Tactical Asset Allocation

Growth is slowing. We are overweight equity relative to fixed income, with a tilt toward defensive factors and sectors. We maintain an overweight duration stance and underweight the US dollar.

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Synopsis

- Our framework remains in a slowdown regime. Historically, this economic backdrop has led to 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 maintain a neutral risk stance relative to our benchmark,[1] with an overweight to equites versus fixed income but a tilt toward defensive equity factors (low volatility and quality) and sectors, and an overweight to developed market equities relative to emerging markets. We are overweight interest rate duration and neutral on credit risk, with an exposure to short and intermediate credit maturities. We moved to an underweight US dollar exposure.

Macro update

Global bond markets have experienced a meaningful hawkish repricing of monetary policy expectations over the past two months, with US bond yields rising across maturities by about 20-40 basis points in January 2022 alone. The initial catalyst for this repricing can, arguably, be attributed to news of the Omicron COVID-19 variant in the third week of November, and the resulting magnification of pre-existing inflationary pressures caused by production and distribution bottlenecks.

While at first the news led to an immediate “growth scare” reaction with falling bond yields and equity markets, the narrative shifted over the following weeks to an “inflation scare,” also acknowledged by the Federal Reserve in its subsequent Federal Open Market Committee (FOMC) meetings. In the January meeting, the FOMC made very clear they are determined to raise rates steadily over the next few quarters, given a very strong labor market and inflation running at 40-year highs across multiple metrics.[2]

But higher interest rates do not address supply-driven inflationary pressures, and the Fed finds itself dealing with a problem that originated elsewhere, namely supply-side disruptions and, in hindsight, excess fiscal stimulus which was, nonetheless, necessary. By tightening financial conditions, the Fed is seeking to slow aggregate demand because the supply-side of the economy is not equipped to handle overheating. As a result, the yield curve has continued to flatten aggressively as bond markets price-in a rapid, front-loaded tightening cycle followed by a return to the low growth / low inflation economy that we saw after the Global Financial Crisis.

While these bond market dynamics have been a prominent part of the market narrative of the past two months, in our opinion they have been in place since the June 15 FOMC meeting, which was the first time that the Federal Reserve explicitly acknowledged the upside risks to inflation and the strength of the labor market, and validated market pricing for rate hikes to commence before the end of 2023. Since then, the market has priced in six rate hikes over the next two years, raising two-year US bond yields by about 102 basis points, from 0.16% to 1.18%. However, 30-year bond yields have declined by about 7 basis points, from 2.18% to 2.11%, resulting in a twist flattening of the yield curve with long-term bonds (10-year +) outperforming short (1-3 year) and intermediate (3-10 year) maturities, posting returns of 1.7%, -1.3% and -2.5%, respectively.[3] We see that as a remarkable outcome given a six-hikes repricing of policy expectations.

While somewhat unique, these market developments are not inconsistent with the historical market implications of our macro regime framework. Our leading economic and market sentiment indicators continue to project a slowdown regime for the global economy (**Figure 1a, Figure 1b, and Figure 2**), which has historically been associated with low but positive returns across asset classes, a convergence in performance between equities and fixed income, and outperformance in higher duration, higher quality assets with more defensive characteristics.[4] Despite the rise in short-term bond yields, and the upcoming tightening cycle, we expect long-term bond yields to remain anchored as the economy slows.

1 Global 60/40 benchmark (60% MSCI ACWI / 40% Bloomberg Barclays Global Aggregate USD hedged)
2 Measures such as US core Personal Consumption Expenditures, core Consumer Price Index and core Producer Price Index currently registering the highest year-on-year rates since the early 1980s.

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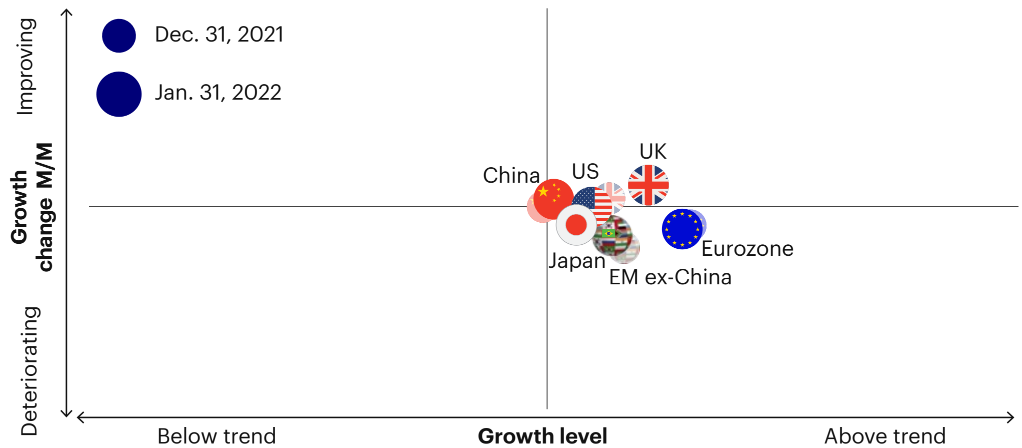
Figure 1a: Macro framework points to a slowdown regime

	LEIs		Global risk appetite		
Region	**Current level of growth**		**Change in global growth expectations**		**Expected macro regimes**
Global	**Above trend**	&	**Growth expectation deteriorating**	=	**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	Above trend				Slowdown
Emerging markets ex-China	Above trend				Slowdown

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

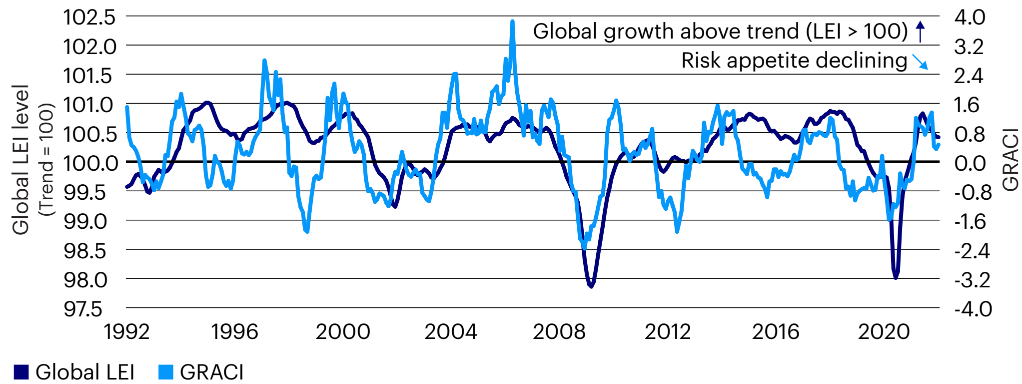


Sources: Bloomberg L.P., Macrobond. Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of Jan. 31, 2022. The Leading Economic Indicators (LEIs) are proprietary, forward-looking measures of the level of economic growth. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets’ risk sentiment.

3 Bond yield changes measured over the period June 15, 2021, to Jan. 31, 2022. Returns calculated using FTSE US government bond total return indices for the 1-3y, 3-10y, and 10y+ sectors, from June 15, 2021, to Jan. 31, 2022.
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. Alessio de Longis, Mo Haghbin, “Dynamic Multifactor Strategies: A Macro Regime Approach”, 2020.

Declining inflation in the near term, and markets' comfort with the new policy path, may reduce uncertainty and boost short-term growth expectations and risk appetite.

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 Jan. 31, 2022. 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.

While we expect this environment to prevail in the near term, what are the potential scenarios from here? What could be the catalyst for a re-acceleration in growth expectations leading our framework to go back into an expansionary regime? Or is this slowdown a precursor to a contraction in the near future?

- Supply side constraints such as declining labor force participation, impaired production and transportation channels have contributed to the decline in real long-term yields and, consequently, nominal bond yields. Improving supply side dynamics could raise real long term interest rates, reduce inflationary pressures, and put the economy on a higher trend-growth path, resulting in rising long-term bond yields and outperformance in growth-sensitive assets (i.e., equities).
- Declining inflation in the near term, and markets' comfort with the new policy path, may reduce uncertainty and boost short-term growth expectations and risk appetite.
- On the other hand, an aggressive Fed tightening cycle could contribute to a more meaningful downward adjustment in growth expectations, with associated underperformance in risk assets.

Adhering to our investment process, we stand ready to alter our asset allocation in response to changing macro/market conditions.

Positive, albeit weak, short-term inflation momentum argues for some exposure to Treasury Inflation-Protected Securities

Figure 3a: US Inflation Momentum Indicator (IMI)

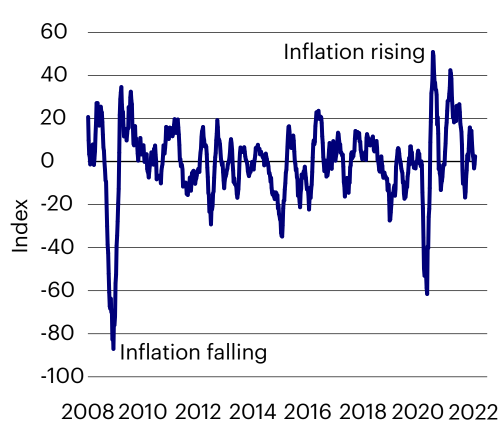
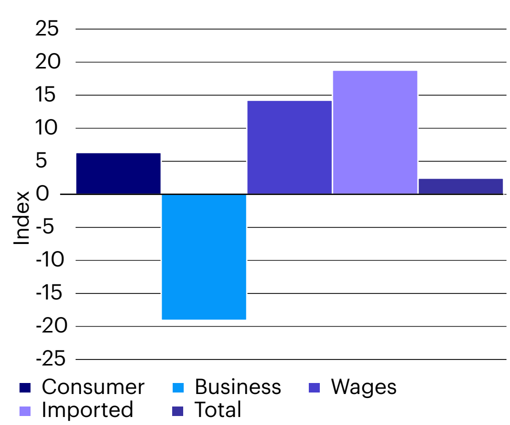


Figure 3b: IIS Inflation Momentum Indicator: Categories



Sources: Bloomberg L.P. data as of Jan. 31, 2022, 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

A slowing economy with growth above trend has historically been accompanied by modest but positive returns across asset classes, with a convergence in performance between growth-sensitive and defensive assets. When earnings 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 maintain an overall neutral risk stance relative to our benchmark in the Global Tactical Asset Allocation model[1]. **We are moderately overweight equities relative to fixed income, and within equities we favor defensive sectors and factors. We maintain a neutral stance on portfolio credit risk,[5] with a higher allocation to short and intermediate credit maturities, and overweight interest rate duration relative to benchmark. (Figure 4, 5, 6).** In particular:

- Within **equities** we overweight defensive factors like quality and low volatility, which tend to outperform via a combination of declining growth expectations and higher duration properties. Similarly, we favor 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 maintain an underweight exposure in emerging markets relative to developed markets as slowing global growth and a deceleration in global risk appetite provide headwinds for riskier markets.
- In **fixed income** we are overweight duration, expecting long-term bond yields to decline as growth decelerates and inflation is likely to peak over the next few quarters. We maintain a neutral credit risk stance relative to benchmark with a higher allocation to short and intermediate maturities in high yield and bank loans, with more income per unit of risk, given historically tight credit spreads, at the expense of investment grade credit. We favor US Treasuries over other developed government bond markets given the yield advantage on a currency-hedged basis. Positive, albeit weak, short-term inflation momentum argues for some exposure to Treasury Inflation-Protected Securities (**Figure 3**).
- In **currency markets** we moved to an underweight US dollar exposure, as growth outside the US is surprising to the upside, while still decelerating. In developed markets we underweight the British pound, Swiss franc, Canadian dollar, and Australian dollar, while we overweight the euro, Japanese yen, Singapore dollar, Norwegian kroner, and Swedish krona. In emerging markets we favor high yielders with attractive valuations such as the Russian ruble, Indian rupee, Indonesian rupiah, and Brazilian real. We underweight the Taiwan dollar, Korean won and Thai baht.

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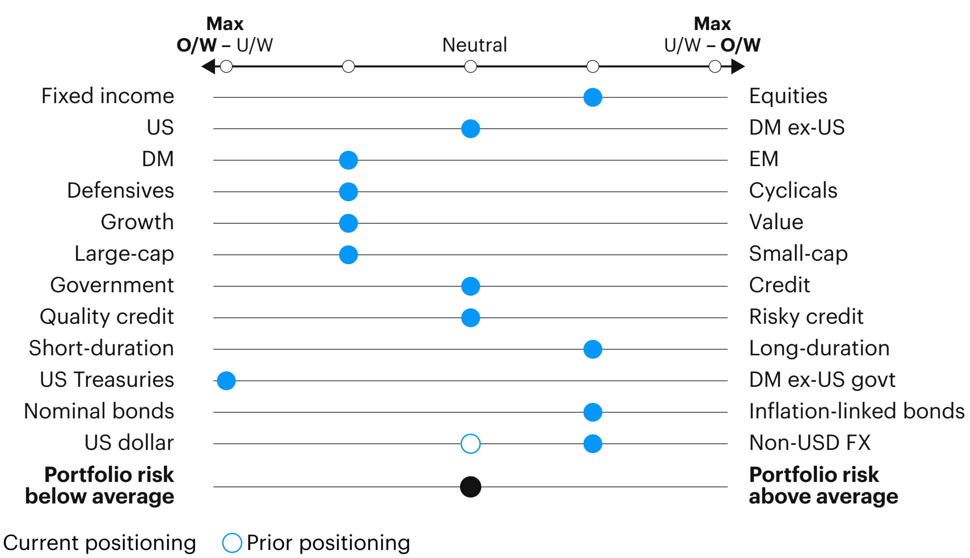
Figure 4: Relative tactical asset allocation positioning

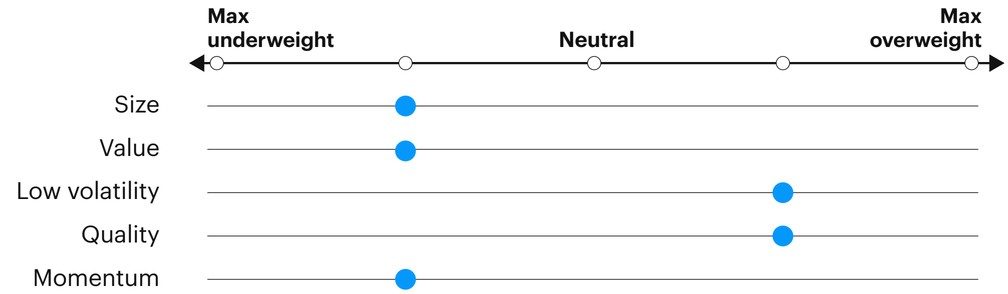
Underweight USD exposure, as growth outside the US surprises to the upside



Source: Invesco Investment Solutions, Jan. 31, 2021. DM = developed markets. EM = emerging markets. FX = foreign exchange. For illustrative purposes only.

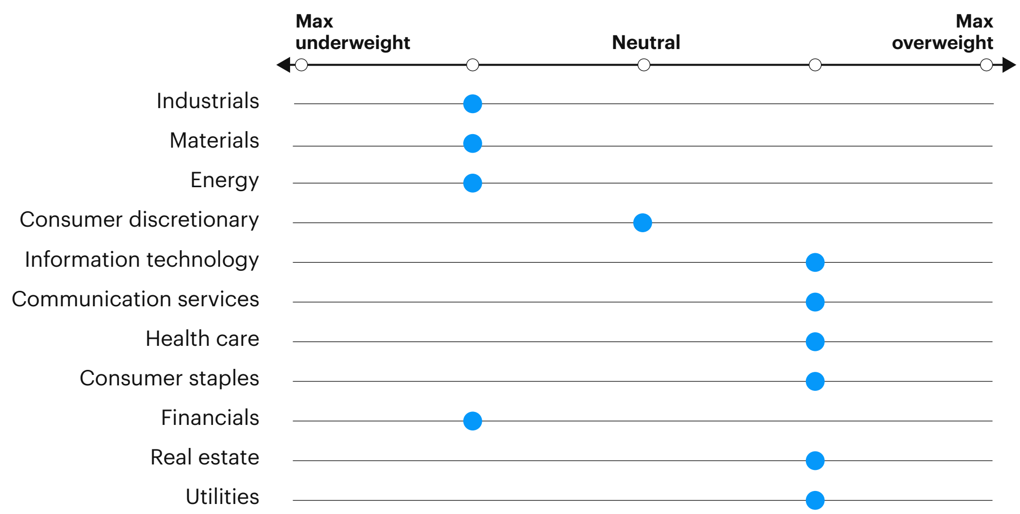
5 Credit risk defined as duration times spread (DTS).

Figure 5: Tactical factor positioning
Factor tilts within the slowdown regime are toward quality and low volatility



Source: Invesco Investment Solutions, Jan. 31, 2021. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

Figure 6: Tactical sector positioning
In a slowdown regime, we overweight defensive sectors relative to cyclicals.



Source: Invesco Investment Solutions, Jan. 31, 2021. For illustrative purposes only. Sector allocations derived from factor and style allocations.

Investment risks

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