Asset Allocation Insights

QUARTERLY REPORT: **MARCH 2023**

FOR PROFESSIONAL INVESTORS ONLY

Policy rate uncertainty and reduced liquidity take center stage, while stabilizing growth and anchored long yields provide offset

The key question for markets is whether a higher-for-longer trajectory for policy rates will continue and reverse the soft-landing narrative. The risk/return of different asset classes and their correlations are changing, opening new opportunities (and risks) for asset allocators.

Highlights

Will the risk-on rally resume after the recent pause?

Stabilization in global growth and inflation expectations suggest long bond yields may be near a peak. Reduced growth and rate differentials could portend a weaker US dollar and a more supportive environment for risky assets. Monetary-tightening lag effects, shrinking liquidity, the US debt-ceiling impasse and increased US-China polarization are key risks to this outlook.

New cycle in equity leadership may be brewing

Still-high valuations and falling earnings growth are likely to continue weighing on equities, particularly in the US. The valuation premium of US equities to the rest of the world has shrunk. Equity flows data suggest investors are eyeing bargains in the Eurozone, Japan and EM, while decreasing allocations to the US.

Is investor favor poised for reversal?

Can last year's laggards among faster-growing stocks regain the edge from value, and can small caps continue to outperform large caps in 2023? High industry-return dispersion improves the opportunity set for industry allocators.

Worst of duration risk may be over; still low but increasing credit risks

With the potential peak in long rates, duration risk may be more muted going forward. Slowing growth and tightening liquidity may increase credit risk, though indicators suggest medium-term credit losses may be moderate.

Investment-grade credit gains appeal

With yields north of 5% and volatility less than half that of equities, global and US investment-grade corporates look attractive on a risk-adjusted basis. Interestingly, for investors with a higher risk budget, note that high yield has offered better risk-adjusted returns than IG over the past five years. Stock/bond diversification benefits could stage a comeback if inflation continues to slow.

Infrastructure and commodities for diversification

Listed infrastructure has outperformed real estate over the past year and offer earnings yields similar to those of fixed income. With low correlations to other asset classes, commodities could provide appealing diversification opportunities over time.

Chart 1: In January, IMF revised higher the 2023 growth projections for most major economies (UK is an exception).

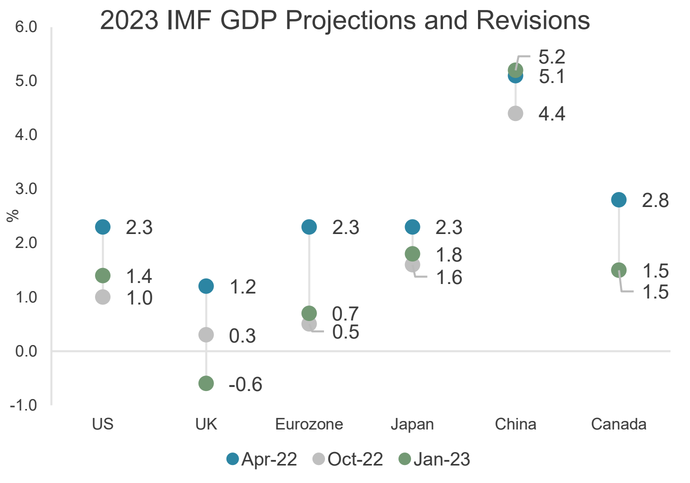
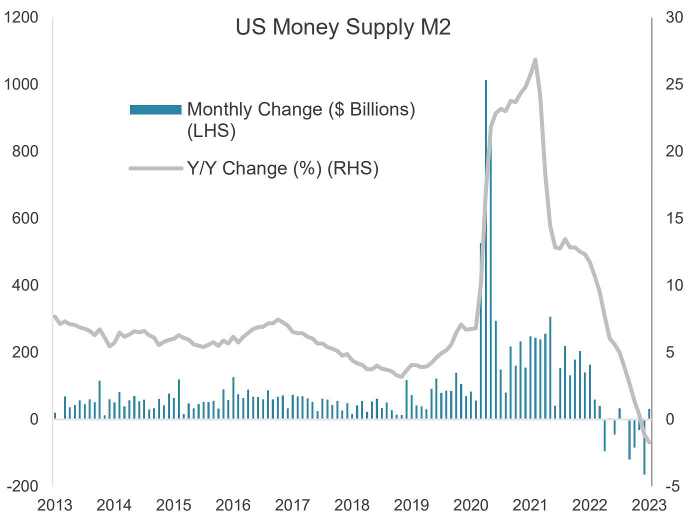


Chart 2: Money supply growth has turned negative amid Fed balance-sheet reductions. Impact of QT remains uncertain.



Source: FTSE Russell/Refinitiv. All data as of February 28, 2023. Past performance is no guarantee of future results. This report should not be considered "research" for the purposes of MIFID II. Please see the end for important legal disclosures. Results in this report are for research / illustrative purposes and do not represent the official performance of the indexes.

Financial Markets Overview

- Normalizing global supply chains and easing consensus inflation expectations (with breakevens below 3%) suggest US inflation has probably peaked, despite recent signs that the pace of declines has slowed. Recent statements by Fed officials and futures data indicate US policy rates may go higher than earlier expected. However, long yields have failed to consistently hold above 4%, underpinned by recent macro indicators. Global growth in 2023 is expected to be positive but lower than in 2022. **Lower but positive growth and stabilizing long yields could be supportive for risk assets**. **Fund flows have risen over the past three months after significant outflows in the middle of last year, a sign of improving investor conviction.**
- (Higher duration) investment-grade credit lagged high-yield corporates over the past three- and 12-month periods. Credit spreads have tightened more in Eurozone and EM than in the US in recent months, resulting in IG and HY Euro bonds outperforming US equivalents in USD terms over the past three months. Yields remain much higher in the US. Declining market-implied probability of default implies credit risk remains low, thanks largely to the plentiful cash on corporate balance sheets. HY credit spreads are likely to increase as economic growth weakens, and bank tightening makes liquidity more scarce. **Yields north of 5% and volatility less than half that of equities make World IG bonds interesting for investors.** Earnings yields for fixed income almost equal that offering on infrastructure. Increased capital flows into bonds indicate increased investor interest. **HY has provided higher volatility-adjusted returns than investment grade corporates over the past one– to five-year periods.**
- Rising rates have weighed on equity valuations, which have contracted to pre-pandemic levels in most markets. While most of the compression in equity valuations is probably behind us, **historical precedent and cross-asset comparisons indicate that equity valuations are more likely to contract than expand.** Earnings growth expectations continue to drop, particularly in developed markets. **US equities have continued to lag global peers this year, in a sharp reversal from the previous decade**, compressing the US equity premium over other markets. Over the last year, investor preferences see-sawed between the earnings resilience of large caps and the more domestic-oriented advantage of small caps amid a soaring US dollar — with small caps taking the lead since Q4 2022. The decisive rotation from growth into value last year has reversed YTD.
- The US dollar hit a multi-decade high in 2022, before reversing significantly since last November. **Tightening interest-rate and growth differentials could further weaken support for the US dollar, thereby easing financial conditions.**
- Most emerging bond markets held up well last year, with far lower credit spreads against G7 bonds than in past crises. EM equity volatility has been in line with that of DMs, though the returns were far lower than that of DM. **Correlations between EM and DM equities steadily lessened over the past two decades,** a trend that could accelerate as US-China polarization continues.
- **Listed real estate underperformed equities last year**, with the most acute underperformance in countries with the highest inflation. The **long-run underperformance of commodities relative to equities appears to have rolled over**. With currency markets (FX returns of commodity exporters vs importers) signalling expectations for commodity prices to stabilize, **this may indicate more downside risk in equities than upside in commodities**.
- **US equities are more correlated with global sovereign bond yields than domestic rates**, not surprising for the largest economy with the world's reserve currency. High-yield bonds are highly correlated to equities, and **stock/bond diversification comes from investment-grade and inflation-linked bonds. Commodities have low correlation to equities**, and have provided diversification benefits even in low-return periods. In the past year, high inflation and rising rates hurt both stocks and bonds, and stock/bond correlations increased to unprecedented highs. This implies a sustained inflation slowdown could bring back the advantages of the 60/40 portfolio.

Table of contents

Source: FTSE Russell/Refinitiv. All data as of February 28, 2023. Past performance is no guarantee of future results. This report should not be considered "research" for the purposes of MIFID II. Please see the end for important legal disclosures. Results in this report are for research / illustrative purposes and do not represent the official performance of the indexes.

Macroeconomic Backdrop

Recession or slowdown? Conflicting signs of strength and weakness in the global economy

Coordinated central bank tightening in the last 12 months is having an impact, despite the recent resilience in recent economic data. Leading indicators in US manufacturing are in contractionary territory (Chart 1). Inflation expectations are falling globally from 2022 peaks (Chart 3), most sharply in the US. The slowing US housing market and normalizing global supply chains (Chart 5) are expected to contribute to further decreases.

China's post-Covid reopening & easing supply-chain disruptions have been recent tailwinds. The IMF upgraded its 2023 GDP growth forecasts for most major economies in January (Chart 2). Financial conditions till February-end have eased (Chart 4).

The impact of monetary tightening has long and variable lags, and we had unprecedentedly rapid rate hikes across DMs this past year, along with a sustained bout of quantitative tightening via balance-sheet reductions and a negative turn in money supply growth (page 1, Chart 2). Whether this results in a global recession or soft-landing scenario remains to be seen.

Chart 1: Forward-looking indicators shows economic activity is contracting, though readings improved in February

Chart 2: China, Japan & EM GDP growth expected to strengthen year-over-year in 2023; US & Eurozone expected to slow

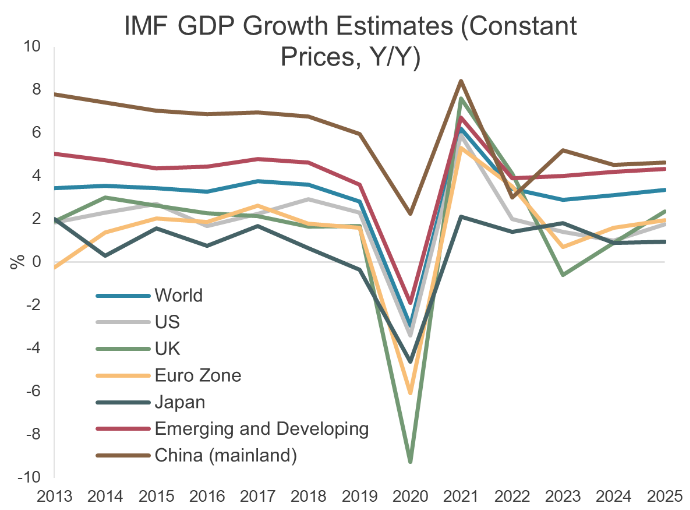


Chart 3: Fairly sharp drop in inflation expected in 2023, led by the US

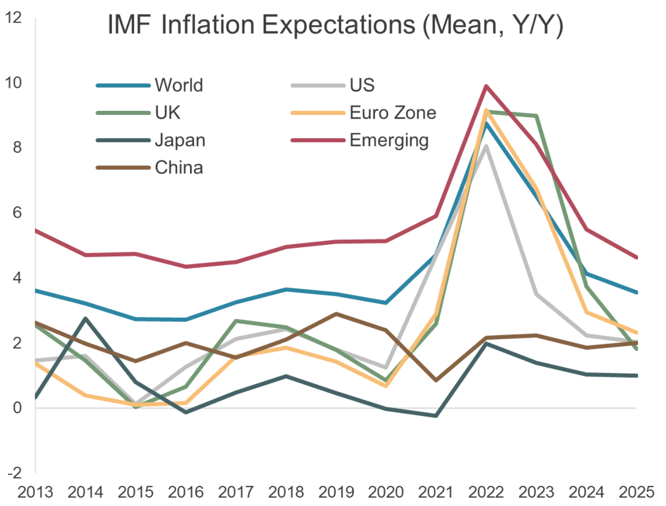


Chart 4: Despite Fed rate hikes and balance-sheet reduction, US financial conditions have eased

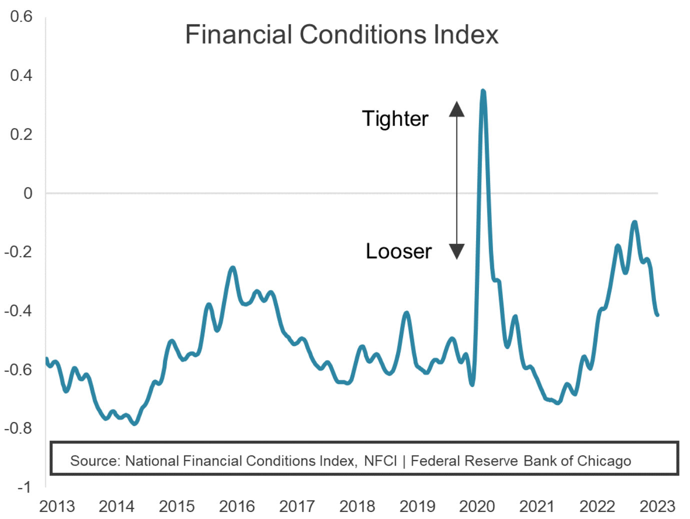
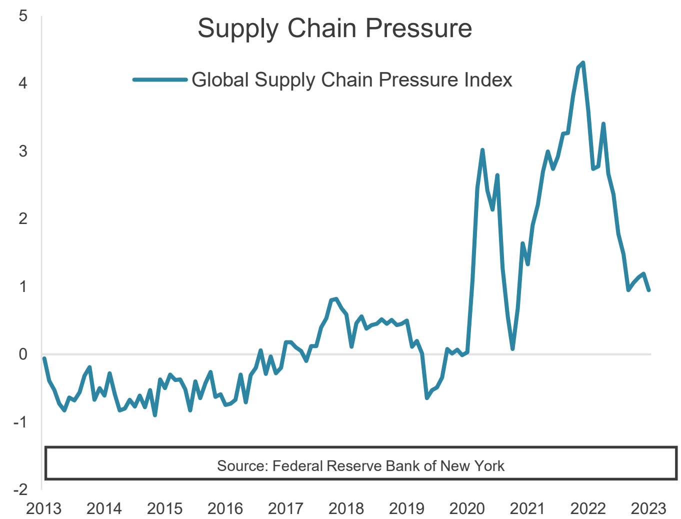


Chart 5: Global supply chain pressures (a key driver of inflation spike in 2022) have significantly normalized to end-2017 levels



Source: FTSE Russell/Refinitiv. All data as of February 28, 2023. Past performance is no guarantee of future results. This report should not be considered "research" for the purposes of MIFID II. Please see the end for important legal disclosures. Results in this report are for research / illustrative purposes and do not represent the official performance of the indexes.

Sovereign Yield Curves

Despite broadly resilient economic data and the resulting signaling for 'higher-for-longer' policy rates from DM central banks, sovereign bond markets are pricing in expectations of inflation mean-reverting to pre-Covid levels soon. Long-end rates and futures data still indicate potential rate peaks this year, particularly at the long end.

Key portions of the US and most G7 countries' yield curves have been inverted since last summer. Recent economic signals have been mixed, with recent data on inflation, job growth, consumer spending and manufacturing improving — yet activity and pricing in key sectors such as housing and construction are decelerating, and manufacturing remains in contraction. **Since yield-curve inversions have almost always been followed by a recession 12-18 months later, the risk of a recession later this year remains high. This also indicates that the worst of duration risk may be behind us.**

Recent Fed statements have suggested the projected 2023 peak for the fed funds rate may be raised from the December dot plot median forecast of just above 5%. Futures market-implied expectations also now show a higher peak of almost 5.5%. However, the term premium, an important contributor to moves in long yields, has stabilized after increasing in recent years. This suggests the 10-year US Treasury yield may be near a peak, and trends in long rates are more important to financial markets.

Chart 1: The pace of yield increases has slowed after months of sharp gains. Yield curves remain inverted

	YTM	YTM Change - 3M	YTM Change - 12M
World 1-3YR	4.03	0.48	3.16
World 7-10YR	3.22	0.54	2.14
US 1-3YR	4.90	0.43	3.52
US 7-10YR	3.93	0.29	2.10
Germany 1-3YR	3.09	1.05	3.66
Germany 7-10YR	2.59	0.67	2.56
	Current	3M Back	12M Back
Slope of World Yield Curve	-0.81	-0.87	0.21
Slope of US Yield Curve	-0.97	-0.83	0.44
Slope of Germany Yield Curve	-0.50	-0.12	0.60

Chart 2: Sovereign bond returns have been fairly flat in past 3M, after a deeply negative 2022, as yield increases stabilized

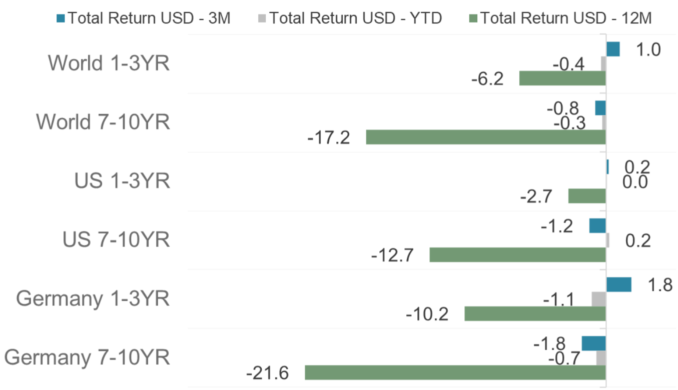


Chart 3: The US & German yield curves are deeply inverted, portending slowing growth in both economies and in most DMs

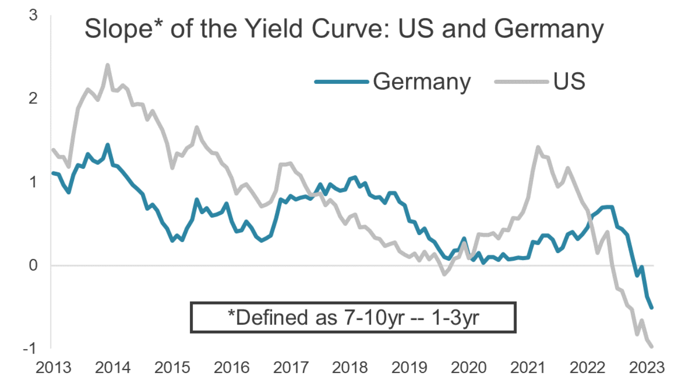


Chart 4: Sovereign bond yields are as high as they have been in a decade, particularly in Germany

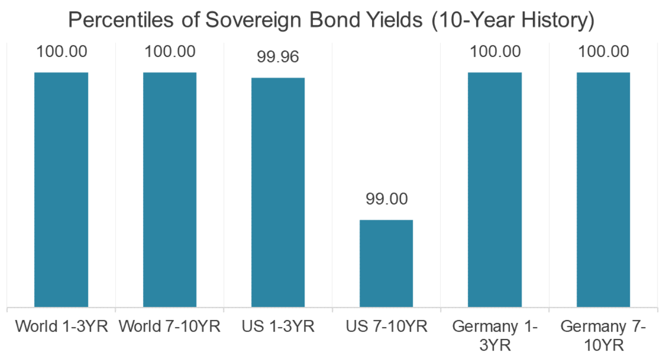


Chart 5: The US 10-year term premium appears to have plateaued, another sign that rates may be near a peak

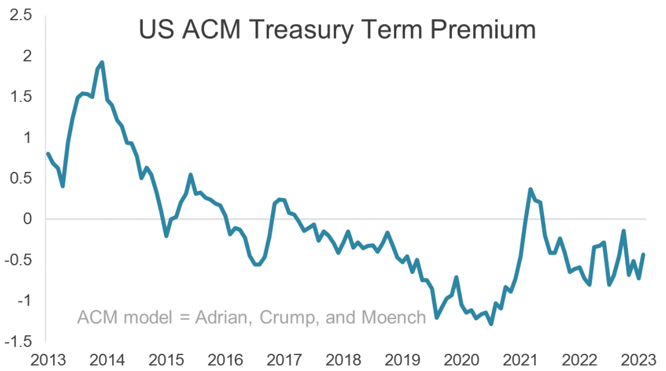
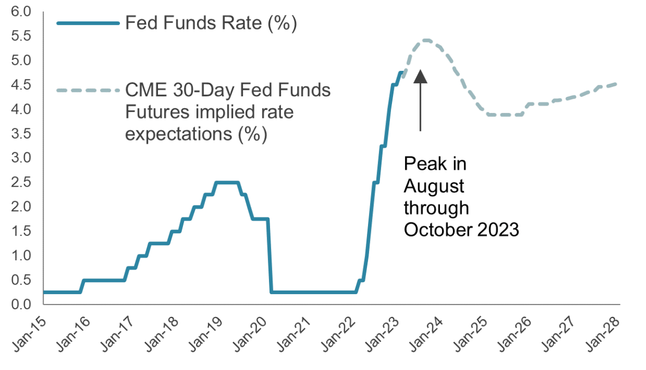


Chart 6: CME futures are pricing in expectations for US policy rates to peak at (higher-than-earlier-expected) 5.4% in 2H 2023



Source: FTSE Russell/Refinitiv. All data as of February 28, 2023. Past performance is no guarantee of future results. This report should not be considered "research" for the purposes of MIFID II. Please see the end for important legal disclosures. Results in this report are for research / illustrative purposes and do not represent the official performance of the indexes.

Credit

Credit spreads have tightened broadly with the resurgence in risk appetite since Q4 2022. HY outperformed IG.

Over the last three and 12 months, investment-grade credit lagged high yield credit in the US, Europe, EM and World indices. According to the NY Fed's Corporate Bond Market Distress Index (time-series measure of bond market functioning), stress is much higher in IG than HY, likely a consequence of IG's higher duration (thus higher duration risk) in a rising-rate environment. Relatively healthy corporate cash balances and longer maturities due to refinancings in recent years have also helped to cushion HY losses (Chart 1 and 3).

Credit spreads have tightened across markets in the last three months, more so in EM and Europe than in the US (Chart 2). China's reopening has been a tailwind, particularly for EM.

With the exception of EM HY, credit spreads were generally lower during the 2022 drawdown than during the China growth crisis of 2015-2016. **A fall in inflation from 2022 highs, recent signs of a growth acceleration and the China reopening have spurred risk-on sentiment and tighter spreads. Credit markets are pricing in expectations of fairly benign market conditions.**

Chart 1: Credit spreads have tightened sharply as risk appetite revived. Markets are pricing in fairly benign business conditions

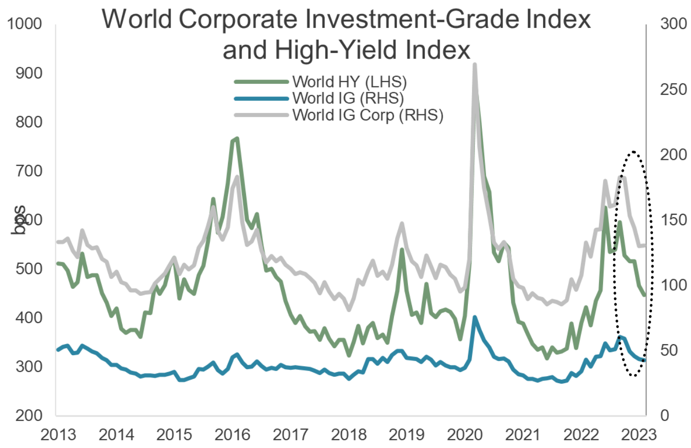


Chart 2: In both IG and HY, spreads have narrowed the most in EM, followed by Europe. China reopening has helped EMs a lot

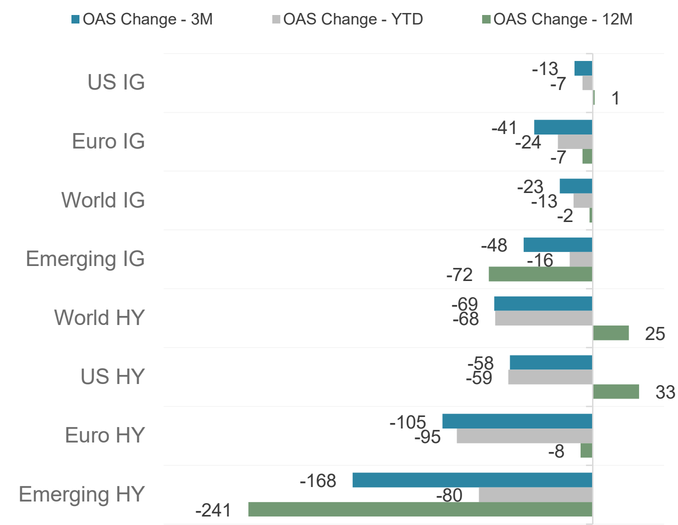


Chart 3: Over the last 3M, IG & HY Euro bonds performed best, followed by EM. HY outperformed IG

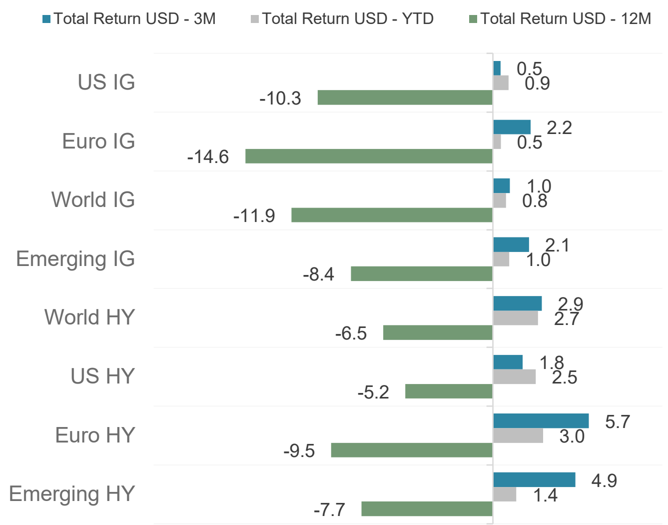


Chart 4: IG corporate credit spreads have been tightening across major markets since last October, with Euro & EM leading the US

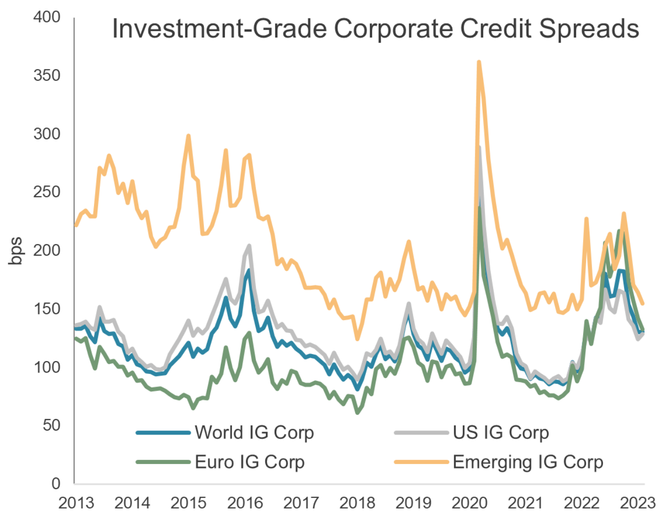
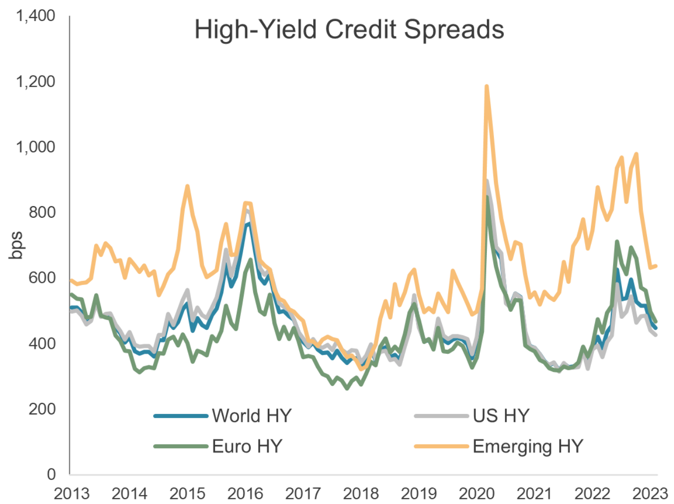


Chart 5: EM HY credit spreads have contracted most sharply of late, after rising the most since the Covid outbreak



Source: FTSE Russell/Refinitiv. All data as of February 28, 2023. Past performance is no guarantee of future results. This report should not be considered "research" for the purposes of MIFID II. Please see the end for important legal disclosures. Results in this report are for research / illustrative purposes and do not represent the official performance of the indexes.