2022 MID-YEAR CHECK-IN

How we are managing our clients' portfolios

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Between a global pandemic, war in Europe and historic levels of economic and market volatility, the first half of 2022 can be summed up by this aphorism: "There are decades where nothing happens; and there are weeks where decades happen."

With global equities down approximately 20% and the global government bond benchmark losing 10% through June 30, financial markets set many records this year, none of them good; equities experienced the worst first half of a year since 1970, while bonds experienced the worst first-half-year performance in more than 100 years. Risks continue to mount as inflation reaches historic highs and central banks pivot to a restrictive stance, amplifying efforts to contain overheated economies by aggressively raising interest rates. At the same time, geopolitical risks, such as the Russia-Ukraine war, have resulted in surging energy prices, and continued COVID-19 lockdowns in China have resulted in slowing growth in the world's second-largest economy and further supply-chain disruptions, intensifying inflationary pressures.

Fears of recession triggered by an overly-hawkish Fed are driving market volatility, but as our investment strategists turn to our cycle, value and sentiment (CVS) investment decision-making process, we believe deeply oversold sentiment provides some reassurance that markets have accounted for bad news and could recover if inflation and growth turn out better than currently feared. With U.S. Treasuries cheap and equity valuations improving, the challenge comes from uncertainty around the cycle outlook. We judge that recession risks at around 35% through mid-2023 are already higher than normal—and they are likely to increase further as the Fed continues its aggressive march in the months ahead.

What this means for investors is that hewing to a rigorous investment decision-making framework is all the more critical. Currently, our portfolio managers are maintaining risk-neutral positioning relative to strategic levels in our clients' portfolios, stressing diversification via the underlying manager lineup as well as a balance of risks coming from credit risk via high yield exposure, while maintaining total portfolio hedges, including an allocation to a defensive interest rate volatility strategy.

Let's take a closer look at how we are seeking to enhance return and manage risk in our clients' multi-asset portfolios.

Equities

We are maintaining our strategic preference for value equities, thanks to historically inexpensive relative valuations. We generally favor non-U.S. developed equities over U.S. equities, as the former are relatively less expensive and should benefit from U.S. dollar weakness if the Fed becomes less hawkish. We reduced the intensity of our regional tilts, trimming the U.K. equity overweight (following strong performance on the back of the energy exposure of the index) and reducing the U.S. underweight. As a result, we now stand neutral to U.K. equities relative to strategic levels, with the primary regional tilt being a slight U.S. equity underweight, to fund a slight European equity overweight. We have a neutral stance towards emerging-market and Japanese equities, due to headwinds faced by economies in the region, but we believe these could recover if there is significant China stimulus, the Fed slows the pace of tightening, energy prices subside and the U.S. dollar weakens.

With our underlying managers' biases towards value, we held a defensive long interest rate strategy as a hedge to provide downside protection to the total portfolio—which has proven extremely beneficial amidst increased interest-rate volatility. With interest rate volatility now quite elevated and uncertainty priced in, we have trimmed the long interest rate volatility position in favor of cash.

Fixed income

Government bond valuations have improved markedly after the rise in yields, with U.S. Treasuries looking increasingly attractive—both in terms of expected return and diversification potential. While we see good value in U.S. bonds, we think Japanese, German and U.K. bonds are still moderately expensive. A positive for government bonds is that markets are well calibrated to the hawkish outlooks for most central banks. In our view, this should limit the extent of any further sell-off.

In our clients' portfolios, we increased our high yield exposure as high yield is starting to show better value with spreads above long-term averages. High yield should perform well if the Fed becomes less hawkish and an economic soft landing becomes likely; but spreads will remain under upward pressure if U.S. recession probabilities increase and the Russia-Ukraine conflict escalates. While we are overweight high yield, we remain roughly neutral on total credit exposure when also taking into consideration an underweight to investment grade corporates.

Real assets and commodities

We were rewarded for our allocation to global listed infrastructure, which has been one of the better performing asset classes so far this year. We also benefited from our exposure to commodities, as this has been the best-performing asset class. That said, energy and agricultural prices have surged on the Russia-Ukraine conflict, and we believe some of these gains will be reversed if hostilities subside. One risk for commodity markets is that China's economy continues to slow. On balance, the case for commodities exposure is still positive, but weaker growth as central banks tighten policy will dampen demand. We are watching the situation closely.

Overall, we are managing a risk-neutral asset allocation, with security selection from our underlying money managers being the dominant driver of risk and returns in portfolios.

Our seasoned team of investment strategists and portfolio managers will continue to monitor the markets and dynamically manage risk within desired levels, helping our clients navigate the months ahead. At the end of the day, our focus is on empowering our clients, and making sure we're putting your money in the right place.

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