Investment Strategy

Tactical Asset Allocation | January 16 2024

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Tactical Asset Allocation: Navigating a year of two parts

- **We take some risk off the table given our Q1'24 volatility expectations.**
- **We turn neutral on equities and fixed income in our tactical asset allocation.**
- **In this note, we detail the other changes we made across the sub-asset classes.**

Macro: Global growth is likely to hold up over the three-month time frame. We still expect a soft-patch in H2'24. The disinflation trend is likely to continue over the course of 2024 but the next few months could prove bumpy with risks of hotter inflation prints. Given this development, most major DM central banks are unlikely to cut interest rates till H2'24. We expect 2-3 rate cuts from US Fed starting in June or July this year. This stands in sharp contrast to market expectations for six rate cuts for the year starting March. This macro backdrop along with scope for earnings downgrades, rising political and geopolitical risks, elevated asset class valuations, stretched investor sentiment, and increased positioning of the recent months all warrant caution on risk in the near-term.

Asset classes: Most asset classes performed strongly through 2023 with the last two months of the year seeing everything rally (for details see Multi-Asset Performance Summary – December 2023/ Full year 2023, January 05 2023). Over the past couple of months, markets not only repriced lower inflation expectations, but also a lower risk of an inflation reacceleration. Against that backdrop 2024 started with most financial market assets looking technically overbought, sentiment very bullish, valuations looking full, and cross-asset correlations near record highs. Overlaying this with the macro view we have for the next three months, we think reducing risk in the portfolios over that time frame is warranted. Therefore, we cut our equities position to neutral (from overweight), and move fixed income to neutral (from underweight); we also raise cash to a neutral (from underweight earlier).

Risks: Upside risks to our neutral stance come from continued goldilocks which the markets enjoyed through Q4'23. Downside risks to our neutral positioning are a sharp escalation in geopolitical tensions and a hawkish Fed causing a severe short-term risk-off.

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Exhibit 1: Tactical Asset Allocation with a 3-month view

	Positioning*					Balanced**		
Asset Class	**SUW**	**UW**	**N**	**OW**	**SOW**	**SAA**	**TAA**	**Active**
Equities			Current	Previous		**41.2**	**41.2**	**0.0**
North America			Current	Previous		25.8	25.8	0.0
Europe	Previous	Current				7.0	6.0	-1.0
Japan			Current			2.3	2.3	0.0
APac ex Japan			Current	Previous		5.0	5.0	0.0
EM ex Asia		Previous	Current			1.0	1.0	0.0
Japan (JPY) off BM				Current		0.0	1.0	1.0
Fixed Income		Previous	Current			**58.8**	**58.8**	**0.0**
DM Treasuries IG		Current				32.8	30.1	-2.7
DM Corporate IG			Current			12.5	12.5	0.0
EM USD Sov. IG			Current			0.8	0.8	0.0
EM LCY IG			Current	Previous		5.1	5.1	0.0
EM Corporate IG		Current				0.6	0.3	-0.3
Global HY			Current			5.0	5.0	0.0
Securitized debt(off BM)				Current		0.0	3.0	3.0
Cash		Previous	Current			2.0	2.0	0.0
Alternatives						**0.0**	**0.0**	**0.0**

Colour legend Current Previous

Source: Bloomberg, Bloomberg BGN, Bloomberg Indices, Hedge Fund Research, MSCI, Standard & Poor's, DataStream, Refinitiv, and ADCB Asset Management | Notes: *Positioning recommendations: SUW = Significant Underweight; UW = Underweight; N = Neutral; OW = Overweight; SOW = Significant Overweight. **Based on balanced risk profile. SAA = Strategic Asset Allocation; TAA = Tactical Asset Allocation; Active weight = TAA weight – SAA weight. Weights may not sum to 100% due to rounding.

Changes to our Tactical Asset Allocation

Asset Management Investment Committee (AMIC), in its meeting on January 10 2024, made the following changes to our TAA.

- **Turn neutral on US equities from overweight**
  US stocks have significantly rallied, posting returns of 26.5% in 2023, helped by the AI-fuelled rally and outperformance of the technology sectors. But, valuations now look stretched and US equities appear overbought on technical parameters. Investor sentiment has also turned extremely bullish from extremely bearish. Downward surprise in Q4'23 earnings or 2024 guidance could put pressure on US equities in the near-term.

- **Trimming our underweight on European equities (by adding UK equity positions)**
  We trim our underweight on European equities by adding preference for UK equities. UK equities recorded returns of 14%, lagging US and Europe. UK equities are trading at significant discount versus peers given the lack of technology weight. Defensive characteristics of the FTSE 100 are particularly attractive during the current backdrop of global soft landing concerns. UK equities holds larger weight to energy and commodities which should act as a good hedge against rise in oil prices due to any potential escalation of geopolitical tensions in the middle-east.

- **Downgrade APAC ex Japan to neutral and upgrade EM ex Asia to neutral (prefer GCC)**
  We observe better value in emerging market equities but are now neutral on the asset class overall. We downgrade APAC ex Japan to neutral (from overweight). We raise EM ex Asia to neutral by adding GCC equities. GCC equities have underperformed global peers in 2023, despite range-bound oil prices. GCC earnings expectations have been lowered in Q4'23. We expect earnings revisions for the region to stabilise and rebound in the months ahead providing a good support for price performance.

- **Trim our "off-benchmark" position on Nikkei 225 in JPY terms**
  After witnessing a strong rally of c28% (LCY terms) in 2023, we further trim our off-benchmark position on Nikkei 225 to 1ppt from 1.5ppt earlier. While corporate governance reforms are still a positive and price momentum is supportive, prospective weakness in USD leading to stronger JPY could begin to weigh on the corporate profitability. Increased possibility of hawkish pivot from the Bank of Japan in Q2'24 poses risks as well.

- **Introduce off-benchmark position in US mortgage-backed securities (MBS)**
  We introduce an off-benchmark position is US mortgage-backed securities. Q4'23 fixed income rally has resulted in spread tightening across the fixed income sub-asset classes. However, US MBS spreads have some more juice left with spreads trading higher compared to the long-term averages. US MBS (predominantly AA rated segment) spreads are also wide versus US IG corporate AA spreads. Decline in UST volatility, better supply-demand outlook, lower pre-payment risks are also supportive for the asset class.

- **Downgrade EM LCY bonds to neutral from overweight**
  We reduce allocation and turn neutral on EM LCY bonds after the strong performance in 2023. While positive tailwinds including lower DM rates, EM central bank easing and weaker USD bias remain, EM LCY valuations are now trading tight vs DM peers. The benefit of front-loaded EM central bank pivot has also started to diminish with DM central banks now catching-up.

- **Upgrade cash to neutral from underweight**
  We upgrade cash to neutral from underweight as we recommend dialling down risk given the extreme bullish sentiment priced into risk assets and prospects of softening global growth momentum.

Exhibit 2: Strategic Asset Allocation

	Cautious	Balanced	Aggressive
Investment objective	**Capital Preservation & Moderate growth**	**Growth & Income**	**Growth & Moderate Income**
Investor Suitability	**Moderately Conservative**	**Moderate**	**Moderately Aggressive**
Asset Allocation			
Equity	20%	35%	65%
Fixed Income	65%	50%	20%
Alternatives	15%	15%	15%

Source: ADCB Asset Management

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