Tactical Asset Positioning



Source: Invesco Investment Solutions Advisory Team, Sept. 30, 2020. For illustrative purposes only.

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

US election scenarios and investment implications

The outcome of the election could have lasting consequences in terms of relative sector and regional performance for equity markets, depending on future changes in fiscal and trade policy over the coming years.

Our investment process does not explicitly consider, or position for, the expected outcome of the US election. As discussed in more detail below, we believe the overall performance of risk assets is likely to be positive over the medium term (multiple months or quarters) regardless of the election outcome, and it should be driven by more enduring drivers of market performance such as growth, fiscal and monetary policy. However, the outcome of the election could have lasting consequences in terms of relative sector and regional performance for equity markets, depending on future changes in fiscal and trade policy over the coming years. While it is important to outline the potential impact of these alternative developments, we do not position for either outcome ahead of the election and follow our macro-driven investment process.

From a risk analysis standpoint, we evaluate three most likely election scenarios based on current opinion polls, sorted from most positive to least positive in terms of expected impact on our portfolio. Before discussing the potential outcomes, however, it's important to discount the near-term uncertainty that will likely characterize the days and weeks after Election Day. Given the high number of absentee ballots expected to be cast this year, processing times are likely to be slower than in previous elections, and it may take several weeks to process the vote count. States certification deadlines generally range between 1-2 weeks post-election day. Furthermore, given the pandemic, some states may ask for an extension. Therefore, regardless of whether election results will be contested, markets will likely need to digest some uncertainty for a few weeks after election day. We expect these developments to yield a **neutral impact on our model portfolio**. We believe rising risk aversion should provide a headwind to our equity, credit and foreign currency overweight. On the other hand, we believe our relative value tilts in equities should benefit from a rise in the US political risk premium, given an underweight to US equities and overweight to global ex-US markets. Similarly, an unwind of extended positioning in momentum/growth sectors could benefit our positioning in value sectors.

Biden Win + Democratic Congress

Changes in fiscal policy may provide a catalyst for the long-awaited cyclical rotation from growth/momentum sectors into value sectors, with materials and industrials to benefit from large infrastructure spending, and consumer discretionary to benefit from higher minimum wage proposals.

Among all scenarios, a Democratic win of the White House and Congress would deliver the potential for meaningful policy changes. Overall, we think the impact on equity and credit markets is likely to be positive in the medium-term, despite risks of an initial sell-off. Given the fragility of the post-COVID job and growth environment, the Biden proposal for higher corporate and personal income taxes is likely to be delayed and/or dampened. In addition, projected increases in infrastructure spending could support growth in the near term and provide an offset to negative impact from higher taxation[3]. Reduced trade policy uncertainty may also benefit risk assets, as, in fact, trade policy was the largest headwind to global growth in 2019. We expect this scenario to have a **positive impact on our model portfolio**, with emerging and developed markets outside the US being the main beneficiaries of lower trade uncertainty, and the US dollar likely to depreciate in tandem. Changes in fiscal policy may provide a catalyst for the long-awaited cyclical rotation from growth/momentum sectors into value sectors, with materials and industrials to benefit from large infrastructure spending, and consumer discretionary to benefit from higher minimum wage proposals.

Biden Win + Split Congress

In this scenario, equity markets outside the US, particularly emerging markets would benefit from lower trade policy uncertainty and a more diplomatic engagement by the White House on trade disputes with other countries. However, a split Congress should translate into largely unchanged fiscal policy on matters such as healthcare, infrastructure spending, minimum wage and tax reform. Historically, policy impasse has often translated into a "no news is good news" narrative, which tends to favor risk assets and dampen markets volatility. However, this scenario would broadly preserve the status quo in terms of relative sector performance, potentially eliminating one catalyst for the growth-to-value rotation. We expect this scenario to provide a **moderately positive impact on our model portfolio.**

Status quo: Trump Win + Split Congress

A continuation of the status quo may be received well by risk assets, lead to US dollar strength in the near term, and reinforce the trend of US equity outperformance, especially for growth and momentum stocks. A continuation of the current trade policy framework is likely to be a headwind for emerging and developed market equities outside the US, on a relative basis. This scenario would likely deliver a **negative impact on our model portfolio,** given our overweight exposures to value, size, FX and equity markets outside the US.

3. Source: As of Sept 30. 2020, the Congressional Budget Office estimates that a Democratic Platform could lead to an additional $2trl in deficits over the next decade relative to the current baseline.

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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