Trimming risk

While we continue to favour equity over fixed income returns, today we are reducing our equity overweight to neutral. In *Outlook 2022…there may come a time to pivot*, published in early December last year, we noted that "dissipating slack and tighter policy could demand a more neutral—or even defensive—stance as H2 2022 gets underway"…and that it would be key to assess whether that pivot may arrive "sooner and faster" than expected. Over the past couple of months, inflation has proved stickier than expected and geo-political risks have risen somewhat.

Most importantly, central banks, including the US Federal Reserve (Fed), have blinked. From collectively signalling rate hikes and a staged withdrawal of liquidity from 2023 or 2024, pressure form elevated inflation and their current near-zero interest rates' starting positions have brought this forward to H1 2022. While we remain constructive on the outlook, we are choosing to adopt a more neutral risk position. We anticipate that once the tightening phase begins and inflation more clearly recedes, a more risk-on position will be warranted in H2 2022.

Staying constructive on economic growth, but from a more neutral position

We remain constructive on the macro-economic outlook, and arguably more comfortable than we were when we published our 2022 outlook on 1 December. At that time, the Omicron variant had just emerged and neither the efficacy of current vaccines nor its mortality rate was known. Moreover, inflation was continuing to surprise higher and the likely response of central banks to inflation risk was less clear. As we have re-emerged in 2022, Omicron cases appear to be peaking, mobility restrictions were modest and due to ease through Q1, and the impact on activity has been limited. We also have a clearer view of central banks, who have lost patience with elevated inflation and decided to begin removing liquidity sooner than expected.

It is also too early to confuse early central bank action with sharply faster and higher rates. We only view the earlier timing as adding modest further tightening to 2022 that still leaves rates quite accommodative. 2022 has also brought increasing signs that inflation pressures are on the cusp of easing (even if this process is somewhat delayed again) as surveys of pricing pressures and supplier deliveries fall in early 2022. Other drivers of a strong growth outlook remain intact, from global consumers flush with cash and pent-up demand for services, while supply-chain rigidities (and strong goods demand) have left inventories historically low, likely underpinning a production and capex upswing across the world in 2022 and 2023. The decision by central banks to normalise rates somewhat earlier may also limit the extent to which the abundance of consumer purchasing power leaks into global consumer inflation.

Prior to the evident disruption of the Omicron variant in early 2022, global growth forecasts for 2022 were in the range of 4-5%. However, we expect this to trend closer to 4% now (after 6.1% in 2021), a still strong and above trend pace of growth. Relatively, the outlook appears strongest across Europe and Australia (both aided by more dovish central banks), the UK and then the US. China appears a game of two halves, with H1 2022 likely to remain weak before the recent easing in policy fosters stronger H2 2022 growth.

Near-term uncertainty warrants a more neutral risk stance

Despite a positive macro outlook, a number of additional cautionary factors have played into our decision to trim risk today:

- The period immediately preceding the first tightening by central banks has historically created volatility and in many cases meaningful drawdowns in equity markets. The recent history of quantitative tightening (QT) has also proved a meaningful initial headwind for markets. Prior to Christmas, what was signalled as the end of bond buying in mid-2022, then rate hikes in late 2022, and then balance sheet run-off somewhere in 2023, is expected this week to be rapidly compressed into Q2 2022 by the Fed. More positively, we also note that equities have typically rallied strongly in the year following the first Fed rate hike.
- While we believe that recent data point to an ebbing and correction lower in inflation through 2022 as the transitory aspects pass through, there is unlikely to be any meaningful disinflation until the March data is released in April, several months ahead.
- Over recent weeks, geo-political tensions have risen, providing additional risks for markets to absorb. Risks of a Russian incursion into the Ukraine have risen sharply. Today, the US State Department has ordered the families of all American personnel at the US embassy in the Ukraine to leave the country. Tensions with China over Taiwan have also not dissipated, and there is scope for military action by Russia to prompt China to take advantage of the situation with its own aggression towards Taiwan.

Ultimately, once markets have absorbed the 'shock' of the Fed and other central banks starting what we believe to be a modest rate hike cycle (and announced their QT policies), we expect equity markets should be in a better position to advance.

The bears are getting noisy…could a valuation correction be afoot?

Of course, given our constructive view on growth and ebbing inflation, why not just hold our current moderate risk-on position that has served us so well, arguably since the pandemic unfolded? As has been the case since valuations post the pandemic moved multiple price/earnings points above their pre-pandemic averages, there has been a persistent concern that, at some point in the future, valuations may mean-revert. Our central case has been to look for a bullish derating of equity markets—as has been unfolding—where strong growth and earnings allow valuations to gradually glide back to pre-pandemic levels over several years.

However, at this point in the cycle, we are confronted with 30-year high inflation (in the US and UK) and decade-high inflation elsewhere. And from the (arguably ludicrous) position of near-zero policy rates and sharply above-trend growth, there must be non-zero risk that a valuation correction comes more quickly. A more neutral stance, as the central bank global normalisation begins, seems more warranted than being moderately risk-on. Again, more positively, we note that economic growth is likely to be slowing through H2 2022 as inflation ebbs. Being early in the central bank tightening cycle, this should caution them about being overly aggressive, limiting the pace and magnitude of rate hikes as the year progresses.

We, therefore, prefer to reflect our preference for equity over fixed income returns from a more neutral risk position. While we typically target 6-12 months for our tactical positioning, this likely reflects a more 3-6 months stance. We anticipate embracing a more risk-on position in the period ahead as our macro views of strong growth and easing inflation become more evident and after markets have digested the first steps towards higher policy rates.

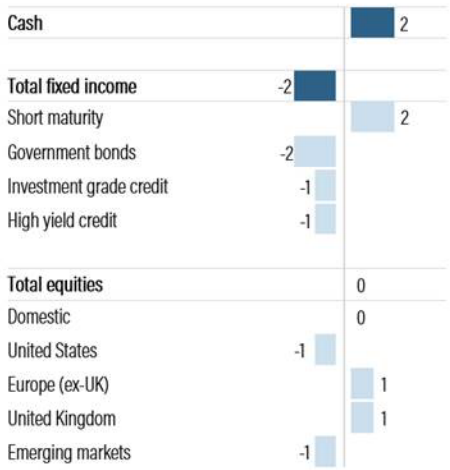
Key tactical asset allocation changes we are making today

Overall, many of our changes today should still resonate with the key messages contained in our 2022 outlook. In particular, our expectation that returns would be more moderate in the year ahead and volatility elevated. Rising bond yields (our target is 2.25%-2.50% on US 10-year bond yields) would favour equities over fixed income, and a rotation within equities from growth to value and tech to non-tech. Heightened volatility and more moderate returns would also significantly favour active management (alpha over beta). We also continue to favour full allocations to alternative assets. Finally, for those implementing new capital, we continue to believe the best way to preserve capital is through a (largely) implemented diversified portfolio. In this regard, the much higher level of bond yields and more attractive equity valuations provide little headwind to implementing a significant share of any new capital.

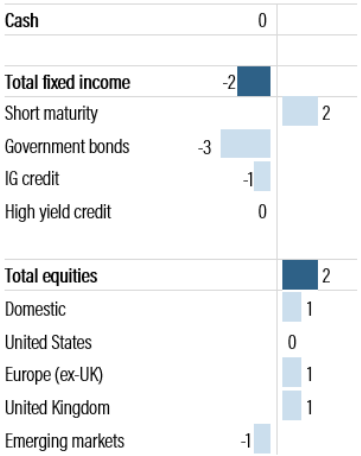
In terms of our key changes today:

- We **maintain our overweight equities positioning relative to government bonds**. However, we are trimming the size of that position (from 5 points to 2 points) largely by reducing our prior equity overweight (+2) to zero.
- Regionally, we continue to **favour European and UK markets** from both a valuation and style perspective, with sectoral composition (being heavier financials, resources and industrials) favouring strong growth and rising bond yields. We are **trimming the domestic equity overweight** to zero (where we are constructive on the upcoming earnings season), while also delaying our telegraphed transition of emerging markets back to neutral from underweight. For the **US,** we are trimming to a **slightly underweight position** to reflect the tech-heavy compositional challenges in that market and more aggressive central bank. In thinking about our valuation risk scenario, while the US market has experienced the most significant correction year-to-date, its prior strong performance leaves it most vulnerable if real rates rise and valuations correct.
- We are continuing the process of **trimming our government bond underweight**. Having moved from -4 to -3 in November 2021, the recent sharp sell-off in yields (from 1.40% to 1.80% in the US) supports another move to a less underweight position (-2).
- Reflecting our constructive outlook and potentially shorter tactical timing of 3-6 months, we have **shifted the equity position to cash**.

New tactical asset allocations (% weights)



Previous tactical asset allocations (% weights)



Source: Crestone Wealth Management. Units refer to the percentage point deviation from strategic asset allocations. Investment grade credit includes Australian listed hybrid securities.