Invesco

Tactical Asset Allocation

Maintain defensive portfolio positioning. Overweight fixed income, defensive equity factors, and quality credit.

Our macro process drives tactical asset allocation decisions over a time horizon between six months and three years, on average, seeking to harvest relative value and return opportunities between asset classes (e.g., equity, credit, government bonds, and alternatives), regions, factors, and risk premia.

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Head of Investments,
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Synopsis

- Risk appetite and leading indicators continue to decline. Underweight portfolio risk in the Global Tactical Asset Allocation model,[1] underweighting equities versus fixed income, favoring US equities, quality, and low volatility. Underweight credit risk, overweight duration, and the US dollar.
- Our macro framework proved effective in guiding asset allocation decisions in the past 12 months, but equity factors have not responded to traditional macro drivers. We expect a normalization in equity market dynamics to lead factors, styles, and sectors to respond again to macro drivers, and reassert fundamental correlations with the growth cycle.

Macro update

Following last month's shift to a contraction regime, our macro framework points to further deceleration in economic activity and market expectations of future growth. Our global leading economic indicator continues to decelerate and moves further below its long-term trend. Recent negative momentum is coming predominantly from the US and China (**Figure 1c**). In the United States, weakness in leading indicators such as consumer sentiment, manufacturing surveys, housing indicators, and manufacturing activity is starting to see confirmation in coincident or lagging indicators such as rising jobless claims, rising unemployment and weakening service-industry surveys. In China, despite the important stabilization in housing and real estate markets, manufacturing orders remain weak and monetary conditions remain restrictive as indicated by deceleration in money supply and total bank lending growth. Furthermore, our global risk appetite framework points to additional weakness in market sentiment and future growth expectations, confirming the inflection point identified last month (**Figure 2**).

Since the identification of an inflection point in early July to a contraction regime, markets seem to be validating this transition. Equities are underperforming fixed income, bond yields have declined by over 50bps, and policy expectations have priced in approximately 100bps in rate cuts. Given the potentially relevant implications of this inflection point, we take a closer at the performance of our macro framework over the past 12 months, to understand how we got here, review which asset classes and markets performed in line with our expectations and which markets did not, and estimate the path forward as our indicators point to some macro headwinds for the remainder of the year.

How did our framework perform between July 2023 - June 2024 when it identified a favorable cyclical backdrop of recovery/expansion for the US and the global economy?

1 Global 60/40 benchmark (60% MSCI ACWI, 40% Bloomberg Global Aggregate USD Hedged).

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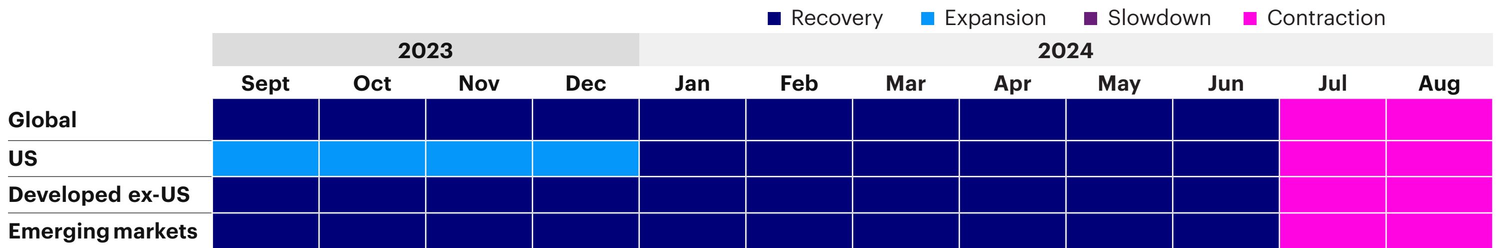
Following last month's shift to a contraction regime, our macro framework points to further deceleration in economic activity and market expectations of future growth.

Figure 1a: Global macro framework remains in a contraction regime
Regional regime signals and components

Region	LEIs: Current level of growth		Global risk appetite: Change in global growth expectations		Expected macro regimes
Global	**Below Trend**	&	Growth expectation deteriorating	=	**Contraction**
United States	**Below Trend**				**Contraction**
Developed markets ex-US	**Below Trend**				**Contraction**
Europe	Below Trend				Contraction
United Kingdom	Below Trend				Contraction
Japan	Above Trend				Slowdown
Emerging markets	**Below Trend**				**Contraction**
China	Below Trend				Contraction
Emerging markets ex-China	Above Trend				Slowdown

Sources: Bloomberg L.P., Macrobond. Invesco Solutions research and calculations. Proprietary leading economic indicators of Invesco Solutions. Macro regime data as of July 31, 2024. 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. Developed markets ex-USA include the eurozone, UK, Japan, Switzerland, Canada, Sweden, Australia. Emerging markets include Brazil, Mexico, Russia, South Africa, Taiwan, China, South Korea, India.

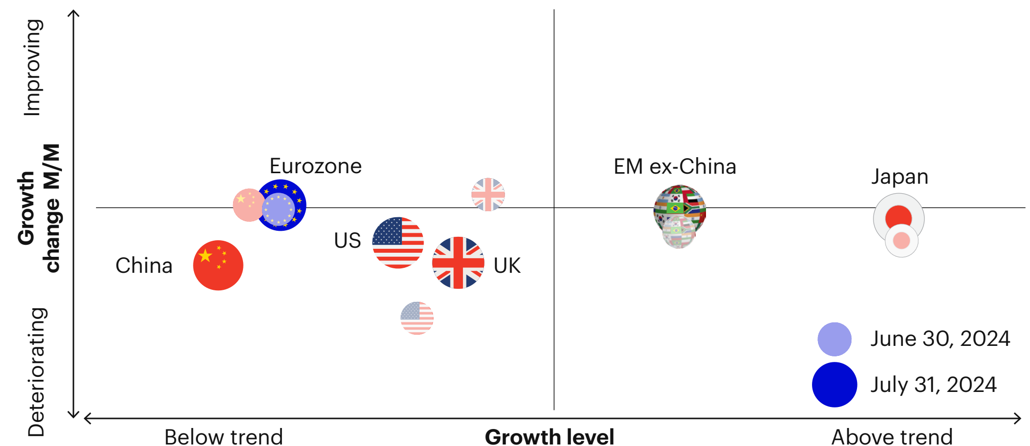
Figure 1b: Trailing 12-month regime history by region
Global economy in a contraction phase with LEIs below their long-term trend and growth expectations deteriorating



Source: Invesco Solutions, as of July 31, 2024.

In the United States, weakness in leading indicators such as consumer sentiment, manufacturing surveys, housing indicators and manufacturing activity is starting to see confirmation in coincident or lagging indicators such as rising jobless claims, rising unemployment, and weakening service-industry surveys.

Figure 1c: Further deterioration in growth, led by contractions in the US, China, and UK



Sources: Bloomberg L.P., Macrobond. Invesco Solutions research and calculations. Proprietary leading economic indicators of Invesco Solutions. Macro regime data, as of July 31, 2024. 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.

Since the identification of an inflection point in early July to a contraction regime, markets seem to be validating this transition. Equities are underperforming fixed income, bond yields have declined by over 50bps, and policy expectations have priced in approximately 100bps in rate cuts.

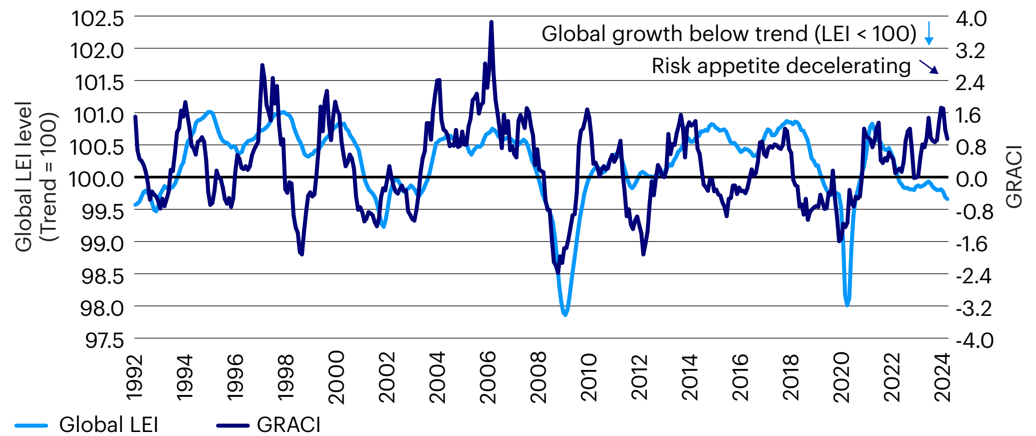
Our framework signaled an improving outlook for global growth and moved into a recovery regime in July 2023.

Over the period, economic data and major asset classes have firmly validated the identification of this recovery environment.

However, we have seen a very different story for equity sectors and factors, which have not responded to macro cyclical drivers in a typical fashion.

Figure 2: Global risk appetite continues to decelerate, and leading economic indicators move further below their long-term trend

GRACI and Global LEI



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Solutions research and calculations, from Jan. 1, 1992 to July 31, 2024. The Global Leading Economic Indicator (LEI) is a proprietary, forward-looking measure of the growth level in the economy. A reading above (below) 100 on the Global LEI signals growth above (below) a long-term average. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment. A reading above (below) zero signals a positive (negative) compensation for risk-taking in global capital markets in the recent past. **Past performance does not guarantee future results.**

Our framework signaled an improving outlook for global growth and moved into a recovery regime in July 2023. At the time, expectations for a cyclical upturn were mixed, as inflation proved stickier than anticipated, and markets delt with concerns of a "higher for longer" interest rate environment, potentially requiring a more pronounced slowdown in the economy to curb inflationary pressures. However, our macro models maintained this favorable cyclical assessment for the following 12 months to June 2024, resulting in a pro-risk and cyclical asset allocation posture. Over the period, economic data and major asset classes have firmly validated the identification of this recovery environment. As illustrated in **Figure 3**, over the 12-month period between July 2023 – June 2024, global equities outperformed fixed income by over 20%, and all major credit sectors experienced a meaningful compression in credit spreads to cycle lows, contributing to strong outperformance of credit markets relative to government bonds of similar duration. These performance patterns are historically consistent with a recovery / expansionary environment.

However, we have seen a very different story for equity sectors and factors, which have not responded to macro cyclical drivers in a typical fashion. As illustrated in **Figure 3**, cyclical factors have not outperformed defensive factors, especially in the US, despite improving risk appetite, tightening credit spreads and rising interest rates. While the growth cycle is one of the most important drivers of factor performance, it is not the sole driver, and other forces have exerted meaningful influence in equity markets over the past 12-15 months.

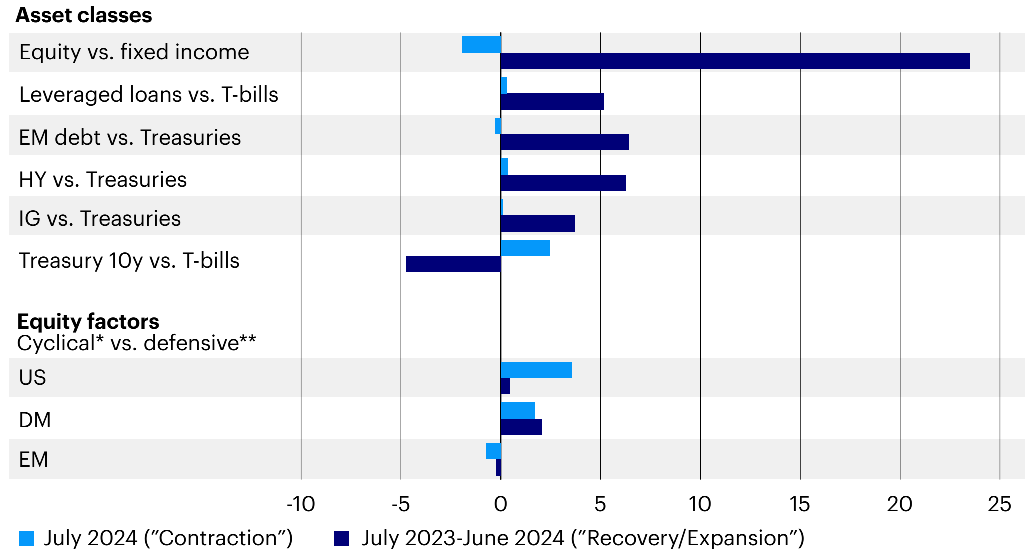
We believe there are two primary causes for this disconnect between equity factor performance and the growth cycle: 1) thematic drivers dominating equity markets; and 2) a temporary breakdown in the correlation between factor performance and bond yields.

1. **Thematic drivers:** Since May 2023, following the Nvidia AI-breakthrough earnings release, the relative performance between equity sectors, styles and factors has been dominated by a thematic AI/technology driven market, subsequently morphing into an idiosyncratic and concentrated market in a few names (i.e., Magnificent 7). Equity markets are adjusting to this one-off structural repricing. While it is challenging, if not impossible, to estimate the magnitude and duration of this structural transition, we believe traditional cyclical patterns will reestablish themselves over time.
2. **Correlation between factor performance and bond returns:** Over the past 12 months, while bond yields have broadly risen with rising growth expectations (recovery/ expansion between July 2023 – June 2024), equity factors have not exhibited the expected correlation to bond yields. In other words, we have not seen outperformance in cyclical factors such as small size and value equities.

Over the 12-month period between July 2023 – June 2024, global equities outperformed fixed income by over 20%, and all major credit sectors experienced a meaningful compression in credit spreads to cycle lows, contributing to strong outperformance of credit markets relative to government bonds of similar duration. These performance patterns are historically consistent with a recovery / expansionary environment.

Figure 3: Relative performance across asset classes consistent with our macro regime expectations, while factors have not responded to macro cycle

Relative performance over past 12 months (%, returns) vs. macro regime identification



Sources: Bloomberg L.P., Invesco, April 30, 2024. Equity = MSCI ACWI Net Return USD Index, Fixed Income = Bloomberg Global Aggregate USD Hedged. Emerging Equity = MSCI Emerging Markets TR Index, Developed Equity = MSCI World TR Index. Investment Grade vs. Treasury = Bloomberg US Corporate Excess Return Index. High Yield vs. Treasury = Bloomberg US High Yield Excess Return Index. *Cyclical = Small Size & Value, **Defensive = Low Vol & Quality. Size and Value = Russell 2XSize/2XValue 5% capped total return index, Quality & Low Vol = Russell 1000 2XQuality/2XLow Volatility 5% capped total return index, and equivalent indices for FTSE Developed ex USA and FTSE Emerging Indices, which are then already paired with the indices.

History shows that these episodes of atypical correlation between bond yields and factors have occurred a few times in the past and have been relatively short-lived.

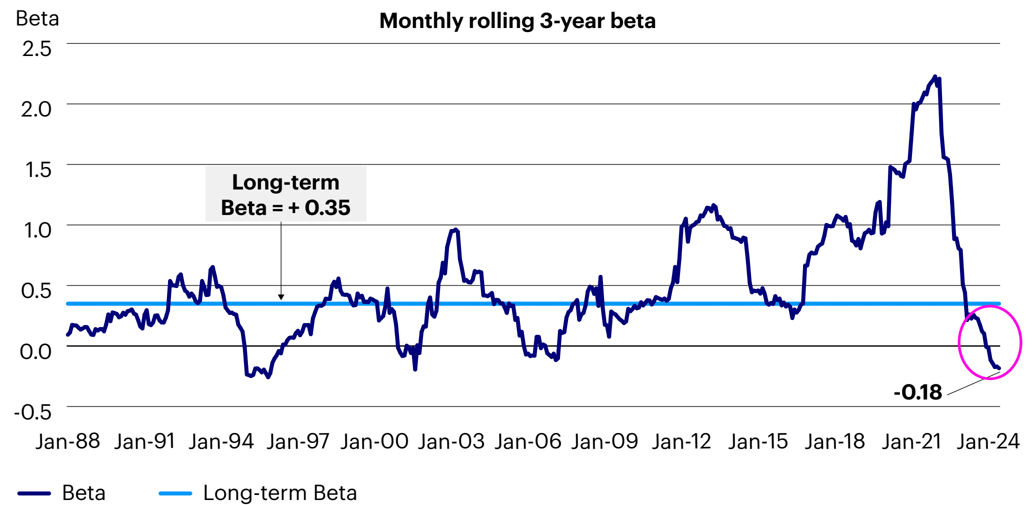
Over the long-term there is a positive correlation between bond returns and the relative performance between defensive factors (quality & low vol) and cyclical factors (small size & value). The beta is positive (0.35) and statistically significant. When bond returns are positive, and yields decline, defensive factors tend to outperform.

Figure 4: Factors have not exhibited the typical correlation to yields

Cyclical factors, rather than defensives, have benefited from falling bond yields

Beta of defensive - cyclical factors to Treasury returns.

Defensive: Quality & low vol, Cyclical: Size & value



Source: Invesco, data as of July 31, 2024. Defensive factors represented by the Russell 1000 2xQ/2xLowVol Index, cyclical factors represented by Russell 1000 2xSize/2xValue Index, and US Treasury returns are represented by Bloomberg US Treasury Index. Statistics calculated using monthly returns data beginning January 1986, the first month of research data. Please see the Appendix for the index methodology. Index returns do not represent fund returns. Performance for periods greater than 1-year are annualized. An investor cannot invest directly in an index. **Past performance does not guarantee future results.**

The correlation has moved to negative in the last couple of years, meaning that negative bond returns, or rising bond yields, have benefited defensive assets such as quality and low vol, at the expense of small size and value stocks.

We expect the correlation between equity factors and bond yields to normalize over time, and macro cyclical drivers to regain importance in explaining the relative performance between equity styles/ factors.

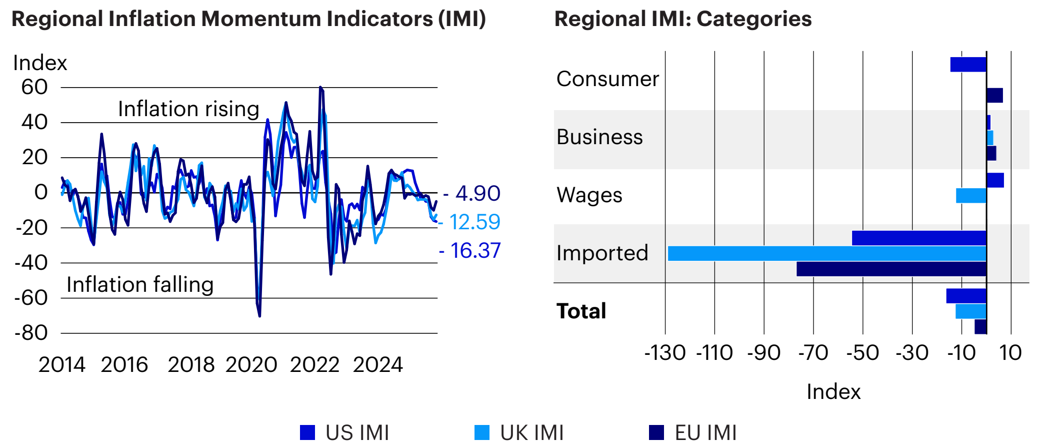
In sovereigns, we favor nominal bonds over inflation protected securities as inflationary pressures continue to decline.

As illustrated in **Figure 4**, over the long-term, there is a positive correlation between bond returns and the relative performance between defensive factors (quality & low vol) and cyclical factors (small size & value). The beta is positive (0.35) and statistically significant. When bond returns are positive, and yields decline, defensive factors tend to outperform. When bond returns are negative, and yields rise, cyclical factors tend to outperform.[2] However, the correlation has moved to negative in the last couple of years, meaning that negative bond returns, or rising bond yields, have benefited defensive assets, such as quality and low vol, at the expense of small size and value stocks. Conversely, small size and value stocks have recently seen outperformance coinciding with falling bond yields. The prevalent fundamental narrative today explains this relationship pointing to the negative impact of higher bond yields on small and mid-cap value stocks given their lower profit margin, higher leverage and higher credit risk. However, we find this explanation not entirely convincing given the strong performance of credit markets during rising rate environments of the past year, including riskier credit sectors with overlapping exposures to small and mid-caps, such as high yield and levered loans, as shown in **Figure 3**.

History shows that these episodes of atypical correlation between bond yields and factors have occurred a few times in the past and have been relatively short-lived. We expect the correlation between equity factors and bond yields to normalize over time, and macro cyclical drivers to regain importance in explaining the relative performance between equity styles/factors. If this correlation returns to positive, we can expect defensive factors to outperform again when bond yields decline, which has historically occurred during slowdown/contraction regimes.

Overall, we believe our macro framework proved quite effective in anticipating the improved cyclical outlook of the past year and guiding asset allocation decisions. We expect a gradual normalization in equity market dynamics to lead factors, styles and sectors to respond again to macro drivers, and reassert fundamental correlations with the growth cycle.

Figure 5: Inflation is decelerating globally, led by lower commodity prices



Sources: Bloomberg L.P. data as of July 31, 2024, Invesco Solutions calculations. The US Inflation Momentum Indicator (IMI) measures the change in inflation statistics on a trailing three-month basis, covering indicators across consumer and producer prices, inflation expectation surveys, import prices, wages, and energy prices. A positive (negative) reading indicates inflation has been rising (falling) on average over the past three months.

3 These dynamics reflect the well-known fundamentals that quality and low volatility stocks have more defensive characteristics, lower operating leverage, and higher duration compared to smaller size and value stocks.

There are no changes in portfolio positioning this month. We underweight risk relative to benchmark in the Global Tactical Allocation Model, underweighting equities relative to fixed income, favoring US equities, and defensive sectors with quality and low volatility characteristics.

Despite the extended positioning in mega-cap quality names, we expect a combination of quality and low volatility characteristics to outperform and provide downside risk mitigation in a scenario of falling growth expectations, falling bond yields, and weaker equity markets.

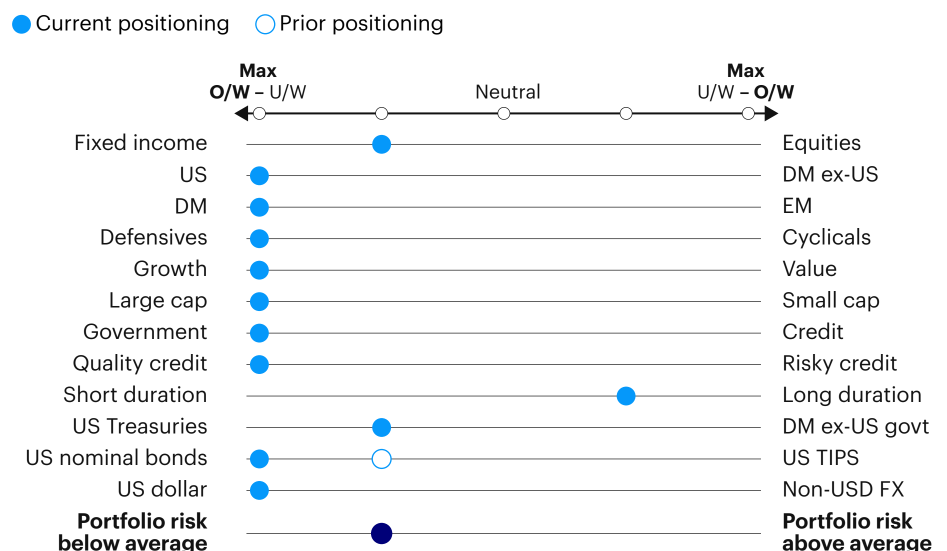
Investment positioning

Our macro signals confirm the defensive asset allocation shifts identified last month and remain positioned for a contraction regime of below-trend and decelerating growth. There are no changes in portfolio positioning this month. We underweight risk relative to benchmark in the Global Tactical Allocation Model, underweighting equities relative to fixed income, favoring US equities, and defensive sectors with quality and low volatility characteristics. In fixed income, we underweight credit risk[3] relative to benchmark and overweight duration via investment grade credit and sovereign fixed income, at the expense of lower quality credit sectors. (**Figures 6 to 9**). In particular:

- In **equities,** we overweight defensive sectors with quality and low volatility characteristics, tilting towards larger capitalizations at the expense of value, mid and small caps. Despite the extended positioning in mega-cap quality names, we expect a combination of quality and low volatility characteristics to outperform and provide downside risk mitigation in a scenario of falling growth expectations, falling bond yields, and weaker equity markets. Hence, we favor exposures to defensive sectors such as health care, staples, utilities, and technology at the expense of cyclical sectors such as financials, industrials, materials, and energy. From a regional perspective, we overweight US equities relative to other developed markets and emerging markets, driven by declining global risk appetite, stronger US earnings revisions versus the rest of the world, and an improving outlook for the US dollar, due to negative surprises in global growth and tighter monetary policy relative to the rest of the world.
- In **fixed income,** we underweight credit risk and overweight duration, favoring investment grade and sovereign fixed income relative to high yield. While the current backdrop does not suggest a major risk for credit spreads, downward revisions to growth expectations are likely to be accompanied by marginally wider spreads from cycle lows and lower bond yields, favoring higher quality and higher duration assets. In sovereigns, we favor nominal bonds over inflation protected securities as inflationary pressures continue to decline (**Figure 5**).
- In **currency markets,** we overweight the US dollar, driven by negative surprises in global growth and tighter monetary policy relative to the rest of the world. Within developed markets we favor the euro, the British pound, Norwegian kroner, Swedish krona, and Singapore dollar relative to the Swiss franc, Japanese yen, Australian and Canadian dollars. In EM, we favor high yielders with attractive valuations as the Colombian peso, Brazilian real, Indian rupee, Indonesian rupiah and Mexican peso, relative to low yielding and more expensive currencies as the Korean won, Taiwan dollar, Philippines peso and Chinese renminbi.

Figure 6: Relative tactical asset allocation positioning

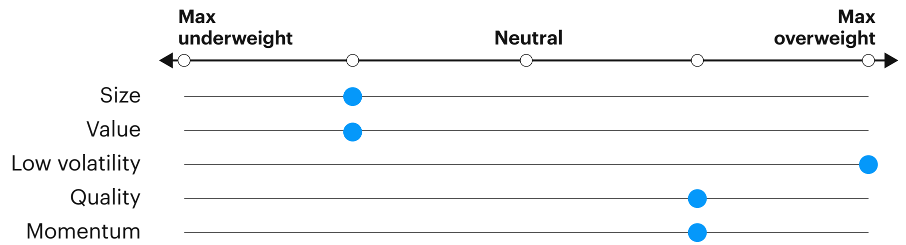
Underweight portfolio risk vs. benchmark, favoring US equities, defensive sectors and quality credit



Source: Invesco Solutions, August 1, 2024. DM = developed markets. EM = emerging markets. Non-USD FX refers to foreign exchange exposure as represented by the currency composition of the MSCI ACWI Index. For illustrative purposes only.

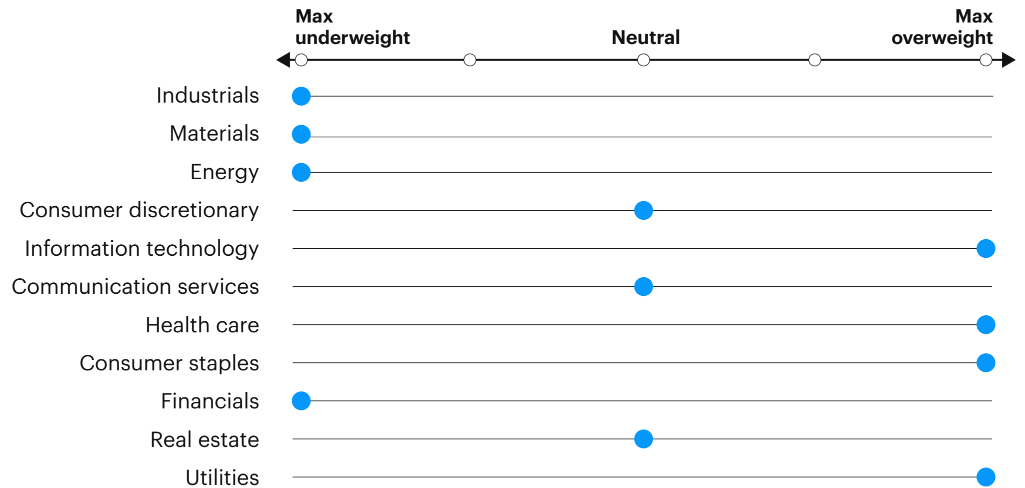
3 Credit risk defined as duration times spread (DTS).

Figure 7: Tactical factor positioning
Overweight quality, low volatility and momentum



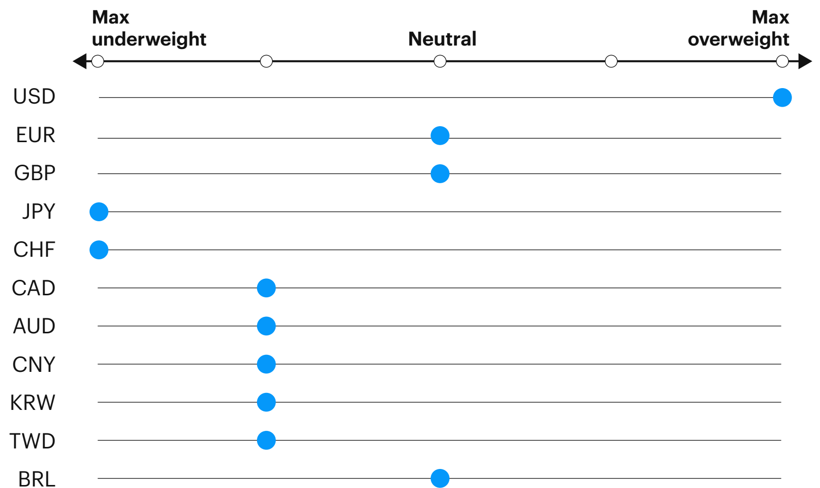
Source: Invesco Solutions, August 1, 2024. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

Figure 8: Tactical sector positioning
Sector exposures favoring defensives



Source: Invesco Solutions, August 1, 2024. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of December 2023, Cyclicals: Energy, financials, industrials, materials; Defensives: Consumer staples, health care, information technology, real estate, and utilities; Neutral: Consumer discretionary and communication services.

Figure 9: Tactical currency positioning
Overweighting US dollar while being neutral to underweight in developed markets



Source: Invesco Solutions, August 1, 2024. For illustrative purposes only. Currency allocation process considers four drivers of foreign exchange markets: 1) US monetary policy relative to the rest of the world, 2) global growth relative to consensus expectations, 3) currency yields (i.e., carry), 4) currency long-term valuations.

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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