Invesco

Tactical Asset Allocation

Increasing downside risks to growth and rising inflationary pressures confirm our neutral portfolio risk stance. We have reduced credit risk and increased the overweight to inflation-linked bonds.

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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.
- The escalation of the Russia/Ukraine conflict increases downside risks to growth and increases upside risks to inflation, amplifying trends already in place for the past few quarters.
- 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, overweight inflation-linked bonds, and underweight credit risk, with exposure to short and intermediate credit maturities.

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

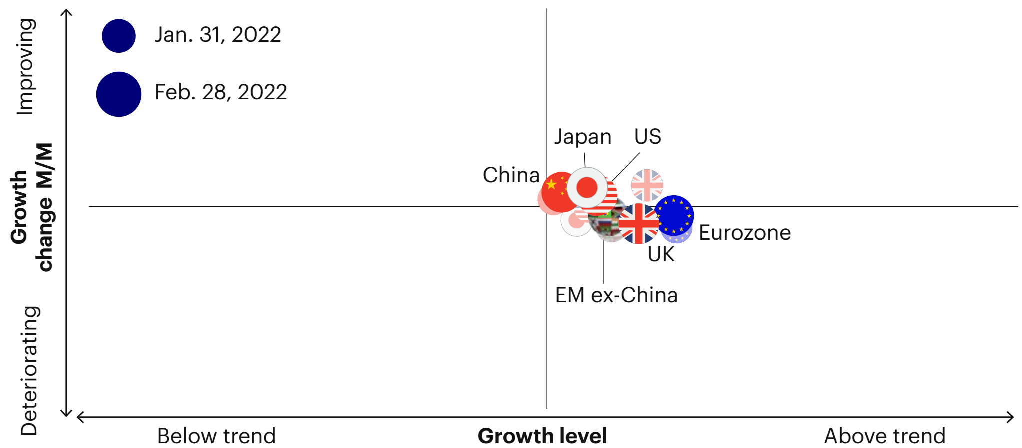
Macro update

Our macro framework continues to point to a decelerating growth environment (**Figure 1 and 2**), coupled with rising inflationary pressures (**Figure 3**). The escalation of the Russia/Ukraine conflict increases downside risks to growth and increases upside risks to inflation, amplifying trends already in place for the past few quarters. The impact on the economy and financial markets is propagated via several direct and indirect channels related to Russia's dominant role in commodity markets, and the severe economic and financial sanctions imposed by the Western world.

Figure 1a: Macro framework points to a slowdown regime

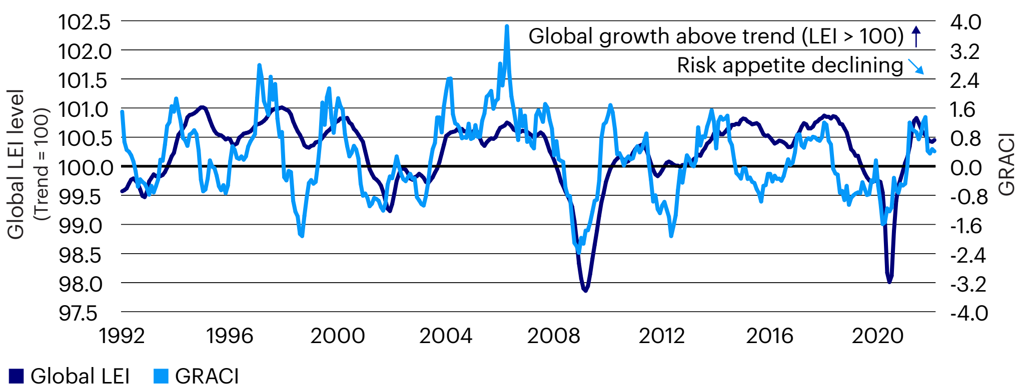
Region	LEIs Current level of growth		Global risk appetite Change in global growth expectations		Expected macro regimes
Global	**Above trend**	&	**Growth expectation deteriorating**	=	**Slowdown**
United States	**Above trend**				**Slowdown**
Developed markets ex-USA	**Above trend**				**Slowdown**
Europe	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 Feb. 28, 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.

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 Feb. 28, 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.

Commodity markets and upside risks to inflation

Russia and Ukraine are both major commodity producers. Russia represents about 12% of the world's oil production and 17% of natural gas production, supplying about 1/3 of Europe's total natural gas consumption. In the metals market, while Russia represents a smaller share of production (between 5% and 10% of the world's copper, nickel, and aluminum), there are important second-round effects to be considered as Russia's energy powers about 40% of Europe's aluminum production, an energy-intensive industry. Therefore, the overall impact on industrial metals is likely to be larger than Russia's metals production numbers might suggest. Furthermore, Russia produces about 40% of the world's palladium and 20% of platinum, key components to catalytic converters used in cars. Finally, Russia and Ukraine account for more than 30% of the world's wheat exports and 20% of corn production, with a direct impact on agricultural commodities and global food prices[2]. Resulting price pressures are emerging also in our inflation momentum indicator, primarily via imported inflation (**Figure 3**).

2 Sources: British Petroleum, US Department of Agriculture, Macrobond

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Figure 3a: US Inflation Momentum Indicator (IMI)

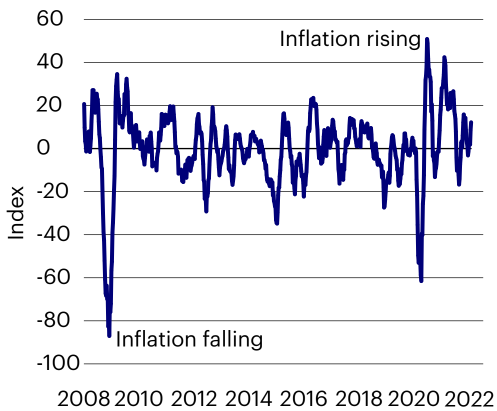
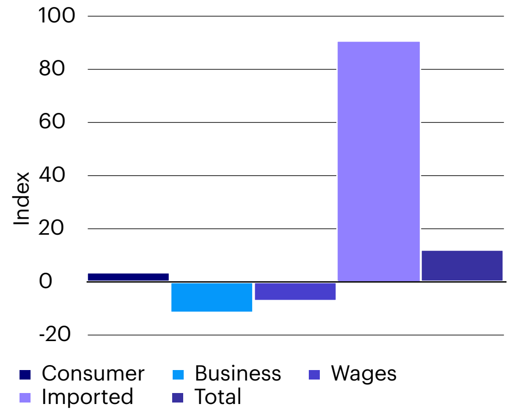


Figure 3b: IIS Inflation Momentum Indicator: Categories



Sources: Bloomberg L.P. data as of Feb. 28, 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.

Financial sanctions and downside risks to growth

Western nations have announced an unprecedented round of economic and financial sanctions, likely to deliver a meaningful hit to the Russian economy, with some non-negligible spillover to key trading partners and global financial institutions. The combination of

- freezing all Russia's central bank foreign exchange reserves (about US$630 billion) held in Western financial institutions[3],
- curtailing the convertibility between the ruble and US dollar, euro, or British pound,
- barring major Russian banks from SWIFT,

will dramatically limit Russia's ability to transact with any global financial institution, since only 15% of Russian exports are denominated in ruble, with the remaining 85% denominated in US dollar and euro. However, these measures are likely to carry a smaller, residual negative impact also for Western institutions and global trade, due to payment and settlement difficulties incurred by countries exporting to Russia, until alternative solutions are put in place.

Market impact

The reaction across financial markets has been notable and directionally intuitive across equity, fixed income, commodity, and currency markets. However, moves have only been outright disorderly for Russian assets, with Russian equities and currency falling by roughly 50% and 30% respectively over the past month. The Federal Reserve and the European Central Bank have announced their readiness to address potential funding stress in money markets with emergency liquidity backstops, with the goal to offset collateral damage from the sanctions. At this stage, it seems unlikely these developments will derail the path of the Fed to steadily raise interest rates in 2022. Adhering to our investment process, we stand ready to alter our asset allocation in response to changing macro/market conditions.

3 Source: International Monetary Fund (IMF)

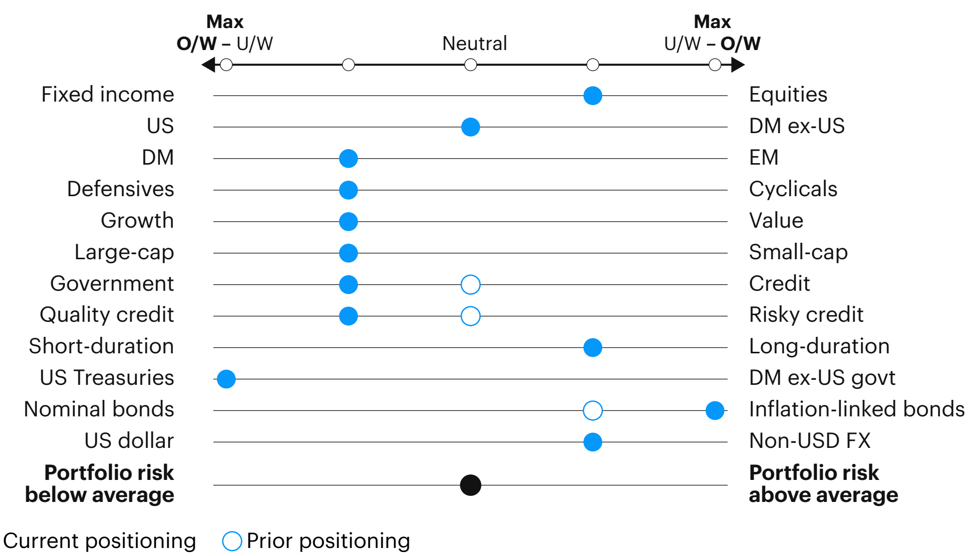
Investment positioning

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 move to an underweight stance on portfolio credit risk[4], 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 rising geopolitical risk provide headwinds to risk appetite in these markets.
- In **fixed income** we remain overweight duration despite the recent decline in bond yields. Rising inflationary pressures are likely to keep short and intermediate bond yields on the rise, once the dust settles, while declining growth expectations should exert downward pressure on the long end of the yield curve. We have increased our inflation-linked bonds exposure to a max overweight relative to nominal Treasuries, given rising inflationary pressures. We further reduce our credit exposure, moving to an underweight stance relative to benchmark, with a higher allocation to short and intermediate maturities in high yield and bank loans, and no exposure to emerging markets debt. We favor US Treasuries over other developed government bond markets given the yield advantage on a currency-hedged basis.
- In **currency markets** we remain underweight in US dollar exposure. In developed markets we underweight the British pound, Swiss franc, Japanese yen, and Australian dollar, while we overweight the euro, Canadian dollar, Singapore dollar, Norwegian kroner, and Swedish krona. In EM we favor high yielders with attractive valuations such as the Indian rupee, Indonesian rupiah, and Brazilian real. We exited our ruble position in early February, despite attractive valuations, on rising idiosyncratic risks. We underweight the Taiwan dollar, Korean won and Philippine peso.

Figure 4: Relative tactical asset allocation positioning

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



Source: Invesco Investment Solutions, Feb. 28, 2022. DM = developed markets. EM = emerging markets. FX = foreign exchange. For illustrative purposes only.

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> We have increased our inflation-linked bonds exposure to a max overweight relative to nominal Treasuries, given rising inflationary pressures.

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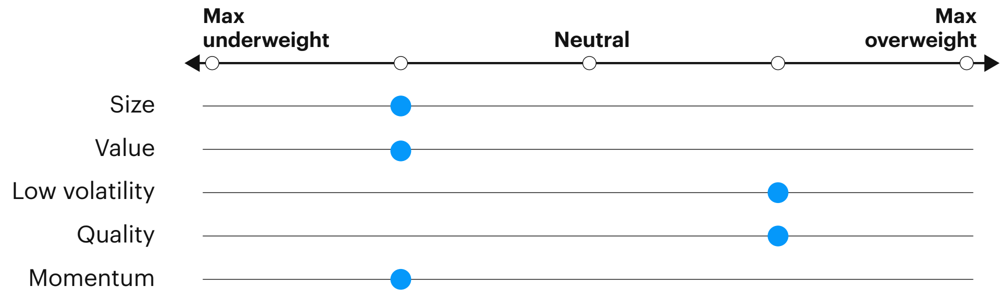
> Adhering to our investment process, we stand ready to alter our asset allocation in response to changing macro/market conditions.

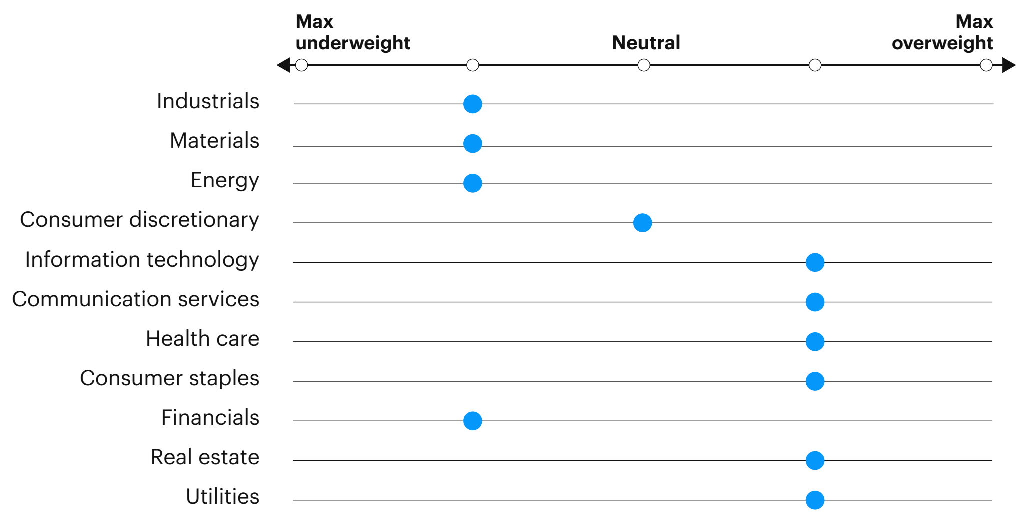
4 Credit risk defined as duration times spread (DTS).

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



Source: Invesco Investment Solutions, Feb. 28, 2022. 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, Feb. 28, 2022. For illustrative purposes only. Sector allocations derived from factor and style allocations.

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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