Quarterly Asset Allocation View for Asia

Q2 2023

Multi-Asset Solutions Team

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Asset Class Overview

Broad Asset Class Outlook

Current outlook

		Less preferred		Neutral		More preferred
Broad Asset Classes	Equities					
	Fixed Income					
	Cash					

Equities: **We remain neutral Equities on a tactical basis and remain cautious** as the market outlook looks concerning, given rising volatility across assets and tightening liquidity. Persistent labour market strength is constructive for growth, but credit standards may tighten, given pressure among certain banks. Elevated inflation requires central banks to keep tightening monetary policy via rates and shrinking balance sheets to restore credibility and re-anchor inflation expectations. However, financial stability concerns are on the rise. We generally prefer a selective geographical location and sector approach to broader market replication. Also, we continue to use risk-management tools and equity futures to manage market volatility on the back of rising inflation, central-bank rate hikes and geopolitical uncertainty. **We are slightly more positive on broad Emerging Market (EM) Equities – while the China reopening narrative has become somewhat consensus, we still see opportunities.** Trade and tourism should further rebound going into Q2 2023, and Asian currencies (FX) are set to further rebound from historical lows. Looking ahead into 2023, we expect a pause in the US Federal Reserve's (Fed) aggressive rate-hike cycle and a pivot to eventually occur (as the narrative shifts to growth concerns). However, until this pivot materialises, we will remain cautious given US labour market resilience and the potential for ongoing Fed tightening beyond what the market has already priced, which would result in further volatility.

Fixed Income **We remain tactically neutral Fixed Income and retain an overall underweight duration stance** due to the broadening tightening cycle by numerous central banks. However, growth slowdown dynamics brought about by tightening financial conditions present opportunities to add some duration risk back to portfolios when appropriate. From a curve perspective, we prefer to have a flattener/inversion curve on but will gradually move towards a steepening position.

Cash: **Cash has been a relatively attractive asset class in the short term** when measured against a complex economic backdrop of increasing market volatility and geopolitical uncertainty**.** We are transitioning towards the peak of the rate-hike cycle and of the view that the inflation is peaking. From a forward-looking perspective, cash yields might reduce, and the attractiveness of fixed-income assets increase as price return may improve given lower rates later.

Source: Multi-Asset Solutions Team (MAST), as of April 2023. Projections or other forward-looking statements regarding future events, targets, management discipline or other expectations are only current as of the date indicated. There is no assurance that such events will occur, and if they were to occur, the result may be significantly different than that shown here.

2 Asset Allocation View

Tactical perspective

Three-month asset allocation view

	Underweight		Neutral		Overweight
Asset Class: Equities					
United States		■			
Emerging Markets				■	
Asia ex-Japan				■	
• Mainland China				■	
• Hong Kong				■	
Europe				■	
Japan			■		
Asset Class: Fixed Income					
US government				■	
US high yields		■			
US investment grade			■		
Developed Markets			■		
Emerging Markets				■	
Asia ex-Japan			■		
Hong Kong			■		
Asset Class: Alternative / Real Assets					
REITS			■		
Global Natural Resources				■	
Listed infrastructure				■	

Strategic perspective

Five-year asset allocation view

	Underweight		Neutral		Overweight
Asset Class: Equities					
United States		■			
Emerging Markets				■	
Asia ex-Japan			■		
• Mainland China			■		
• Hong Kong			■		
Europe				■	
Japan				■	
Asset Class: Fixed Income					
US government			■		
US high yields				■	
US investment grade				■	
Developed Markets			■		
Emerging Markets				■	
Asia ex-Japan			■		
Hong Kong			■		
Asset Class: Alternative / Real Assets					
REITS			■		
Global Natural Resources				■	
Listed infrastructure				■	

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Q2 2023 Equity View

- Tighter financial conditions, heightened geopolitical risks, and recessionary fears have taken a heavy toll on the economic outlook and valuations. The recent shutdown of multiple regional banks and the merger of two Swiss banks have further added to concerns across the market. Uncertainties continue to weigh on investor sentiment as markets worry about financial stability. Elevated inflation persists, give we are currently operating in a period of energy and commodity-supply shortages. These are being driven by the Russia-Ukraine situation, tight labour markets, and disrupted supply chains – albeit inflation has moderated since the summer of 2022.
- Although the issues these banking entities face are likely company specific, given they are highly concentrated in industries with significant funding, regulatory, or legal pressures, possible impacts on confidence and the availability of credit are likely to be seen, given unrealised losses on bank fixed-income portfolios. We do not see this event as a systemic challenge to the banking system. However, it largely depends on two key questions: 1) whether the liquidity backstops put in place by the Fed and the Swiss National Bank prove sufficient, and 2) how far contagion from the US regional banks and Swiss banks' spreads.
- Even though the data has moderated in the past few months, inflation was still elevated in February. In the US, headline CPI inflation came in at 0.4% MoM, 6.0% YoY (from 0.5%, 6.4%), but core CPI inflation was sequentially a bit hotter at 0.5% MoM, 5.5% YoY (from 0.4%, 5.6%). Shelter inflation drove 70% of the CPI's gain in February, but momentum should slow significantly. CPI inflation data is not cold enough for a "pause" but also not hot enough for more aggressive hikes. Given the recent bank failures, the Fed and other central banks have lost the luxury of focusing solely on the fight against inflation. However, the Fed remains hawkish, raising the target range for the Fed funds rates by 25 basis points (bps) to 4.75% to 5.0% at the March FOMC meeting. The bond market has priced in no more hikes this year, expecting the Fed to hold for May and June before cutting by 25 bps in July, September, November and December.
- The odds of a recession remain high, given tighter lending standards. The shutdown of regional banks has reinforced our base-case expectations for the U.S. economy. We continue to expect growth to slip into negative territory around Q4 2023. The impact of Fed tightening typically takes some time to hit the real economy. Most of the world's advanced economies — including the US, Eurozone, UK and Canada — are expected to slow in 2023. The US Leading Economic Index fell to -6.5% in February. This level is usually only seen prior to recessions.
- Our broad asset allocation is tilted towards defensive, quality assets that provide ballast to the portfolios in times of increased uncertainty. The low-volatility, defensive attributes of consumer staples, utilities, and a broad range of dividend names may find some insulation. **We also like income-themed portfolios that offer resilience whilst keeping pace with inflation. We are underweight US Equities and more positive on Europe, EMs, Asia and China equities**. Europe's recent macroeconomic data surprises and corporate earnings have been relatively robust. The China reopening narrative has become consensus resulting in a more positive view of Emerging Market equities through trade and tourism. Asia FX will benefit if USD weakens, considering recessionary concerns. Stock valuations are also fairly priced relative to historical levels, which could provide an attractive tactical entry point. However, deteriorating economic conditions and the likelihood of a recession—not to mention its associated impact on earnings—could be headwinds for returns.

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Q2 2023 Fixed Income / Alternatives

- The Fed has reaffirmed its focus on high inflation readings as it rapidly adjusts its restrictive policy setting. It has raised the Fed funds rate up to 4.75%-5%, the highest level since 2007. **We believe a further 25 bps of tightening is expected for the remainder of 2023, according to the forecast revealed by the Fed's dot plot. However, the bond market is pricing in no more rate hikes and even rate cuts towards the end of the year – the latter we feel is too optimistic**. In light of the current banking turmoil, questions remain about the extent of de-facto tightening coming from tighter lending standards and, thus, how much further central banks will need to hike via conventional interest rate policies. Global central-bank tapering and rate hikes in developed markets (DMs) and EMs will likely worsen global liquidity conditions. Yields have continued to increase – albeit there has been a recent softening of peak terminal rate expectations.
- China markets pulled back on concerns about risky fixed-income exposures after the two Swiss banks' merger. China strives to maintain an accommodative monetary stance and is prioritising economic growth. The Chinese government has announced its first reserve requirement ratio (RRR) cut this year by 25bps for all banks (except for those with an RRR of 5%) and rolled out a series of supportive measures for the real-estate sector to ease onshore debt financing risk amongst property developers and improve their liquidity profiles. The policies have been deemed positive to reduce property-sector headwinds, but we think the property market fundamentals will take time to recover. It is also vital to monitor the effective implementation of these measures and any recovery in physical market sales.
- Overall, we retain an underweight duration stance due to the broadening tightening cycle by numerous central banks. However, whilst concerns about persistent inflation continues to build, growth slowdown dynamics, brought about by tightening financial conditions, will eventually present opportunities to add some duration risk back to portfolios. **We hold a near-term neutral view on the US dollar (USD) but expect it will weaken on US recessionary concerns.**
- **We are overweight US Government Bonds/Treasuries, which act as safe-haven assets in times of market volatility, especially during a recession.** US investment-grade credit and higher-quality bonds are rated relatively neutral, given their increasingly attractive yield profiles and the solid fundamentals of the underlying securities. We remain underweight US High Yields given its peaking fundamentals, expectations for higher defaults and limited value/compensation for these risks. Outcome-oriented portfolios, particularly those generating a high income, will still need to clip yield from the asset class, although the risks will remain monitored. We remain neutral DMs ex-US debt, as the asset class could provide relatively attractive returns on a currency-adjusted basis. Still, risks remain, as policy normalisation will push their rates higher, bringing headwinds to bond markets. We also remain slightly positive on EMs debt, which has been negatively impacted by last year's USD strength but has proven increasingly resilient and poised for outperformance, given how EM central banks have navigated this tightening cycle. The asset class continues to provide an attractive yield profile. However, possible continued/short-term USD strength and cooling growth in developed economies could suppress the global manufacturing impulse.
- We are constructive on Alternatives over the short term, given their attractive yields, dividend prospects, diversification effects and inflation-hedge characteristics, which provide a low correlation to volatile markets. Agricultural commodities remain well supported as geopolitical factors and operational challenges constrain key grain exporters. The recent declines in listed infrastructure valuations provide compelling entry points amid improving forecasted returns.

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