Reducing risk in our regional equity allocations

We remain comfortable with our high-level thesis that the global economy will continue recovering in 2022 and that inflation will eventually subside into mid-year, paving the way for solid equity market returns in the second half of 2022. However, the recent intensification of developments in the Russia-Ukraine conflict, including the severity of sanctions and upward pressure on oil and other commodity prices, now suggests the previously forecast well above-trend pace of global growth for 2022 faces downside risks, mostly via reduced consumer purchasing power. Central banks also have little option than to at least begin lifting rates despite negative real wage growth. The timing for some relief on elevated inflation pressures has also drifted further into mid-year from early Q1.

What changes are we making?

Reflecting this, we are making some adjustments to our regional equity allocations. Key considerations centre on relative exposures to the war in Ukraine and the vulnerability to elevated energy prices (including currency implications). They also reflect a desire to reduce our risk budget in a time of great uncertainty. Today, we are:

- Closing our equity overweight to Europe by moving underweight
- Increasing our exposure to the US (from underweight to neutral)
- Increasing our exposure to domestic equities (from neutral to overweight).
- We take both UK (overweight) and emerging market equities (underweight) to neutral.

Signs of easing inflation, or a pause in central bank tightening on the back of less buoyant leading indicators of growth, will be key to assessing future moves to add risk (or indeed, reduce it further).

Staying with a preference for equities, but edging back risk once again

On 24 January, we adjusted our tactical positions, reducing equity allocations from overweight to neutral as a result of stubbornly persistent inflation, accelerated central bank rate hikes, and rising geo-political risks. As we noted in our March *Core Offerings*, unusually, all these risks have intensified over the past six weeks. We remain comfortable with our high-level thesis that the global economy will continue recovering in 2022 and that inflation will eventually subside into mid-year, paving the way for solid equity market returns in the second half of 2022. To that end, we maintain our current preference for equities over fixed income returns, reflected by a tactically neutral position in equities, underweight in fixed income (both bonds and credit) and overweight to cash. We continue to look for an opportunity to add risk via equities, potentially during Q2 or around mid-year.

Despite this, the sanctions imposed on Russia (arguably more material than expected), and other supply-chain disruptions associated with the ongoing conflict, are likely to be enduring, even if a resolution to the situation in Ukraine is found in the near term. The most obvious impact of this has been (and will likely continue to be) felt in energy prices, which we now expect to remain elevated, even as geo-political tensions ebb and flow. We expect the resultant hit on consumers' purchasing power to be more damaging to global growth than many are currently forecasting. As noted in the recent Crestone Investment Forum, "oil is nature's interest rate", and it appears central banks are going to have little choice but to begin a rate hiking cycle when real wage growth is negative and consumer purchasing power is being challenged. While consensus global growth estimates remain well above 4% for 2022, the impact of elevated oil and other commodity prices suggests forecasts are likely to be lowered over coming months closer to 3.5%.

Reflecting these concerns, we are making some adjustments to our regional equity market positioning. In making these changes, which are explained in more detail below, currency market moves are an important consideration. Since the initial Russian invasion of Ukraine, the Australian dollar has strengthened materially against the euro and the British pound. Additionally, our expectation is that elevated commodity prices (as well as a shift to a more hawkish stance from the Reserve Bank of Australia (RBA) in time) are likely to maintain upward pressure on the Australian dollar, reducing returns of unhedged foreign currency exposures. In addition to tilting towards markets less exposed to ongoing conflict in Ukraine we have, therefore, also reduced foreign currency exposure as a whole. Whether a region is a net energy importer or exporter has also been factored into our adjusted regional tilts.

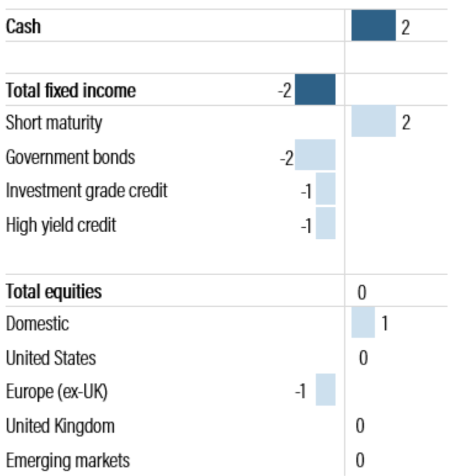
At a regional level, our tactical shifts, in essence, reflect a desire to reduce our risk budget in a time of great uncertainty. The COVID - 19 pandemic offered up numerous signposts that dictated the path of our equity exposures (e.g. fiscal and monetary stimulus, stabilisation in credit markets, vaccine success, mobility indicators etc.). In the current environment, the path forward is challenged by already very accommodative monetary positions, stretched fiscal budgets, very stressed commodity markets, and decelerating (yet still positive) growth and earnings. Clarity on these and other indicators will dictate the direction of equity markets. Until then, the appropriate course of action appears to be one focused on risk management, rather than a returns-based (i.e. buy-the-dip) mentality.

Rationale for each regional equity allocation

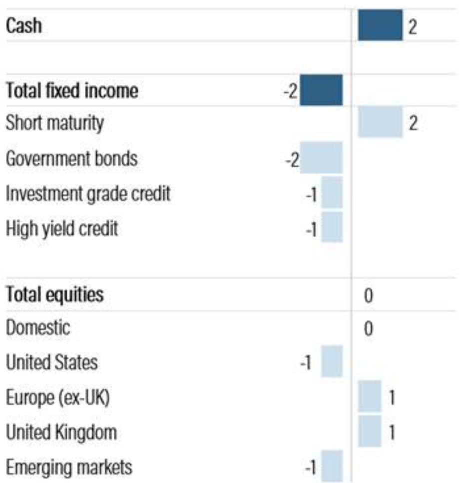
Consequently, we are making the following changes to reflect a further modest reduction in risk-taking. New and previous tactical asset allocation changes, as well as active portfolio weights, are shown in the tables below.

- **Australia to overweight from neutral**: This reflects Australia's role as a net energy exporter, with likely continued upward appreciation of the Australian dollar. The latest reporting season was strong and valuations remain a full point below the five-year average (and in line with the 10-year average). Domestic equities should act as somewhat of a defensive exposure given yields, balance sheets, geographic distance from the Russia-Ukraine conflict and exposure to China, which is abandoning its zero-tolerance approach to COVID-19 and easing at the margin.
- **The US to neutral from underweight**: This reflects the US role as a defensive safe-haven during times of macro uncertainty, from both an equity market perspective and a US dollar perspective. We continue to acknowledge that rates are likely to initially rise faster in the US than in Europe or Australia which will be a headwind for equities, but there remains great uncertainty as to the velocity and ultimate end point for the Fed funds rate. The US is a net energy exporter and there is also more scope for revisions to interest rate pricing should growth slow or inflation pressures ease.
- **Europe to underweight from overweight**: Prior to the Russian invasion of Ukraine European equities had been outperforming the MSCI World index. Unfortunately, the addition of a significant geo-political risk premium and its implications for energy security, business confidence and monetary policy, has once again made investing in Europe difficult. The region's lack of energy independence, in the main, could drive a sustained risk premium in key input costs, pressuring corporate margins and consumer confidence.
- **UK to neutral from overweight**: Until recently, the UK equity market had been one of the best performing developed markets globally. We continue to believe that the UK offers a multi-year investment opportunity and its index composition should remain broadly favourable, albeit the situation in Europe complicates the demand side of the equation. We believe that valuations remain suitably supportive for a neutral exposure, despite its proximity to Europe.
- **Emerging markets to neutral from underweight**: China is emerging from its zero-tolerance approach to COVID-19 and is easing at the margin, albeit the region continues to underperform materially. The latest China NPC also signalled a stronger higher target and greater fiscal support than expected. Emerging Europe will likely continue to be an underweight exposure. For Asia-Pacific equities, oil prices have historically been positively correlated, although oil supply shocks have been typically negatively correlated. Still, over time Asia is likely to benefit from its emergence from COVID-19, China is likely to become stronger, and the US dollar weaker.

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.

Active portfolio weights and active tactical asset allocation tilts

	ACTIVE TILT	YIELD (%)	BALANCED (%)	GROWTH (%)	ENDOWMENT (%)
CASH	**2**	**5**	**5**	**5**	**5**
FIXED INCOME	**-2**	**51**	**33**	**15**	**12**
Short maturity	2	8	7	5	5
Government bonds	-2	28	11	4	2
Investment grade credit	-1	12	11	4	4
High yield credit	-1	3	4	2	1
EQUITIES	**0**	**24**	**42**	**60**	**38**
Domestic	1	13	20	29	12
United States	0	6	11	16	13
Europe (ex-UK)	-1	2	3	4	3
United Kingdom	0	2	3	4	3
Emerging markets	0	1	5	7	7
ALTERNATIVES	**--**	**20**	**20**	**20**	**45**

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