

We remain underweight risk relative to benchmark<sup>1</sup>.



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### Synopsis

- Our framework remains in a contraction regime. We expect decelerating earnings to drive equities lower.
- Underweight risk relative to benchmark in the Global Tactical Asset Allocation model<sup>1</sup>, favoring fixed income over equities, underweighting credit risk<sup>2</sup>, overweighting duration, the US dollar and defensive equity factors.

### Macro update

Leading economic indicators continue to weaken, suggesting growth likely to be below trend across regions. Surveys of consumer sentiment remain around all-time lows in both the United States, Eurozone, and United Kingdom, but have stabilized in the last three months. Business surveys, manufacturing activity and the construction sector continue to decline towards their long-term trend, while monetary conditions continue to tighten. Risk sentiment continues to deteriorate, with equity markets underperforming fixed income, and credit spreads widening again to recent highs. We believe this process has further to run and is indicative of deteriorating growth expectations (**Figure 1** and **Figure 2**).

**Figure 1a: Macro framework points to a contraction in the global economy**

	LEIs		Global risk appetite	
<b>Region</b>	<b>Current level of growth</b>		<b>Change in global growth expectations</b>	<b>Expected macro regimes</b>
<b>Global</b>	<b>Below trend</b>	&	<b>Growth expectation deteriorating</b>	<b>Contraction</b>
<b>United States</b>	<b>Below trend</b>			<b>Contraction</b>
<b>Developed markets ex-USA</b>	<b>Below trend</b>			<b>Contraction</b>
Europe	Below trend			Contraction
United Kingdom	Below trend			Contraction
Japan	Above trend			Slowdown
<b>Emerging markets</b>	<b>Below trend</b>			<b>Contraction</b>
China	Below trend			Contraction
Emerging markets ex-China	Above trend			Slowdown

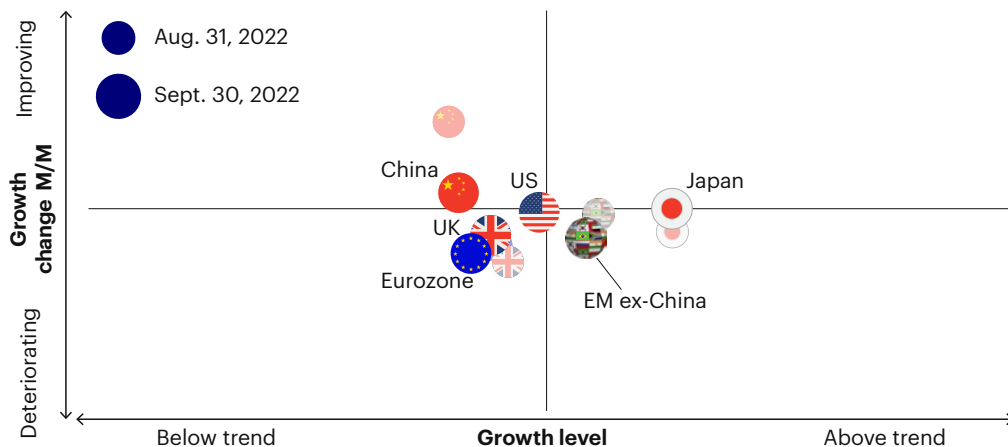
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1. Global 60/40 benchmark (60% MSCI ACWI, 40% Bloomberg Global Aggregate USD Hedged).  
2. Credit risk defined as duration times spread (DTS).



Leading economic indicators continue to weaken, suggesting growth likely to be below trend across regions.

**Figure 1b: Developed markets continue to decelerate, while China is bottoming out.**



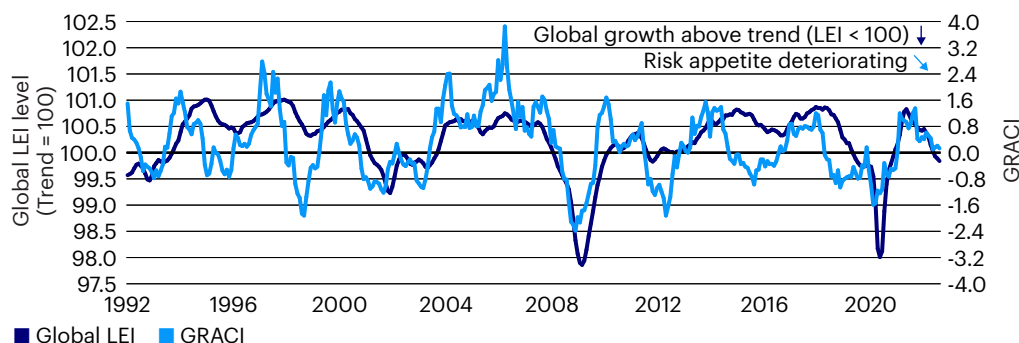
Sources: Bloomberg L.P., Macrobond. Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of Sept. 30, 2022. The Leading Economic Indicators (LEIs) are proprietary, forward-looking measures of the level of economic growth. The Global Risk Appetite Cycle Indicator (GRACI) is a proprietary measure of the markets' risk sentiment.



Risk sentiment continues to deteriorate, with equity markets underperforming fixed income, and credit spreads widening again to recent highs. We believe this process has further to run and is indicative of deteriorating growth expectations.

**Figure 2: Market sentiment signals 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 Sept. 30, 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.



Despite inflation running at 40-year highs, long-term inflation expectations remain anchored at 2-2.5%, except for a brief breach of this ceiling in the spring, highlighting market confidence in central banks' inflation targeting objectives.

The sell-off in bond yields has gathered steam over the past two months, inflicting additional pain to investors after experiencing the worst bond market performance in recorded history. A closer inspection of the dynamics in bond yields this year, however, reveals some interesting observations. Despite inflation running at 40-year highs, long-term inflation expectations remain anchored at 2-2.5%, except for a brief breach of this ceiling in the spring, highlighting market confidence in central banks' inflation targeting objectives. **Figure 3** illustrates the decomposition of nominal 10-year US Treasury yields between real rates and inflation expectations, highlighting how the entire underperformance in government bond markets this year can be attributed to the rise in real yields, i.e., the yield on inflation-protected securities (TIPS), not inflation expectations. The rise in real yields from -1.2% to +1.7% is indicative of a meaningful shift in the global supply and demand for capital, namely a sharp decline in the supply of savings relative to investment demand, leading to a rise in the real cost of capital. Expectations for quantitative tightening and liquidity withdrawal have contributed to this meaningful shift.

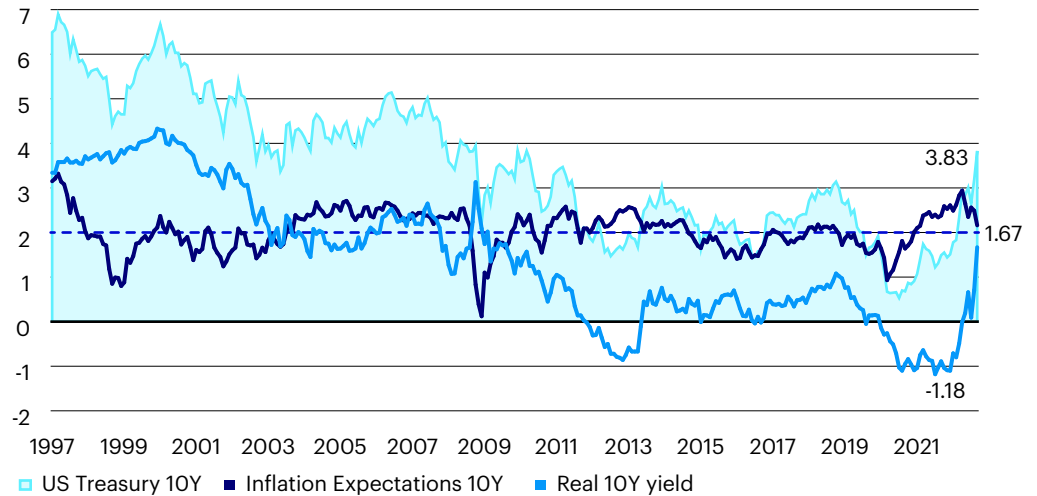
Why is this distinction important? In an investment world where inflation expectations remain anchored, we can assume a stable inflation volatility premium going forward, and a lower likelihood of dysfunctional bond market dynamics echoing the 1970s. While the future direction of real rates is far from certain, today's 1.7% is more in-line with the average real rate of 2% prevailing in the pre-quantitative easing period between 2002 – 2008, increasing the likelihood of a stabilization in nominal and real bond yields over the next few months and quarters. The recent decline in inflation expectations is also consistent with the decelerating inflation momentum we registered over the past three months (Figure 4).



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**Figure 3: Rise in bond yields driven by real yields, not inflation expectations**

UST 10Y yields = 10Y TIPS yield + 10Y inflation expectations

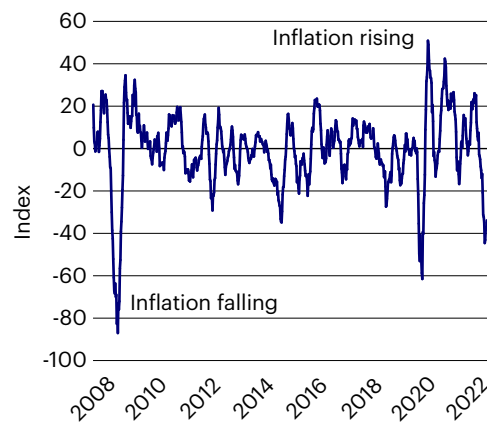


Source: Bloomberg. Breakeven inflation expectations calculated as the difference between Nominal 10Y US Treasury yields and the yield on 10Y Treasury Inflation Protected Securities (TIPS). Sample January 1997 - September 2022.

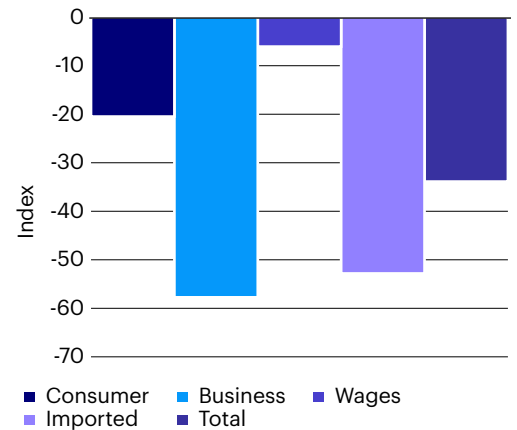


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**Figure 4a: US Inflation Momentum Indicator (IMI)**



**Figure 4b: IIS Inflation Momentum Indicator: Categories**



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



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On the other hand, we believe equity markets are yet to reflect higher growth risks and the associated potential earnings correction. The underperformance in global equities relative to credit and government bonds markets over the past month is a step in this direction, in our opinion, and consistent with a repricing of growth risk. Our framework suggests this process has further to go, as risk sentiment remains on a downward trend and leading economic indicators continue to decline.

## Investment positioning

**There are no changes this month in our Global Tactical Asset Allocation model. We maintain an underweight risk stance relative to benchmark, expressing a defensive bias across most levers in the portfolio, and overweight the US dollar. We remain underweight equity in favor of fixed income, which now offers attractive 5-6% yields in investment grade or 8-9% yields in risky credits. Within fixed income we remain underweight credit risk<sup>3</sup> and overweight duration relative to benchmark (Figure 5, 6, 7).**

In particular:

- Within **equities** we are underweight value, small and mid-cap equities, favoring defensive factors like quality, low volatility, and momentum, resulting in defensive sector exposures with higher duration characteristics and lower operating leverage such as information technology, communication services and health care, at the expense of financials, industrials, and materials. We expect these defensive characteristics to outperform in an environment of below-trend and slowing growth, declining inflation, and peaking bond yields. From a regional perspective, we maintain a moderate underweight in emerging markets relative to developed markets despite the modest improvements in China's leading indicators. Historically, a global contraction regime with tightening financial conditions has provided headwinds to emerging markets, offsetting positive local momentum. We remain neutral between US and developed ex-US equities.
- In **fixed income** we are underweight risky credit as a contractionary regime has historically led to underperformance in high yield, bank loans and emerging markets relative to higher quality debt with similar duration. While high yield spreads have widened again to about 5.5%, average recessionary regimes see spreads widen to 7-8%, hence we remain underweight and wait for further widening before increasing exposure. We favor investment grade credit and duration in long-dated government bonds, expecting more flattening in the yield curve. We expect further compression in breakeven inflation expectations given declining price pressures, overweighting nominal treasuries relative to inflation-linked bonds.
- In **currency markets** we maintain a max overweight position in the US dollar, despite expensive valuations, as global growth is underperforming consensus and monetary policy continues to tighten. Historically, this combination of cyclical forces has overcome demanding valuations in the greenback. Within developed markets we favor the euro, the British pound, Norwegian kroner and Swedish krona relative to the Swiss Franc, Japanese yen, Australian and Canadian dollars. In EM we favor high yielders with attractive valuations as the Colombian peso and Brazilian real, while we underweight the Korean won, Taiwan dollar and Chinese renminbi.



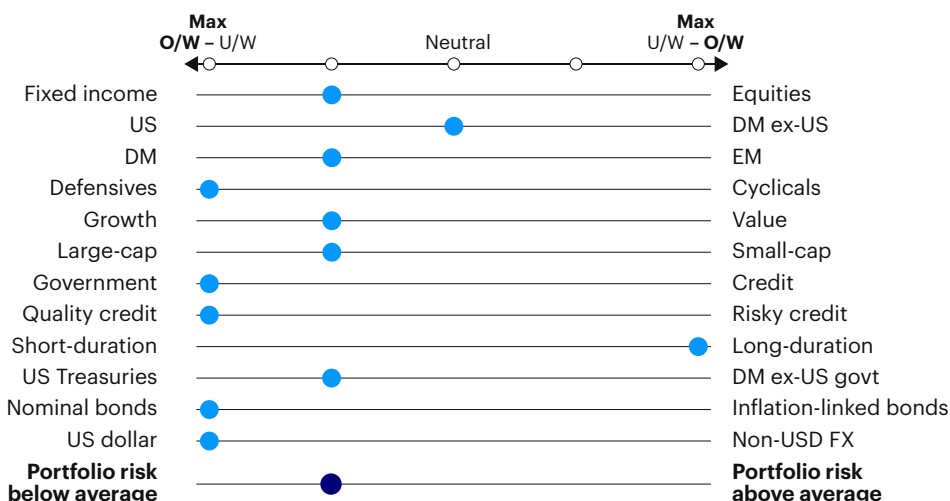
We expect defensive equities to outperform in an environment of below-trend and slowing growth, declining inflation, and peaking bond yields.

While high yield spreads have widened again to about 5.5%, average recessionary regimes see spreads widen to 7-8%, hence we remain underweight and wait for further widening before increasing exposure.

We maintain a max overweight position in the US dollar, despite expensive valuations, as global growth is underperforming consensus and monetary policy continues to tighten.

**Figure 5: Relative tactical asset allocation positioning**

Underweight portfolio risk vs. benchmark, underweight equities and credit. Overweight defensives and duration.

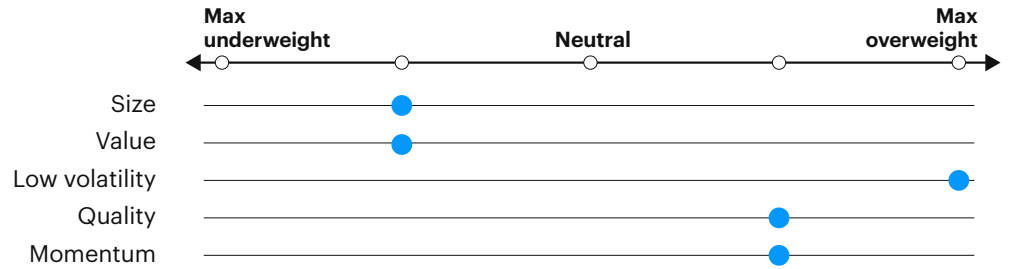


Source: Invesco Investment Solutions, Sept. 30, 2022. DM = developed markets. EM = emerging markets. FX = foreign exchange. For illustrative purposes only.

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

**Figure 6: Tactical factor positioning**

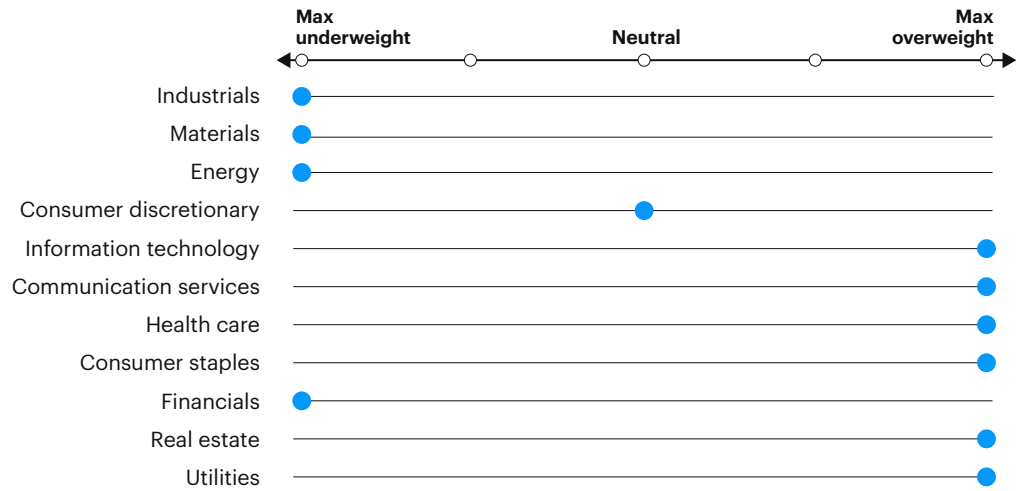
Overweight quality, low volatility and momentum in a contraction regime.



Source: Invesco Investment Solutions, Sept. 30, 2022. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

**Figure 7: Tactical sector positioning**

Moving from a slowdown to a contraction regime, sector exposures are further tilted towards defensives.



Source: Invesco Investment Solutions, Sept. 30, 2022. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of June 2022, Cyclical: energy, financials, industrials, materials; Defensives: consumer staples, health care, information technology, real estate, communication services, utilities; Neutral: consumer discretionary.

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