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Tactical Asset Allocation

We maintain an underweight risk stance relative to benchmark and increase exposure to the US dollar, as global growth surprises to the downside and the tightening cycle continues.

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Synopsis

- We remain in a contraction regime and expect decelerating earnings to drive the next phase lower in equity markets.
- We are underweight risk relative to benchmark in the Global Tactical Asset Allocation model[1], expressing a defensive bias across most levers in the portfolio, underweighting equity and credit risk[2], overweighting duration, defensive factors, and the US dollar.

Macro update

Global growth continues to weaken, with leading indicators below their long-term trend and decelerating across most regions. China's leading indicator improved for the second consecutive month, driven by a rebound in the industrial sector following lockdowns in the spring. In the developed world, weakness is most pronounced in consumer surveys, where sentiment remains around all-time lows in both the United States, Eurozone, and United Kingdom. High and rising inflation rates have been the primary driver of pessimism among consumers. Business surveys, manufacturing activity and the construction sector remain marginally above their long-term trend but declining rapidly in response to tightening monetary and credit conditions, evident in mortgage rates, money supply growth, credit spreads and surveys of bank lending standards. The evolution of economic indicators is in line with historical cycles, with the impact of monetary policy starting in credit sensitive and cyclical parts of the economy, followed by the broader consumer sector, the service sector and labor markets. We believe this process has further to run, leading to lower growth expectations, as proxied by our global risk appetite indicator (**Figure 1** and **Figure 2**).

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

	LEIs		Global risk appetite		
Region	**Current level of growth**		**Change in global growth expectations**		**Expected macro regimes**
Global	**Below trend**	&	**Growth expectation deteriorating**	=	**Contraction**
United States	**Below trend**				**Contraction**
Developed markets ex-USA	**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

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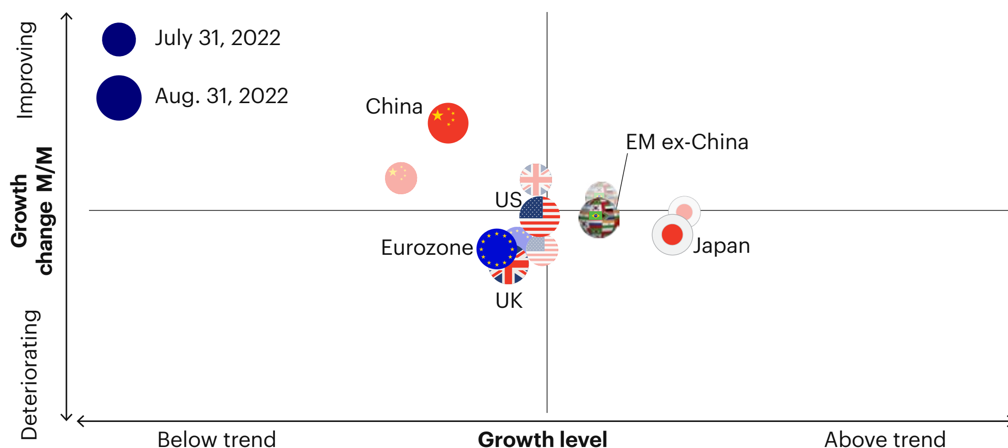
1. Global 60/40 benchmark (60% MSCI ACWI / 40% Bloomberg Barclays Global Agg USD hedged)
2. Credit risk defined as duration times spread (DTS).

The evolution of economic indicators is in line with historical cycles, with the impact of monetary policy starting in credit sensitive and cyclical parts of the economy, followed by the broader consumer sector, the service sector and labor markets.

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

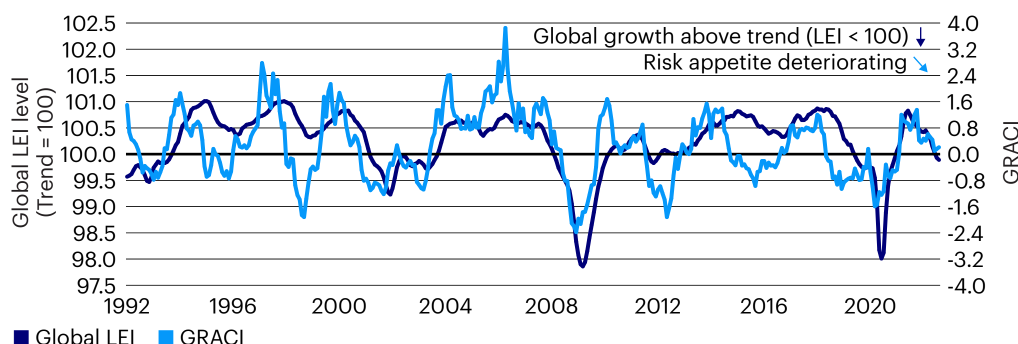


Sources: Bloomberg L.P., Macrobond. Invesco Investment Solutions research and calculations. Proprietary leading economic indicators of Invesco Investment Solutions. Macro regime data as of August 31, 2022. The Leading Economic Indicators (LEIs) are proprietary, forward-looking measures of the level of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

We believe this process has further to run, leading to lower growth expectations, as proxied by our global risk appetite indicator.

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 August 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.

In other words, the labor market is too strong, the unemployment rate needs to rise, and a recession is unlikely to bring rate cuts until inflation is back to 2-3%.

In his concise, direct, and effective speech at Jackson Hole, Federal Reserve Chair Jerome Powell has clarified the Fed sees no reason to "pivot" at this stage: "Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth". Further, "restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy". In other words, the labor market is too strong, the unemployment rate needs to rise, and a recession is unlikely to bring rate cuts until inflation is back to 2-3%. The situation is no different in Europe, where the European Central Bank is confronted with headline and core inflation rates showing no sign of a peak, and the unemployment rate is at generational lows. For the first time in 30 years, central banks are more likely to err on the hawkish side than on the dovish side, with the associated asymmetric risks in the growth / inflation trade-offs.

As discussed in previous updates, we believe equity markets are yet to price a recessionary scenario, or a prolonged period of below-trend growth. Valuations have already undergone healthy corrections, but these adjustments predominantly reflect higher discount yields rather than lower growth. Earnings have decelerated to their long-term trend but remain in positive growth, and in-line with previous cyclical patterns. As illustrated in **Figure 3**, global earnings momentum and market sentiment are strongly correlated, signaling downside risks if compared to previous contraction episodes.

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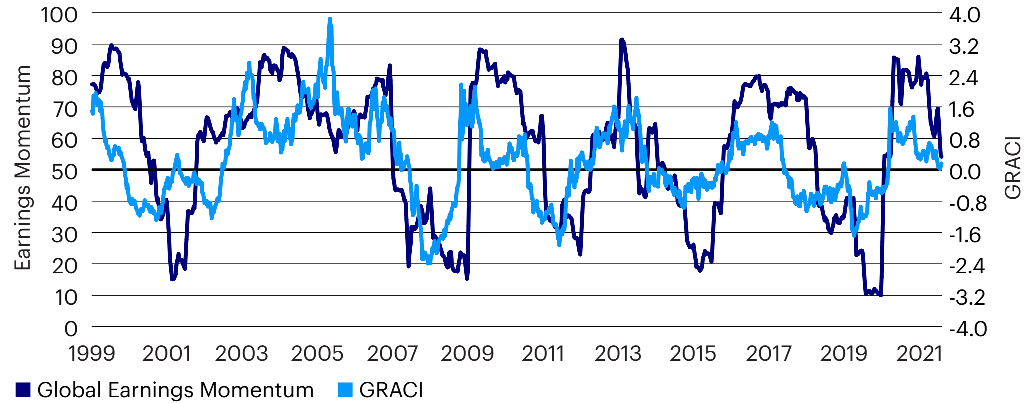
Figure 3: Earnings momentum catching up with weaker market sentiment
GRACI and Global Earnings Momentum



Sources: Bloomberg L.P., MSCI, FTSE, Barclays, JPMorgan, Invesco Investment Solutions research and calculations, from December 1999 to August 31, 2022. Global Earnings Momentum Index is a proprietary measure of acceleration / deceleration in trailing 12-month earnings in the MSCI ACWI Index. A reading above (below) 50 indicates accelerating (decelerating) earnings. 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.

The likelihood of a global recession has risen sharply, but it is far from certain. What would an optimistic scenario look like? Prices adjust, and the economy has proven time and time again to be more dynamic than often assumed. To the extent inflation were to fall more rapidly than anticipated, and ahead of meaningful adjustments in labor conditions, market sentiment is likely to respond very favorably, anticipating the end of the tightening cycle, and the beginning of an economic recovery (**Figure 4**). Following our investment process, we track the evolution of growth, inflation and financial markets through our macro framework, and stand ready to adjust portfolio exposures, balancing risk and return opportunities.

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Figure 4a: US Inflation Momentum Indicator (IMI)

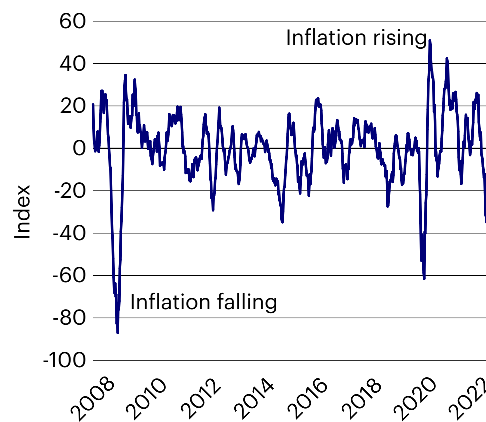
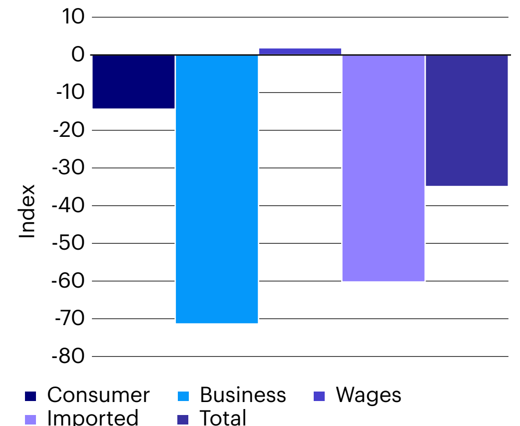


Figure 4b: IIS Inflation Momentum Indicator: Categories



Sources: Bloomberg L.P. data as of August 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

We maintain an underweight risk stance relative to benchmark in the Global Tactical Asset Allocation model, expressing a defensive bias across most levers in the portfolio, and increase exposure to the US dollar. We remain underweight equity vs. fixed income, underweight credit risk[3] 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. We favor investment grade and duration in long-dated government bonds, expecting more flattening in the yield curve. We expect further compression in breakeven inflation expectations, overweighting nominal treasuries relative to inflation-linked bonds.
- In **currency markets** we move to an overweight position in the US dollar, despite expensive valuations, as global growth is now underperforming expectations 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 and South African Rand.

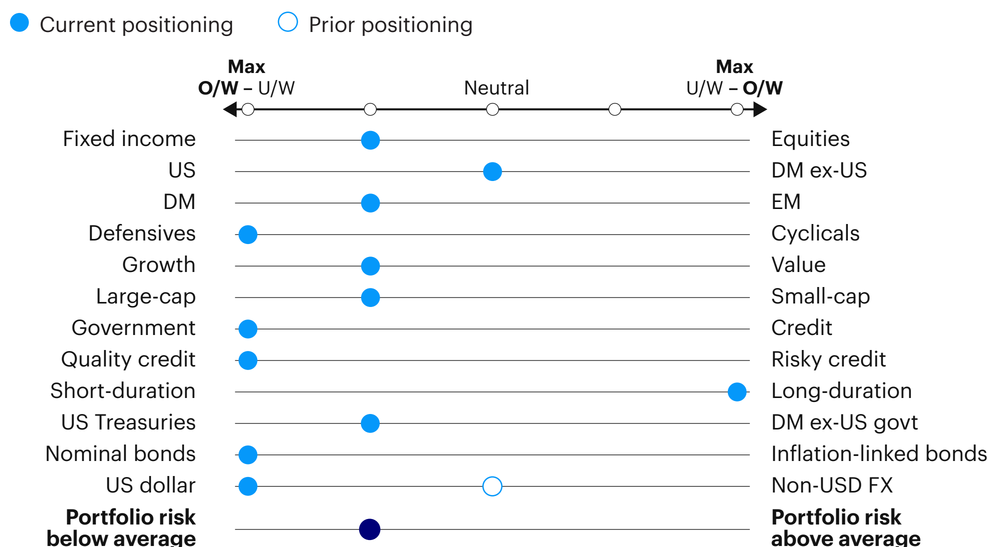
We expect these defensive characteristics to outperform in an environment of below-trend and slowing growth, declining inflation, and peaking bond yields.

We expect further compression in breakeven inflation expectations, overweighting nominal treasuries relative to inflation-linked bonds.

We move to an overweight position in the US dollar, despite expensive valuations, as global growth is now underperforming expectations and monetary policy continues to tighten.

Figure 5: Relative tactical asset allocation positioning

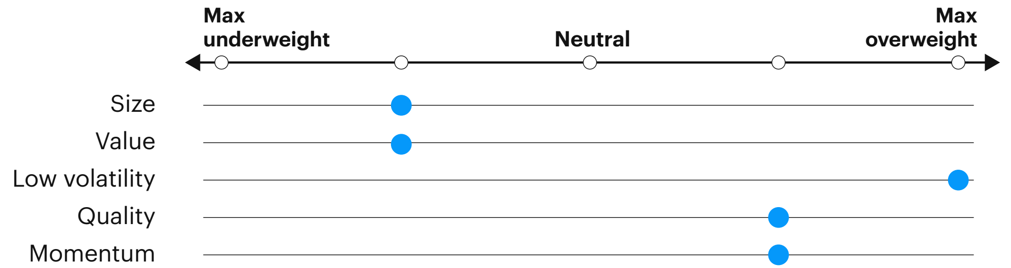
Underweight portfolio risk vs. benchmark, underweight equities and credit. Overweight defensives and duration.



Source: Invesco Investment Solutions, August 31, 2022. DM = developed markets. EM = emerging markets. FX = foreign exchange. For illustrative purposes only.

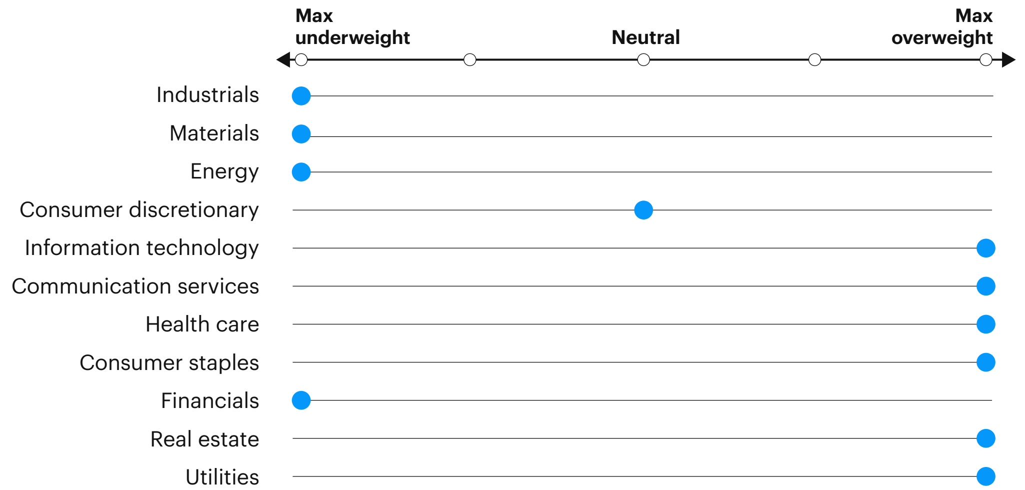
3. Credit risk defined as duration times spread (DTS).

Figure 6: Tactical factor positioning
Overweight quality, low volatility and momentum in a contraction regime.



Source: Invesco Investment Solutions, August 31, 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, August 31, 2022. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of June 2022, Cyclicals: energy, financials, industrials, materials; Defensives: consumer staples, health care, information technology, real estate, communication services, utilities; Neutral: consumer discretionary.

Investment risks

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