December 2021

Tactical Asset Allocation

We expect global growth to slow. We have reduced portfolio risk, reducing the overweight in risky assets, increasing duration, and tilting toward defensive factors.

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Synopsis

- Our framework has entered a **slowdown regime**. We expect global growth to remain above trend, but to decelerate over the next few quarters. For the first time in 18 months, we register a deceleration in global risk appetite, signaling declining growth expectations and diminishing returns for risky assets relative to safer asset classes.
- Historically, this economic environment has been associated with **modest but positive returns across asset classes**, with a convergence in performance between growth-sensitive and defensive assets, as compensation for growth risk diminishes.
- We have **reduced portfolio risk to a neutral stance relative to benchmark**,[1] reducing our overweight to equities and risky credit, and extending duration to an overweight exposure. We rotated into defensive sectors and factors (low volatility and quality) and moved to an underweight in emerging market equities relative to developed markets.

Macro update

For the first time in 18 months, we register a clear downshift in global market sentiment. Market participants are revising down future growth expectations as the economy transitions its growth engine from fiscal stimulus to private sector demand. As recently discussed, hawkish rhetoric by central banks has contributed on the margin to this repricing of future growth, causing global yield curves to flatten and price in very low nominal and real long-term rates. The latest developments on the COVID front and the emergence of a new variant (Omicron) are likely to increase the uncertainty of growth estimates over the next year, justifying this softening in risk appetite. Based on our macro framework, **we expect the global economy to enter a slowdown regime, with growth decelerating while remaining above its long-term trend** (**Figure 1a, 1b, and 2**). Leading economic indicators have already peaked. In the developed world, consumer confidence continues to decline, which is partially a reflection of high inflation, reduced spending power, and renewed concerns around lockdowns, especially in Europe. While business surveys, manufacturing activity, and housing indicators remain resilient, activity is likely to peak in the near future. As anticipated last month, China's growth is stabilizing, with the negative momentum in manufacturing and real estate surveys dissipating, and monetary and credit conditions improving. However, we expect growth to remain below trend.

Figure 1a: Macro framework points to a slowdown regime

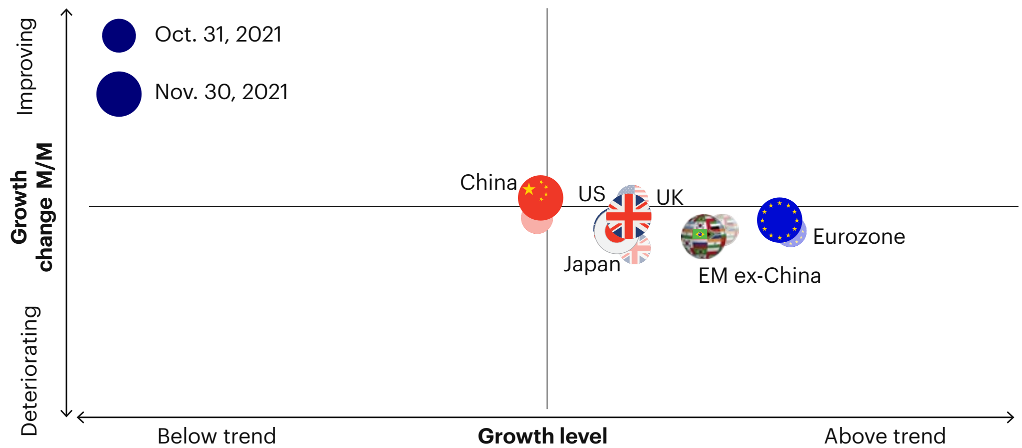
	LEIs		Global risk appetite		
Region	**Current level of growth**		**Change in global growth expectations**		**Expected macro regimes**
Global	**Above trend**	&	**Deteriorating growth expectations**	=	**Slowdown**
United States	**Above trend**				**Slowdown**
Developed markets ex-USA	**Above trend**				**Slowdown**
Europe	Above trend				Slowdown
United Kingdom	Above trend				Slowdown
Japan	Above trend				Slowdown
Emerging markets	**Above trend**				**Slowdown**
China	Below trend				Contraction
Emerging markets ex-China	Above trend				Slowdown

Sources: Bloomberg L.P., Macrobond, Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of Nov. 30, 2021. 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.

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

For the first time in 18 months, we register a clear downshift in global market sentiment. Market participants are revising down future growth expectations as the economy transitions its growth engine from fiscal stimulus to private sector demand.

Figure 1b: Leading economic indicators continue to decelerate at a moderate pace across regions



Sources: Bloomberg L.P., Macrobond, Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of Nov. 30, 2021. 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.

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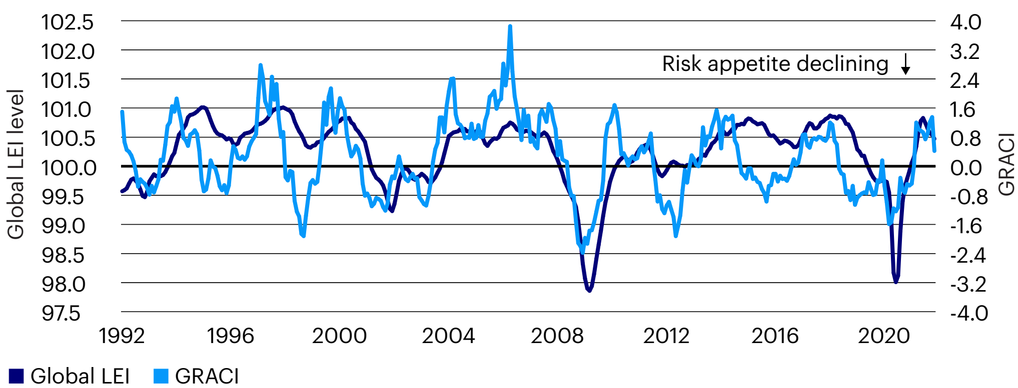
Figure 2: Global risk appetite is decelerating, signaling declining growth expectations

GRACI and the global LEI



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Investment Solutions research and calculations, from Jan. 1, 1992 to Nov. 30, 2021. 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.

This picture is consistent with consensus economic forecasts, seeing US real growth slowing from 5.5% in 2021 to 3.9% (2022) and 2.5% (2023). For the eurozone, consensus estimates see growth decelerating from 5.1% in 2021 to 4.2% (2022) and 2.3% (2023). Finally, China is expected to slow to 5.3% in 2022 and 2023.[2]

Our gauge of inflation momentum has recently increased, reflecting upside surprises in inflation statistics in the past two months (**Figure 3a and 3b**). However, the sharp decline in commodity prices over the past few weeks suggests inflation momentum may abate soon; hence, we reiterate our view for a peak by mid-2022. Despite current inflation running at 30-year highs, we don't see any evidence of a self-fulling inflationary psychology among consumers at this stage. On the contrary, surveys of consumer sentiment suggest high prices are causing spending to be postponed rather than front-loaded in anticipation of higher prices, particularly for purchases of durable goods.[3] While the near-term picture on inflation remains dependent on the resolution of supply-chain bottlenecks and fluctuations in commodity prices, we don't see a risk of rising wage trends outside historical cyclical dynamics, especially if our expectations for a slowing economy materialize. As discussed last month, high precautionary savings and anemic credit demand should keep a lid on long-term inflation expectations and interest rates.

2 Consensus economic forecasts from Bloomberg L.P. surveys.

3 Based on recent results from the Surveys of Consumers by the University of Michigan, one of the primary benchmarks of consumer sentiment in the economic community, with data going back to the 1960s. (https://data.sca.isr.umich.edu/fetchdoc.php?docid=68530)

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Figure 3a: US Inflation Momentum Indicator (IMI)

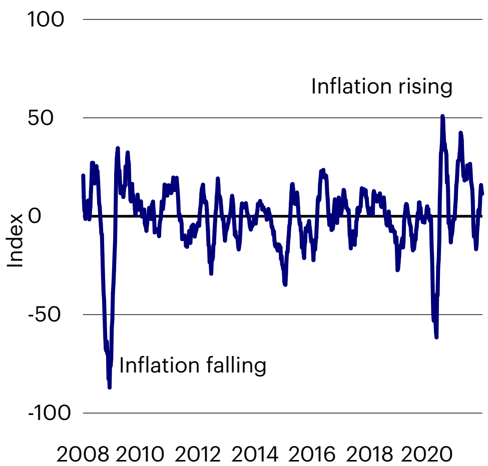
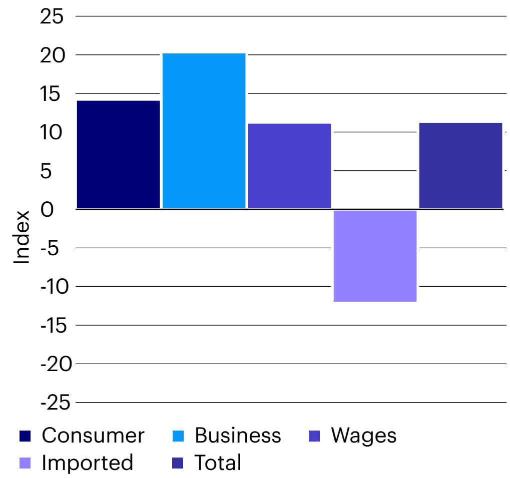


Figure 3b: IIS Inflation Momentum Indicator: Categories



Sources: Bloomberg L.P. data as of Nov. 30, 2021, Invesco Investment 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.

Investment positioning

Transitioning from an expansion to a slowdown regime has important implications for our investment process and portfolio positioning. As illustrated in previous research,[4] this economic environment has been associated with modest but positive returns across asset classes, with a convergence in performance between growth-sensitive and defensive assets. When cash-flow growth expectations decelerate, compensation for growth risk diminishes (i.e., credit and equity excess returns), while compensation for duration risk tends to increase, often explaining the bulk of total returns across asset classes.

We reduced our overall portfolio risk to a neutral stance relative to benchmark risk in the Global Tactical Asset Allocation model.[1] **We reduced the overweight in equities relative to fixed income, and within equities, we rotated out of cyclical into defensive sectors and factors. We reduced our portfolio credit risk to neutral, moving toward higher-quality credit assets and increasing duration to an overweight stance relative to the benchmark.** (**Figure 4, 5, and 6**). In particular:

- Within **equities**, we rotated out of cyclical factors such as value and (small) size into defensive factors like quality and low volatility, which tend to outperform via a combination of declining growth expectations and higher-duration properties. We reduced our exposure to the momentum factor, which has historically underperformed at cyclical turning points when fundamental and price dynamics shift. Similarly, we repositioned toward defensive sectors with quality characteristics and positive exposure to lower bond yields such as information technology, communication services, health care, consumer staples, etc. (**Figure 6**). From a regional perspective, we moved to an underweight exposure in emerging markets relative to developed markets as decelerating global growth and risk sentiment don't bode well for investors' appetite toward riskier markets.
- In **fixed income**, we moved to an overweight duration exposure, expecting long-term bond yields to decline as growth decelerates and inflation peaks. With about 30-40 basis points (bps) higher 10-year US bond yields already priced-in over the next 12 months, above-average duration provides attractive positive carry also in a potentially range-bound yield environment.[5] We moved to a more neutral credit risk stance relative to our benchmark,[6] reducing exposure to high-yield credit and moving to shorter maturities, with more income potential per unit of risk. We remain overweight bank loans and emerging markets hard currency debt at the expense of investment grade on a duration-matched basis. We favor US Treasuries over other developed government bond markets given the yield advantage.

4 Alessio de Longis, "Dynamic Asset Allocation Through the Business Cycle: A Macro Regime Approach," 2019; and Alessio de Longis, Dianne Ellis, "Market Sentiment and the Business Cycle: Identifying Macro Regimes Through Investor Risk Appetite," 2019

5 Market pricing references as of Dec. 1, 2021.

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

- In **currency markets,** we maintain an overweight to the US dollar, as negative growth surprises outside the US continue to flag near-term risk to foreign currencies despite attractive valuations. Within developed markets, we underweight the British pound, the Swiss franc, the Australian dollar, and the Swedish krona, while we are overweight the Japanese yen, the Canadian dollar, the Singapore dollar, and the Norwegian kroner. In emerging markets, we favor high yielders with attractive valuations such as the Russian ruble, the Indian rupee, the Indonesian rupiah, and the Brazilian real. We are underweight the Taiwan dollar and the Korean won.

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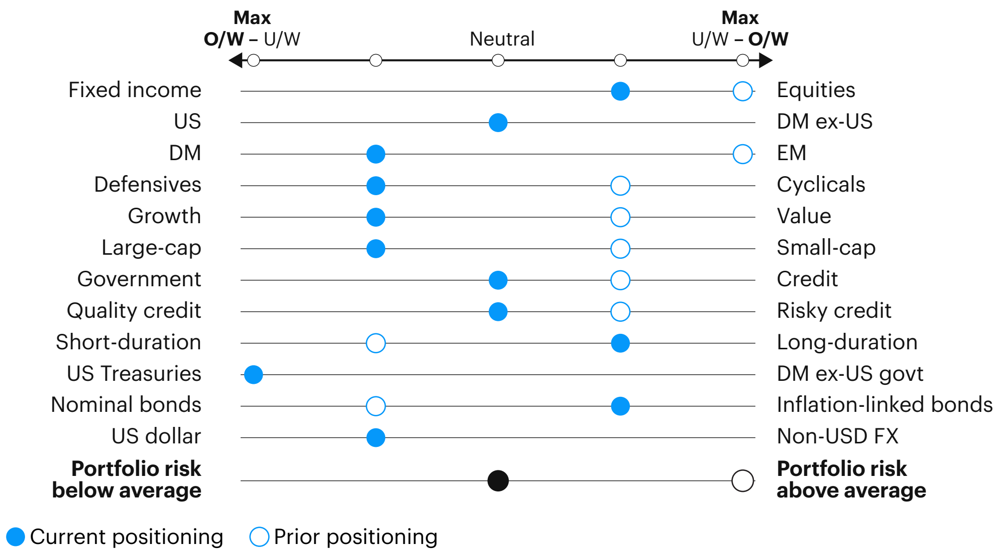
Figure 4: Relative tactical asset allocation positioning for the slowdown regime with lower portfolio risk



Source: Invesco Investment Solutions, Nov. 30, 2021. DM = developed markets. EM = emerging markets. FX = foreign exchange. For illustrative purposes only.

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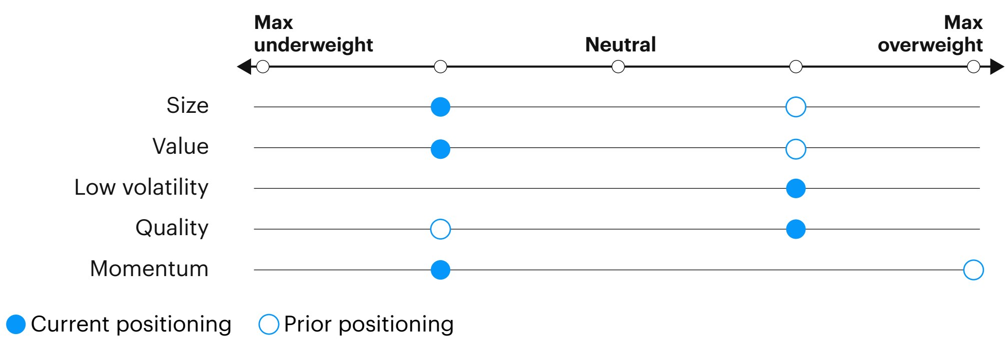
Figure 5: Tactical factor positioning

Factor tilts within the slowdown regime are toward quality and low volatility

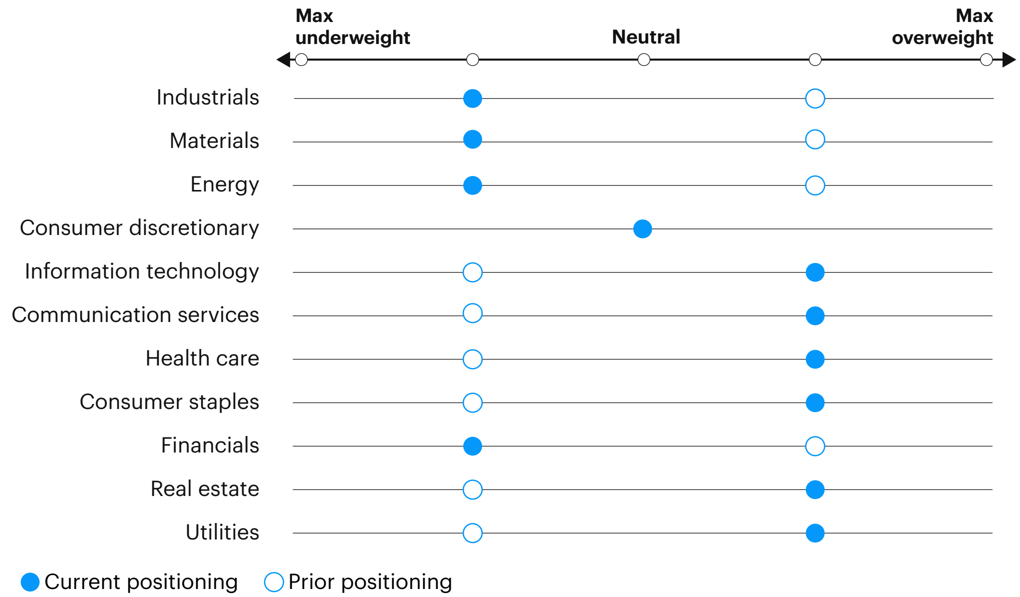


Source: Invesco Investment Solutions, Nov. 30, 2021. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

We repositioned toward defensive sectors with quality characteristics and positive exposure to lower bond yields such as information technology, communication services, health care, consumer staples, etc.

Figure 6: Tactical sector positioning

In a slowdown regime, we overweight defensive sectors relative to cyclicals.



Source: Invesco Investment Solutions, Nov. 30, 2021. For illustrative purposes only. Sector allocations derived from factor and style allocations.

Investment risks

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