AEGON Asset Management

GLOBAL HOUSE VIEW

● Overweight ● Neutral ● Underweight

Asset class		Opportunity set	UW	N	OW	Change	Comments
Main asset class		Equities	●			▼	Monetary tightening and weakening economic growth will likely put further pressure on multiples
Main asset class		Fixed Income			●	▲	Yields are at attractive levels and fixed income markets are beginning to price in a recession
Main asset class		Commodities		●			Producers incentivized to increase production; however, Russia-Ukraine war can also keep prices elevated
Main asset class		Cash		●			Real rates still relatively subdued given inflationary backdrop
Preference by asset class	Equities	US		●		▼	Late cycle typically good for US equities; however, increased Fed hawkishness creates more caution
Preference by asset class	Equities	EU		●			Technical and valuation signals are supportive; however, sentiment bearish given proximity to Ukraine
Preference by asset class	Equities	UK			●	▲	Weak pound sterling and elevated commodity prices strong drivers for UK equities in short-term
Preference by asset class	Equities	Japan	●				Challenging global economic background and high oil prices are negative for domestic market
Preference by asset class	Equities	Asia ex-Japan		●			A strong US dollar and Asia's position as a warrant on global growth continue to suggest caution
Preference by asset class	Equities	REITS		●		▼	Aggressive rate hikes in near term may act as short-term headwind for asset class
Preference by asset class	Fixed Income	Government bonds	●				Selectively underweight in Europe and Japan where central banks are still trailing the hiking cycle
Preference by asset class	Fixed Income	Investment Grade			●		Spreads now more than compensate investors for a (mild) recession. Investment grade, therefore, relatively attractive
Preference by asset class	Fixed Income	High Yield			●		A similar story to investment grade; spread levels are increasingly attractive from a valuation perspective
Preference by asset class	Fixed Income	EM Debt		●			Tightening Fed and Ukraine conflict present clear headwinds; however, relatively attractive versus developed market
Preference by asset class	Fixed Income	Securitized		●			Fundamentals and technicals negative on macro back drop, but relative value is still prevalent
Preference by asset class	Currency	USD		●			Bearish arguments of high valuations and overcrowding balanced by bullish case of declining growth
Preference by asset class	Currency	Euro			●	▲	EUR posed to rebound significantly when European Central Bank starts hiking rates
Preference by asset class	Currency	Japanese Yen	●				BoJ remains at odds with other central banks, and continued dovishness will underpin its depreciation
Preference by asset class	Currency	GBP	●			▼	Negative consumer sentiment, less fiscal expenditure and Bank of England turning less hawkish all unsupportive

Figure 1: All investments contain risk and may lose value. The above overview is intended to illustrate major themes for the identified period. No representation is being made that any particular account, product, or strategy will engage in any or all of the themes discussed. Our asset class overweights/underweights in a hypothetical model portfolio as of June 30, 2022, on a 3-month horizon. Up/down arrows indicate a positive (▲) or negative (▼) change in view since the prior quarterly global house view. These views should not be construed as a recommended portfolio. This summary of our individual asset class views indicates strength of conviction and relative preferences across a broad-based range of assets but is independent of portfolio construction considerations.

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Our asset allocation decisions – in short

Cross asset allocation: Our pessimistic views on the direction of global growth have led us to change our scores for equities from neutral to underweight, and fixed income from neutral to overweight; commodities and cash remain neutral.

While equity market valuations are now at more attractive levels and technically, they appear oversold, we still view the asset class with caution given bearish fundamental and sentiment indicators. The squeeze in financial conditions and aggregate demand will put downward pressure on both margins and earnings for many corporates. Therefore, we have downgraded equities to underweight, prompted by the current environment of tightening policy and slowing growth.

In contrast, recent falls in sovereign yields show that investors are pricing in the growing likelihood of a recession. While inflation remains a risk for bonds, the aggressiveness of central banks and fall in consumption should dampen core inflation in the coming months and increase demand for safe-haven fixed income instruments.

Within fixed income: Our views in fixed income are unchanged since last quarter. We remain underweight duration, specifically Japanese and European government bonds. We view these two assets as less attractive relative to US Treasurys and UK Gilts, given the European Central Bank (ECB) and Bank of Japan (BoJ) are yet to begin hiking interest rates to lower inflation.

Meanwhile, we continue to be overweight spread categories in investment grade and high yield. We believe recent spread widening has been overdone, and current spread levels are now attractive. Corporate balance sheets remain in reasonably good shape at this point in the cycle and defaults are low.

Within equities: We have reduced our US equity view from overweight to neutral. While slowing growth has led us to downgrade equities as a whole, regionally, we view US as one of the markets most at risk; given the aggressiveness of the Fed and the fact that many of the market's constituents continue to trade at elevated margins and valuations. Our pessimistic view of the economy's outlook leads us to believe that many US companies' earnings are in danger of being missed, so we have therefore taken more precaution this quarter in our scoring.

Elsewhere, we have upgraded our UK equity view to overweight. The pound has fallen to lows versus the dollar not seen since 2008 and the energy prices remain elevated well above trend. Both are positives for the UK index; UK stocks tend to perform relatively well when the pound falls because many companies that are part of the FTSE 100 Index are multinationals with overseas revenues, while a significant portion are also energy-related equities which have captured the commodity rally.

Finally, we have reduced our Japan equities score to underweight. While we acknowledge the market has corrected to attractive valuations, we feel earnings are in danger of not being met. High commodity prices and geopolitical issues will also influence domestic GDP, which continue to outweigh the bull case of valuations in our view.

Within currencies: We have moved EUR from neutral to overweight. In a scenario where European energy supplies are not significantly disrupted and Chinese macro policy becomes more stimulative, the euro could rebound significantly, particularly as the ECB is expected to raise rates to positive territories in the coming quarters.

We also reduce our Japanese yen view to underweight. The yen has fallen to multi-decade lows versus the USD as interest rate differentials continue to widen. Relative monetary stances between the Fed and the Bank of Japan remain at odds with each other and are unlikely to change in the short term, and given we also believe the threshold for currency intervention in Japan's view is higher than current levels, we see the JPY continuing to remain weak this quarter.

Finally, we have also reduced our pound sterling score to underweight. Political uncertainty, coupled with; the cost of living crisis and slowing growth, a less hawkish central bank, and insufficient fiscal policy to cushion higher consumer prices; all suggest GBP should remain vulnerable for the foreseeable future.

Market Commentary

The first half of 2022 has been defined as one of the worst periods in equity market history. Any optimism of a post-pandemic boom in growth has been soured by rising inflation. Elevated commodity prices, tight labor markets and excessive aggregate demand have only reinforced this. Central banks have underestimated the stickiness of inflation and their reaction functions have been behind the curve. Thus, markets have priced in that interest rate paths going forward will have to be considerably aggressive for the current cost of goods and services to meaningfully trend lower. The Fed is still forecasted to hike a further 1.65% by year-end to a benchmark rate of 3.4%. Other central banks such as the ECB and Bank of England have also made it clear that inflation is of primary focus, with rates in Europe expected to lift off from negative levels to 1.25% by December. However, we expect some caution from the ECB as it looks to protect peripheral yields in the likes of Greece and Italy to avoid another debt crisis.

While we believe the pivot in central bank policy will ultimately dampen inflation to trend levels, this is unlikely to happen until 2023. We expect most central banks will have to maintain their hawkishness for at least the remainder of the year even as growth begins to meaningfully slow. A dynamic of rapidly rising rates and sticky inflation creates a challenging dilemma for markets in the short term. Inflation, particularly in Europe, is still not at its peak. Strong corporate and household balance sheets have protected consumption thus far, but going forward, we expect consumption to slow, especially given consumer price inflation remains above the real rate of wage growth. Indeed, anecdotal evidence from consumer discretionary companies cutting earnings forecasts suggests that consumers are already having to change their spending habits in light of above-trend prices. Economic activity remains relatively robust at the moment but recent PMIs in Europe and US also suggest that growth is beginning to slow.

Historically, when growth has shown signs of decline, central banks have moved to support financial markets by providing liquidity and cutting interest rates. However, given the ongoing inflation narrative, we believe many will be forced to remain hawkish despite slowing growth. Any let up in hawkish rhetoric can undo much of the tightening already achieved which would only cause central banks to hike further. We expect central banks will have to raise interest rates to above-normal levels to effectively lower prices therefore, raising the probability of recession for developed economies in late 2022 or early 2023 as aggregate demand meaningfully slows. Tightening financial markets on top of slowing aggregate demand is likely to drive equity markets down further as corporates face a squeeze on earnings and margins.

Our pessimism in financial market outlook is reflected in the changes made in our Global House View, where we have repositioned asset class scores to favor fixed income over equities. Yields, particularly in US and UK sovereign markets, are now attractively priced and have begun to react to the growing likelihood of recession, and we believe credit spreads have overshot and now offer opportunities to narrow so long as the economy remains in shape in the near-term. Equities on the other hand have not fully priced in slowing growth and can capitulate further when earnings expectations are reduced. Ultimately, we favor being short equity risk until we see signs of inflation fall meaningfully down towards trend levels.

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