Invesco

Tactical Asset Allocation

Asset and factor correlations are normalizing. Maintain defensive portfolio positioning. Overweight fixed income vs. equities, favoring 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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Senior Portfolio Manager,
Head of Investments,
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Synopsis

- As we exit the high inflation regime of the past two years, correlations between asset classes are normalizing, with equities and fixed income negatively correlated once again. This has favorable implications for asset allocation, portfolio diversification and macro-driven investment strategies. Similarly, equity factor cyclical properties are resuming, with defensive factors outperforming in rallying bond markets.
- Our framework remains in a contraction regime. We maintain a defensive asset allocation relative to the benchmark, overweighting fixed income relative to equities, favoring US equities and defensive sectors with quality and low volatility characteristics. In fixed income, we remain overweight duration and underweight credit risk.

Macro update

Our macro framework continues to suggest the global economy is likely to remain in a contraction regime, with growth below its long-term and decelerating. Despite a modest improvement over the past month, global risk appetite remains on a decelerating trend, pointing to lower growth expectations. Leading economic indicators improved marginally in the US and the UK, but these improvements were offset by weakness in Europe, Japan, and emerging markets (EM), particularly China (**Figures 1** and **2**).

China's business surveys for September showed broad-based weakness in domestic demand conditions and increasing uncertainty in export demand. Surveys of manufacturing new orders fell to the lowest reading since September 2022, and export orders fell to the lowest reading since August 2023.[1] Further softening in non-manufacturing surveys also provides worrying signals for consumer spending and the service sector, which is burdened by weak employment and property markets. In response to these economic challenges, the government signaled urgency to step up policy support and announced notable policy shifts, in an unusually bold and coordinated series of initiatives across government authorities. The PBOC announced comprehensive easing measures, including policy rate cuts and RRR cuts and measures to stabilize housing and equity markets. The Politburo meeting called for strengthened countercyclical policy measures, putting a high priority on growth, housing, unemployment, and the stock market.

These announcements have led to meaningful outperformance in Chinese equities. However, given the lack of positive spillover into other Asian markets (Korea, Taiwan, etc.), the immediate price action seems more indicative of a powerful short squeeze in Chinese equities rather than a macro game changer for the region and emerging markets. At this point, the macro impact seems still modest, and market expectations are building for additional fiscal policy announcements by Chinese authorities.

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1. Caixin manufacturing PMI surveys.

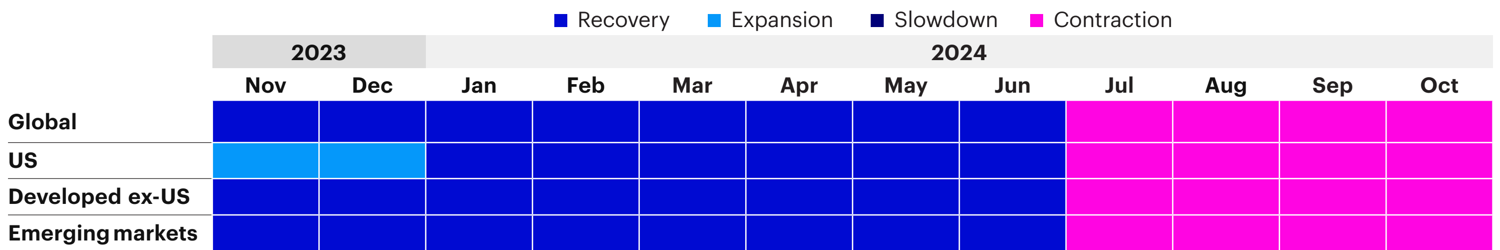
Our macro framework continues to suggest the global economy is likely to remain in a contraction regime, with growth below its long-term and decelerating.

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 Sept. 30, 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.

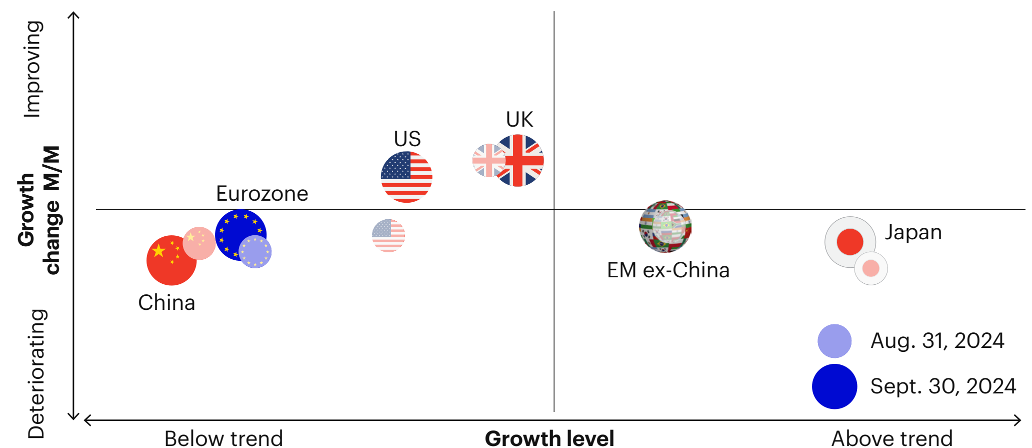
Figure 1b: Trailing 12-month regime history by region
Global economy in a contraction phase with LEIs below their long-term trend and growth expectations deteriorating



Source: Invesco Solutions as of Sept. 30, 2024.

Leading economic indicators improved marginally in the US and the UK, but these improvements were offset by weakness in Europe, Japan, and emerging markets (EM), particularly China.

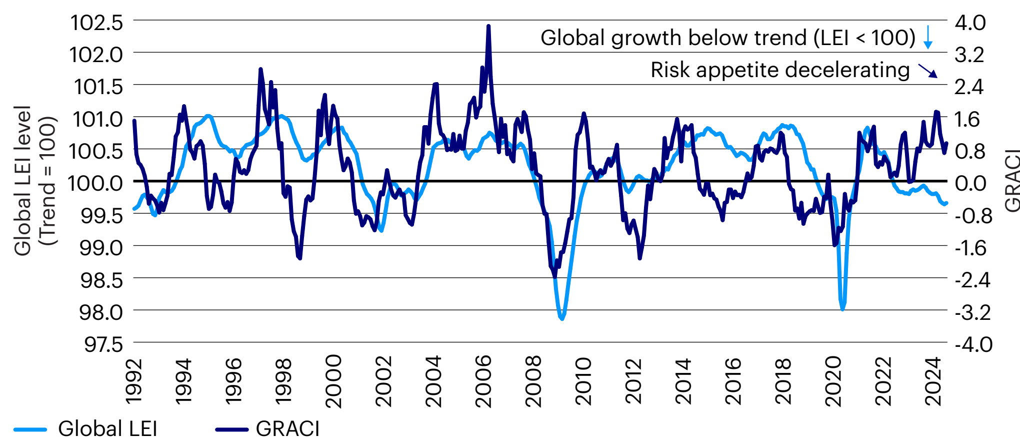
Figure 1c: Further growth deterioration in China and Eurozone, while improving in the UK and US, which remain below trend



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

Figure 2: Despite recent modest improvement, global risk appetite remains on a decelerating trend, and leading economic indicators remain stable

GRACI and Global LEI



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Solutions research and calculations, from Jan. 1, 1992 to Sept. 30, 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.**

In our opinion, this shift in policy focus and market dynamics has potentially major implications for the correlations between asset classes and, as a result, asset allocation decisions.

Over the past few weeks, we have seen early signs of a return to a regime where "bad news is bad news," meaning that with a renewed focus on growth and employment, negative growth surprises are associated with rising concerns for earnings, anticipation of rate cuts to support the economy, and a negative correlation between equities and fixed income.

Assuming the inflation genie is back in the bottle, we expect this normalized correlation regime to persist, with very important and favorable implications for asset allocation.

Market drivers and correlations are changing

Following the July and August US payroll reports and Chair Powell's speech at Jackson Hole, we outlined our perspective on a potential major shift in market drivers from inflation and artificial intelligence to growth and employment. With a surprise 50 basis points (bps) cut, the Federal Reserve has indicated the need for monetary policy to return to a neutral stance as quickly as possible and implicitly reiterated that the outlook has shifted from upside risks to inflation to downside risks to growth and employment.

In our opinion, this shift in policy focus and market dynamics has potentially major implications for the correlations between asset classes and, as a result, asset allocation decisions. Historically, macro environments characterized by high inflation, such as the period between 2022 and mid-2024, have led asset prices to exhibit heightened sensitivity to inflation data, above and beyond the response to growth data. As a result, the adage "bad news is good news" was used to describe the tendency for both equity and fixed income to outperform in response to bad growth data, anticipating that economic weakness would lead to lower inflation and lower discount yields. The resulting lower discount yields would boost asset price valuations across all asset classes, driving a positive correlation between equities and bonds and distorting the correlation between bonds, cyclical and defensive assets (as recently discussed in our August 2024 update).

As the high inflation regime of the past two years comes to an end, the outlook is changing, and so are market correlations and perceived risks. Over the past few weeks, we have seen early signs of a return to a regime where "bad news is bad news," meaning that with a renewed focus on growth and employment, negative growth surprises are associated with rising concerns for earnings, anticipation of rate cuts to support the economy, and a negative correlation between equities and fixed income (**Figure 3**). Similarly, we are witnessing a normalization in the correlation between bonds and equity styles/factors, where falling bond yields (i.e., rising bond returns) are once again accompanied by outperformance in defensive equity styles (quality, low volatility) relative to cyclicals (small, mid and value), in-line with long-term fundamentals and correlations (**Figure 4**). Assuming the inflation genie is back in the bottle, we expect this normalized correlation regime to persist, with very important and favorable implications for asset allocation. In this environment, we expect fixed income assets to reestablish a more persistent negative correlation with equity markets, regaining diversification properties in a multi-asset portfolio. Similarly, we expect equity sectors, style and factors to resume their typical macro / cyclical characteristics, providing additional tools to efficiently calibrate top-down macro exposures in a portfolio.

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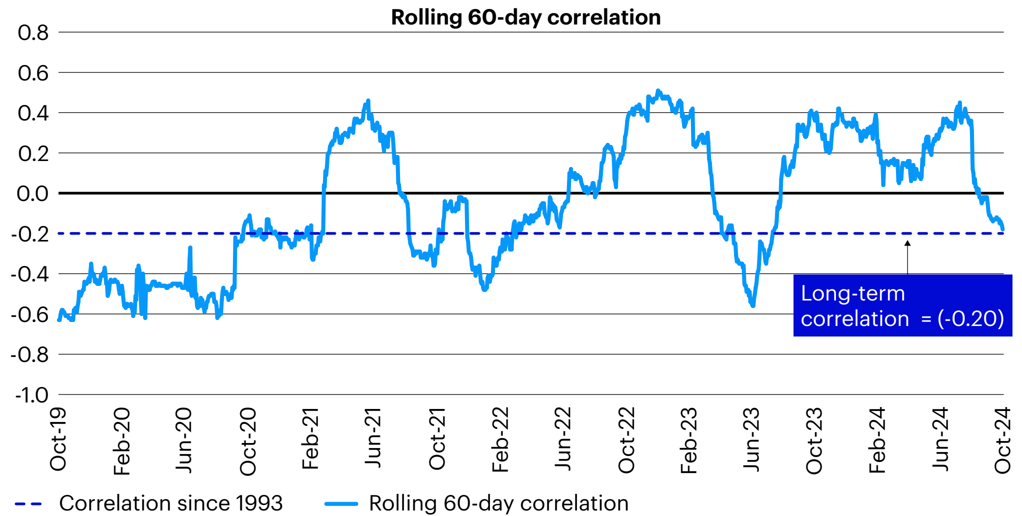
Figure 3: As the high inflation regime dissipates, the correlation between equities and fixed income is returning to negative. Bad growth news is bad news for equities, again

S&P 500 Index correlation to US Treasury returns



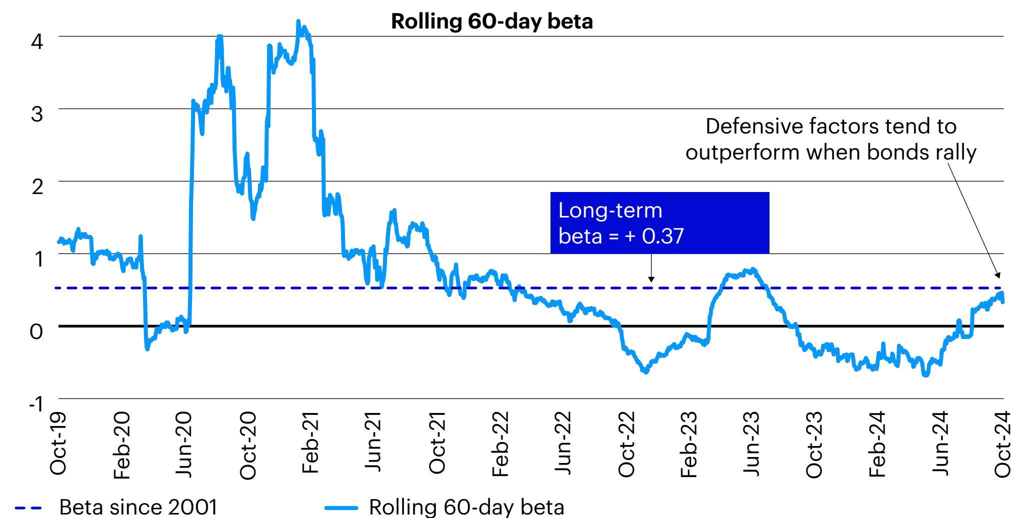
Source: Invesco, data as of Sept. 30, 2024. US Treasury (7-10-year) returns are represented by FTSE US Government Bond 7-10 Years Index. Statistics calculated using daily returns data beginning January 1993. Please see the Appendix for the index methodology. Index returns do not represent strategy returns. Performance for periods greater than 1 year is annualized. An investor cannot invest directly in an index. **Past performance does not guarantee future results.**

Similarly, we are witnessing a normalization in the correlation between bonds and equity styles/factors, where falling bond yields (i.e., rising bond returns) are once again accompanied by outperformance in defensive equity styles (quality, low volatility) relative to cyclicals (small, mid and value), in-line with long-term fundamentals and correlations.

Figure 4: Following the dislocation of the past 18 months, factor correlations with other assets are normalizing. Defensive factors likely to outperform again if bonds rally

Beta of defensive - cyclical factors to US Treasury returns

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



Source: Invesco, data as of Sept. 30, 2024. Defensive factors are represented by the Russell 1000 2xQ/2xLowVol Index, cyclical factors are represented by Russell 1000 2xSize/2xValue Index, and Treasury returns are represented by Bloomberg US Treasury Index. Statistics calculated using daily returns data beginning January 2001. Please see the Appendix for the index methodology. Index returns do not represent strategy returns. Performance for periods greater than 1 year is annualized. An investor cannot invest directly in an index. **Past performance does not guarantee future results.**

Investment positioning

There are no changes in portfolio positioning this month. We underweight risk relative to the benchmark in the Global Tactical Allocation Model,[2] 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 the 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:

Thus far, the performance in other Asian equity markets suggests limited transmission of positive sentiment from China to the region, indicating largely a short squeeze in Chinese equities at this stage rather than a game changer for the broader emerging markets.

- 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 maintain an overweight position in US equities relative to other developed markets and emerging markets, driven by declining global risk appetite, stronger US earnings revisions vs. the rest of the world, and a still favorable outlook for the US dollar. We wait for the impact of China's recent monetary stimulus on global risk appetite, the US dollar, and earnings expectations to assess the case for a rotation into emerging markets in the next few weeks and months. Thus far, the performance in other Asian equity markets suggests limited transmission of positive sentiment from China to the region, indicating largely a short squeeze in Chinese equities at this stage rather than a game changer for the broader emerging markets. However, in case of more meaningful developments in the near future, our panel of relevant indicators, such as global risk appetite, the US dollar and earnings revisions, should respond in real-time and indicate whether the tide is turning in favor of emerging markets.
- 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 have reduced our overweight in nominal bonds versus inflation-protected securities, as inflationary pressures continue to decline but at a less rapid pace (**Figure 5**).
- In **currency markets**, we maintain a moderate overweight in the US dollar, as yield differentials with major foreign currencies are narrowing. However, overall higher yields and negative surprises in global growth still inform our position in favor of the greenback. 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 such as the Colombian peso, Brazilian real, Indian rupee, Indonesian rupiah, and Mexican peso, relative to low yielding and more expensive currencies, such as the Korean won, Taiwan dollar, Philippines peso, and Chinese renminbi.

2. Reference benchmark 60% MSCI ACWI, 40% Bloomberg Global Aggregate Hedged Index.
3. Credit risk defined as duration times spread (DTS).

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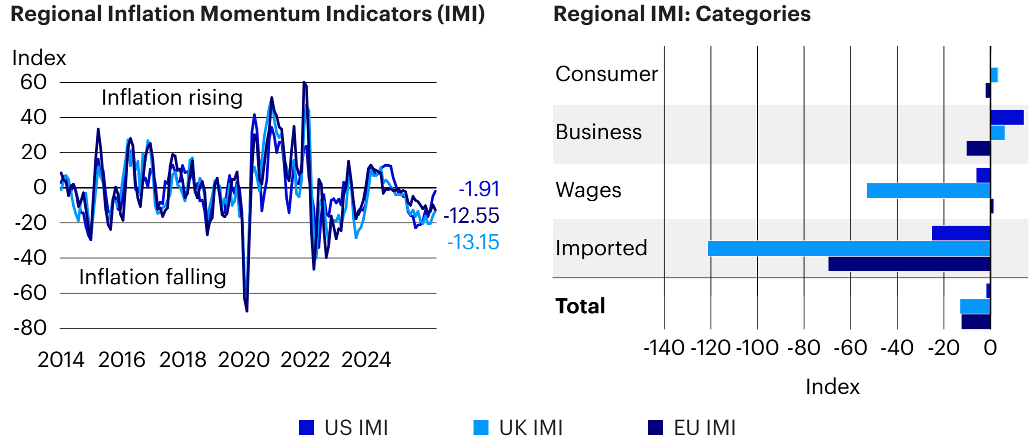
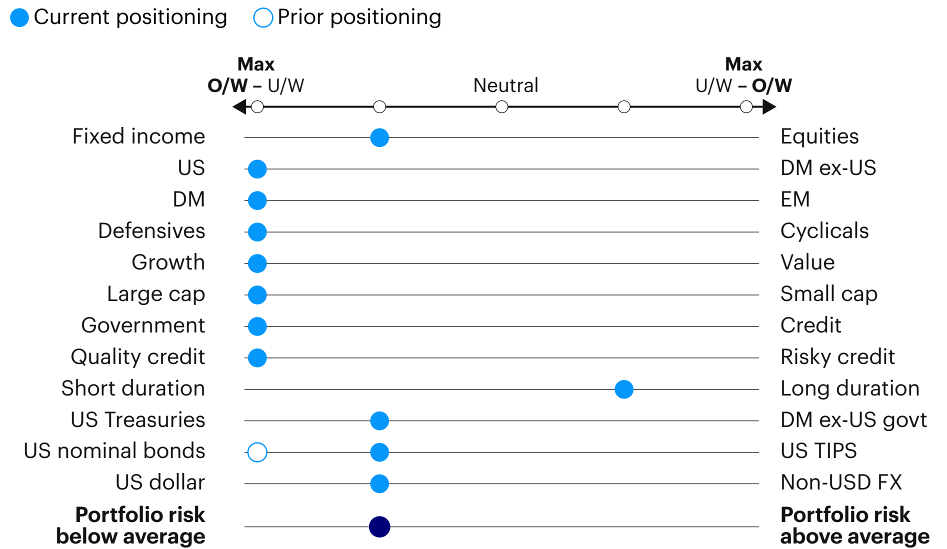
Figure 5: Inflation is decelerating globally, led by lower commodity prices



Sources: Bloomberg L.P., data as of Sept. 30, 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.

Figure 6: Relative tactical asset allocation positioning

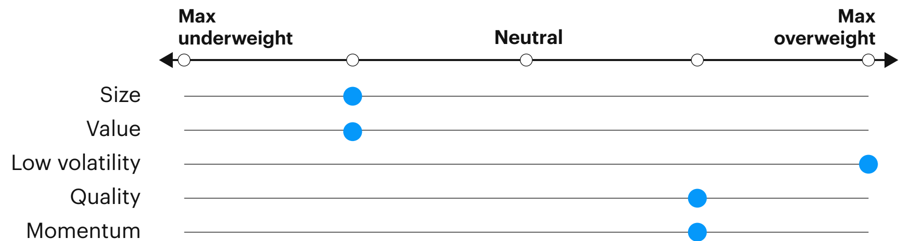
Underweight portfolio risk vs. benchmark, favoring US equities, defensive sectors, and quality credit



Source: Invesco Solutions, Oct. 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.

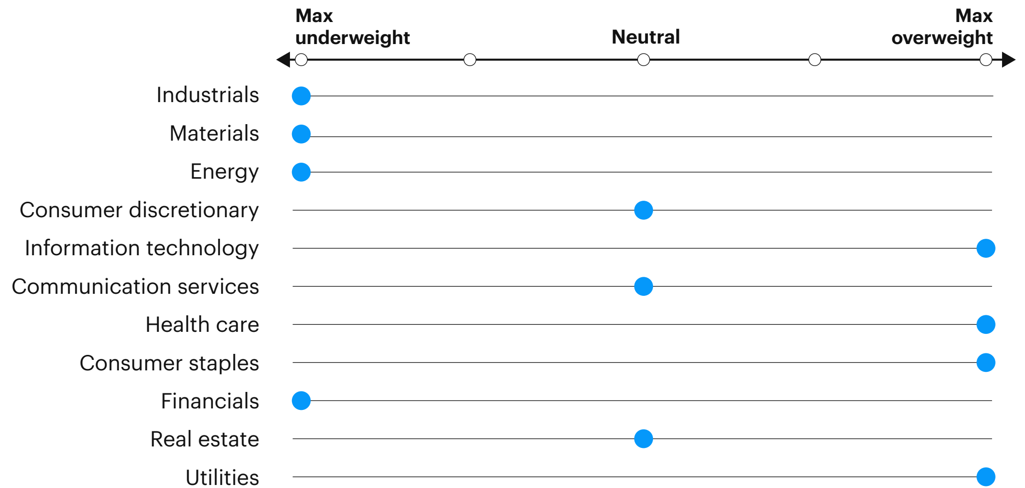
Figure 7: Tactical factor positioning

Overweight quality, low volatility, and momentum



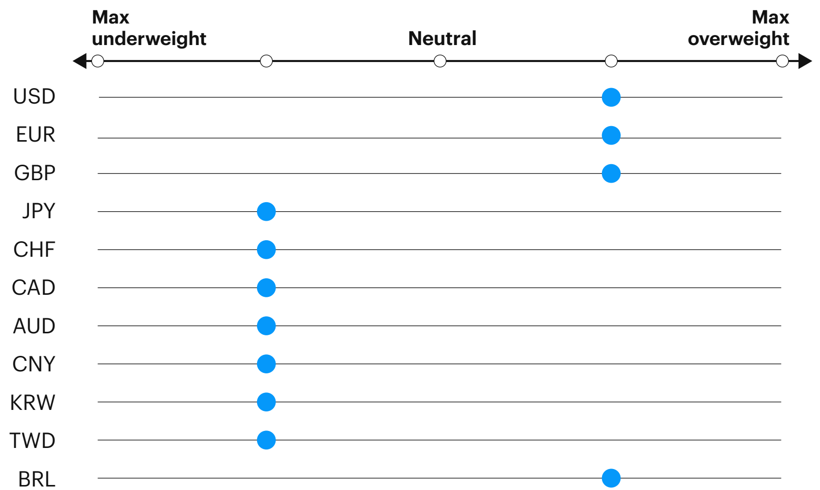
Source: Invesco Solutions, Oct. 1, 2024. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

Figure 8: Tactical sector positioning
Sector exposures favoring defensives



Source: Invesco Solutions, Oct. 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, utilities; Neutral: consumer discretionary and communication services.

Figure 9: Tactical currency positioning
Overweighting US dollar, favoring euro and sterling vs. other developed currencies



Source: Invesco Solutions, Oct. 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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