Invesco

Tactical Asset Allocation

A reversal in market sentiment, driven by higher-than-expected inflation, leads us to position defensively for a low and decelerating growth environment in the near term. We reduce portfolio risk, overweighting fixed income relative to equities, underweighting emerging markets, and cyclical factors.

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Synopsis

- Monetary policy expectations are being revised for a higher terminal rate. Market sentiment has reacted negatively, incorporating downward revisions to near-term growth prospects. Our framework moves to a contraction regime of below-trend and decelerating growth.
- Underweight risk relative to benchmark in the Global Tactical Allocation Model[1], favoring fixed income over equities, developed markets over emerging markets, defensive sectors and factors. We favor investment grade over high yield, loans, and emerging market debt, and neutralize the US dollar exposure.

Macro update

Recent inflation prints have dispelled the notion that inflation could return quickly to the 2-3% range sufficient to justify a pause in the monetary tightening cycle. The latest US inflation reports for personal consumption expenditures (PCE), producer prices indices (PPI), business and consumer inflation surveys all came in above consensus expectations, causing a noticeable repricing in policy expectations. The Fed Funds rate is now expected to reach 5.40% by July 2023, compared to the 5% peak priced-in at the beginning of the year. Both 10-year real yields and breakeven inflation expectations have moved higher by 40bps and 20bps, respectively, over the past month, reflecting the higher cost of capital required to slow the economy and inflation. Indeed, US consumer spending and employment still show noticeable resilience. The repricing of short-term interest rates has pushed the yield curve further into inverted territory with an inversion of nearly 100bps between short and long maturities. Similarly, markets have raised expectations for the terminal rate of the European Central Bank (ECB) to reach 4% by early 2024, 50bps higher than expected two months ago, which would represent the highest policy rate in the history of the Eurozone. Overall, inflation is still likely to fall meaningfully over the course of 2023, but maybe not as fast as expected at the beginning of the year. Our barometer of US inflation momentum still points to falling inflationary pressures, but it's off the lows since the most recent inflation reports (**Figure 3**).

Market sentiment has reacted negatively, likely reflecting the impact that a longer and deeper tightening cycle may have on growth, earnings, and profit margins going forward. Over the past month, cyclical assets have underperformed their more defensive alternatives, and this repricing has been consistent across all capital markets, with global equities underperforming fixed income, emerging markets underperforming developed markets, and credit spreads widening modestly. The US dollar has also strengthened, outperforming all major currencies year-to-date, and interrupting a four-month weakening trend that started in October 2022. Declining risk appetite, coupled with cyclical economic indicators below their long-term average, moves our macro regime framework back into a contraction regime, last registered between August – November 2022.

European economic indicators continue to rebound led by consumer confidence, an improving inventory cycle, and rising production expectations. Evidence of cyclical divergence between the US and the rest of the world continues to grow as leading indicators in the US point to a weakening housing and industrial sector, partially offset by rising consumer sentiment. Cyclical indicators in emerging markets have also improved over the past month, led by Asia, with rising consumer confidence, business surveys and industrial activity, while housing and international trade remain soft (**Figure 1** and **Figure 2**).

1. Global 60/40 benchmark (60% MSCI ACWI, 40% Bloomberg Global Aggregate USD Hedged).

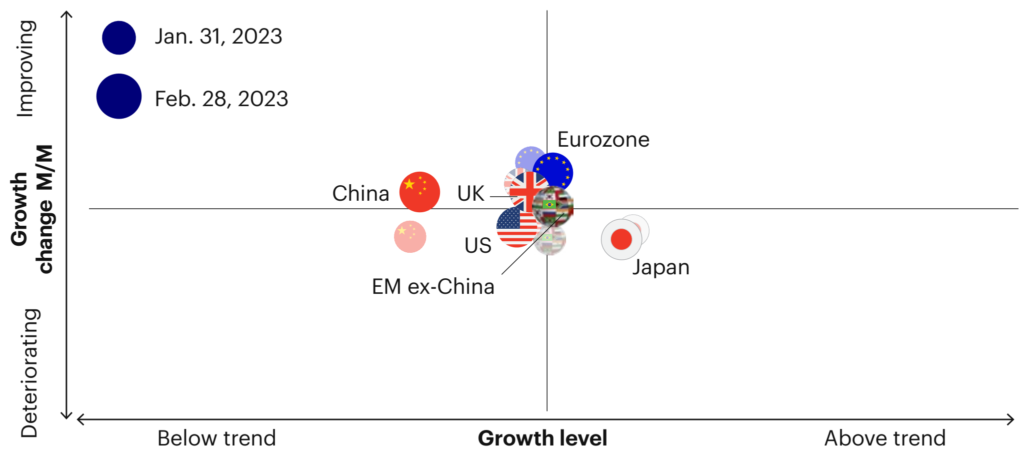
Declining risk appetite, coupled with cyclical economic indicators below their long-term average, moves our macro regime framework back into a contraction regime, last registered between August – November 2022.

Figure 1a: Macro framework moves back to a contraction regime

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

European economic indicators continue to rebound led by consumer confidence, an improving inventory cycle, and rising production expectations.

Figure 1b: Europe continues to improve, highlighting cyclical divergence vs. the United States.



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, 2023. 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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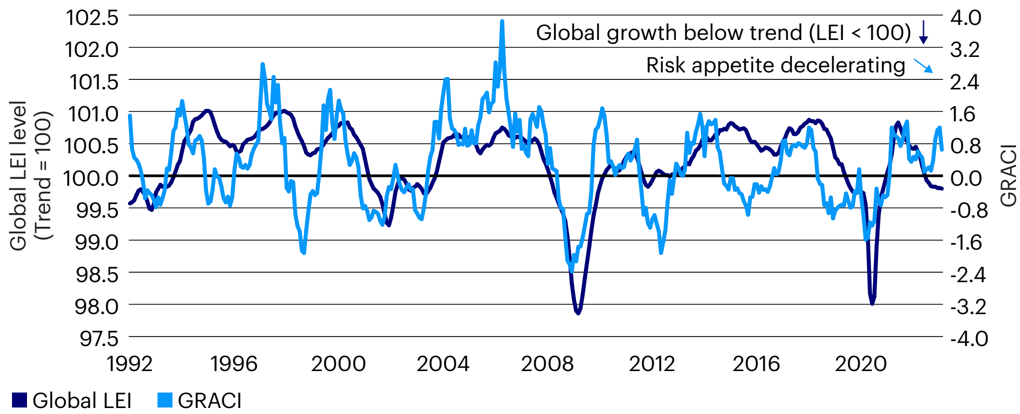
Over the past month, cyclical assets have underperformed their more defensive alternatives, and this repricing has been consistent across all capital markets, with global equities underperforming fixed income, emerging markets underperforming developed markets, and credit spreads widening modestly.

Figure 2: A reversal in market sentiment points to a low and decelerating growth environment

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, 2023. 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.

Overall, growth remains low, and the odds of a deceleration remain elevated, as the long and variable lags of monetary policy are still making their way into the economy, as evidenced by higher mortgage rates and tighter lending standards. The rapid repricing in favor of risky assets at the start of the year, coupled with disappointing inflation reports, suggests sentiment may have run “a little too far, too fast”, as the optimistic scenario of falling inflation with resilient labor markets is being challenged.

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Overall, inflation is still likely to fall meaningfully over the course of 2023, but maybe not as fast as expected at the beginning of the year.

Figure 3a: US Inflation Momentum Indicator (IMI)

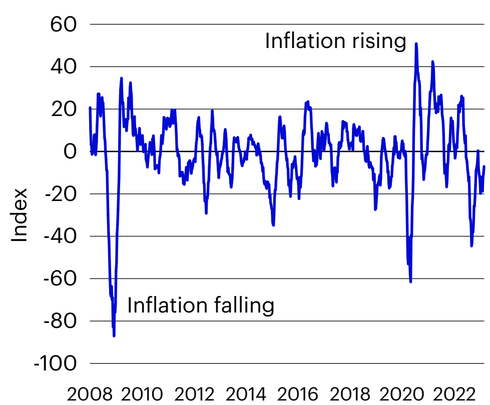
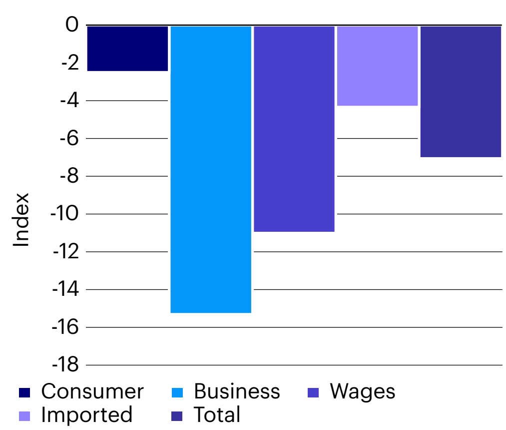


Figure 3b: IIS Inflation Momentum Indicator: Categories



Sources: Bloomberg L.P. data as of Feb. 23, 2023, 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.

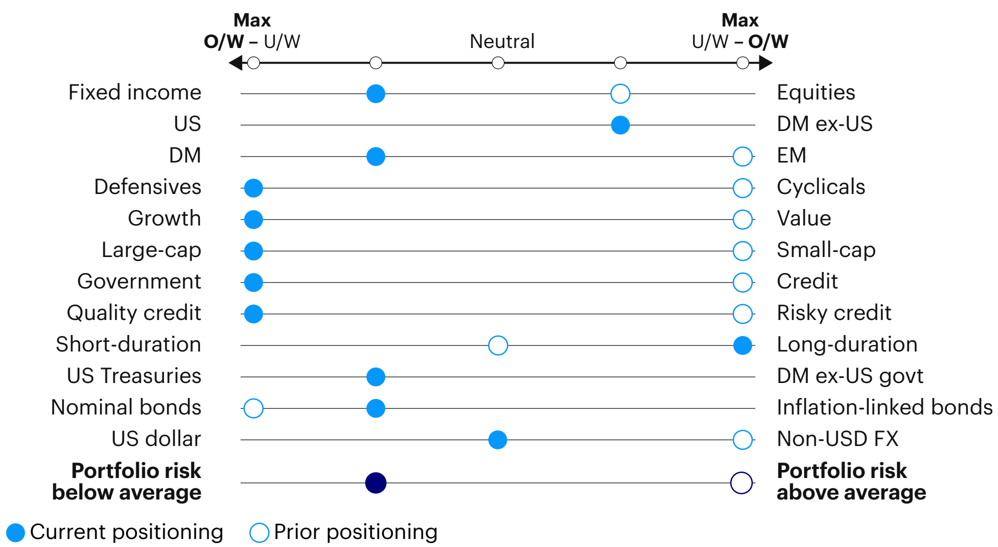
Investment positioning

We transitioned the portfolio to a more defensive positioning, reflecting expectations for an environment of low and decelerating growth. We moved to an underweight risk stance relative to benchmark in the Global Tactical Allocation Model, favoring fixed income over equities, defensive sectors and factors, and underweighting emerging market equities relative to developed markets. We underweight credit risk and overweight duration, favoring investment grade and government bonds relative to high yield, loans, and emerging market debt. We neutralized foreign currency exposure versus the US dollar (Figure 4, 5, 6, 7). In particular:

- Within **equities** we overweight defensive factors with low operating leverage and lower exposure to economic risk such as quality and low volatility, at the expense of cyclical exposures such as value and small/mid-caps. Similarly, we favor defensive sectors such as health care, staples, utilities, and technology, at the expense of financials, industrials, materials, and energy. From a regional perspective, we move to a moderate underweight stance in emerging markets given the decline in risk appetite but continue to favor developed ex-US equities relative to US equities, driven by continued cyclical divergence between the regions, with positive momentum in Europe relative to the US, and still favorable currency valuation.
- In **fixed income**, we reduce credit risk and overweight duration, favoring investment grade credit and government bonds, underweighting riskier sectors such as loans, high yield, and emerging markets debt, given the downshift in global risk appetite. Income strategies remain attractive, especially relative to equities, given the higher level of real and nominal yields, and spreads at historical long-term averages. In this low growth environment with transient and data-dependent investor sentiment, investment grade provides a defensive solution with attractive yields between 5-6%. We continue to favor nominal treasuries relative to inflation-linked bonds.
- In **currency markets** we close our underweight exposure to the US dollar and move to neutral. Renewed widening in rate differentials in favor of the US offsets the downward pressure on the greenback resulting from above-consensus growth in Europe. Within developed market currencies 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, relative to low yielding currencies as the Korean won, Taiwan dollar and Chinese renminbi.

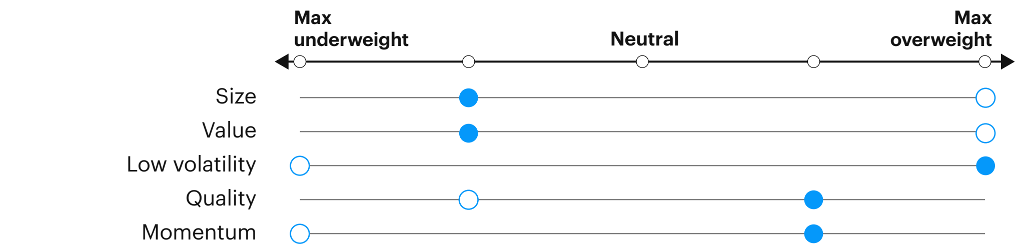
Figure 4: Relative tactical asset allocation positioning

Underweight portfolio risk vs. benchmark, overweight fixed income, quality credit, and defensives



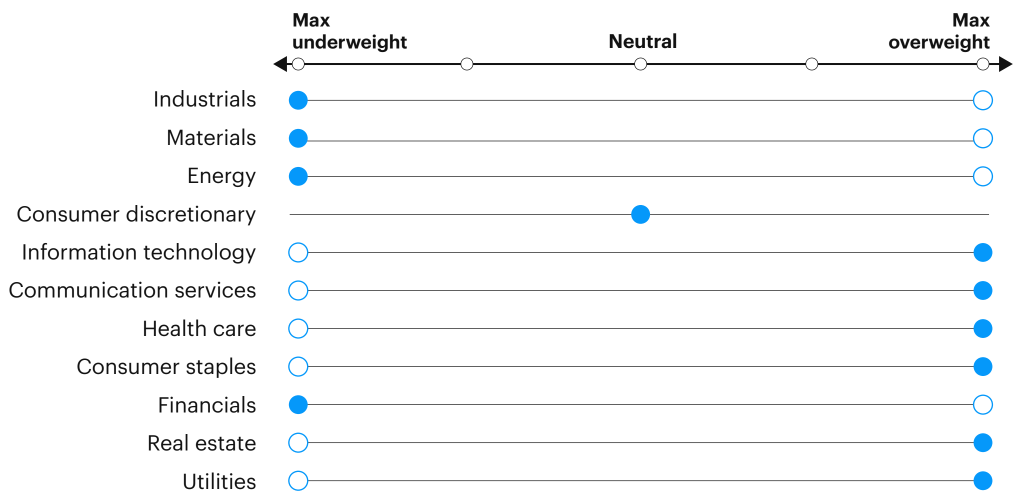
Source: Invesco Investment Solutions, March 1, 2023. DM = developed markets. EM = emerging markets. Non-USD FX refers to foreign exchange exposure as represented by the currency composition of the MSCI ACWI Index.
For illustrative purposes only.

Figure 5: Tactical factor positioning
Overweight low volatility, quality and momentum



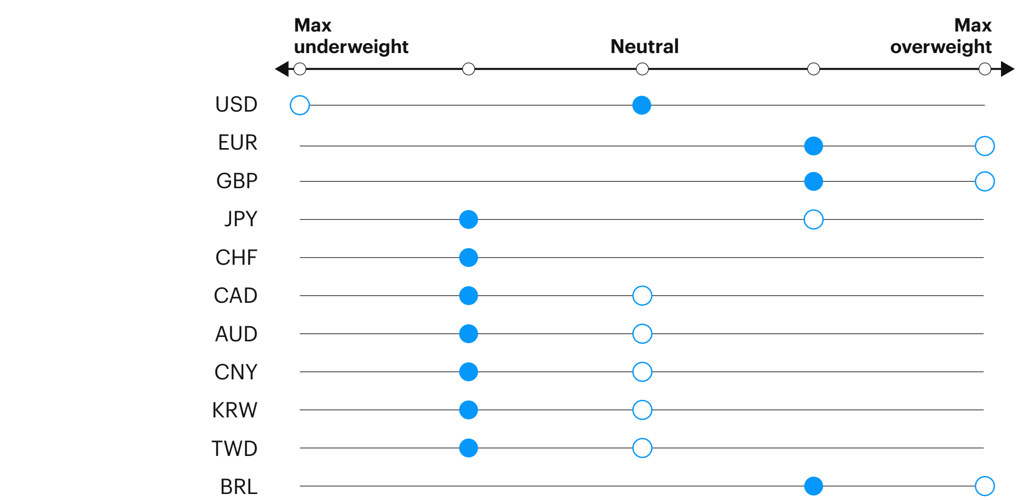
Source: Invesco Investment Solutions, March 1, 2023. For illustrative purposes only. Neutral refers to an equally weighted factor portfolio.

Figure 6: Tactical sector positioning
Sector exposures favoring defensives.



Source: Invesco Investment Solutions, March 1, 2023. For illustrative purposes only. Sector allocations derived from factor and style allocations based on proprietary sector classification methodology. As of November 30th, 2022, Cyclicals: energy, financials, industrials, materials; Defensives: consumer staples, health care, information technology, real estate, communication services, utilities; Neutral: consumer discretionary.

Figure 7: Tactical currency positioning
Move from underweight to neutral on the US dollar.



Source: Invesco Investment Solutions, March 1, 2023. For illustrative purposes only. Currency allocation process considers four drivers of foreign exchange markets: 1) US monetary policy relative to the rest of the world, 2) global growth relative to consensus expectations, 3) currency yields (i.e., carry), 4) currency long-term valuations

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