Navigating Changing Correlations

June 2022

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The US led the rebound in risk assets during the last week of May. However, most markets ended the month flat. The S&P 500 returned 0.2% (USD), the MSCI Europe was down 0.6% (EUR) and MSCI Japan paused its downward trajectory of previous months, ending May up 0.9% (JPY)[1]. The MSCI Emerging Markets Index returned 0.5%[1]. Energy continued to be the clear sector outperformer with the MSCI ACWI Energy index up 12.2%, on the back of slowly rising oil prices[1]. The US 10-Year Treasury yield appears to have finally settled, ending the month a fraction lower than in April, at 2.8%[2]. The VIX moved down to end the month at 26[2].

The fall in the S&P 500 at the beginning of the month appeared mostly driven by multiple compression. Despite a bounce in the final week, we still believe though this is likely a bear market rally, due to increasing signs of deteriorating consumer confidence and slowing growth. We finally saw the correlation between equities and fixed income turn negative. Should equities fall, investors at least now may have somewhere to hide. Now that the correlation appears to have been restored, we are increasingly comfortable with fixed income and believe the decline in yields should stabilise. With tentative signs that inflation is plateauing, as we progress through the late stages of the cycle, we believe US investment grade credit should outperform high yield credit and equities, especially if recession risks rise. That said, we do not anticipate a US recession until 2H 2023.

Notes:

[1] Bloomberg, 1-month return, as of 31 May 2022.

[2] Bloomberg, as of 31 May 2022.

Investment Implications

We have been keeping our powder dry, so we can move cash back into markets at opportune moments. We are already seeing opportunities in the fixed income space. In May we maintained our allocation to equities, but deployed cash to increase duration risk by allocating broadly to fixed income. Before the last week of the month, we increased equity exposure via futures, as options deltas had dropped. This is consistent with the team's view that the market may be oversold in the near term. The subsequent rally in equities in the last week of May indicated our view was correct.

We have made the following tactical changes over May. The implementation of these is dependent on portfolio guidelines and some portfolios may not permit:

High Dividend, Low Volatility Equities

We added an overweight to high dividend, low volatility equities, through an ETF. This offers an attractive dividend yield from US equities, plus exposure to defensive and value sectors, which continue to trade at a discount to growth. The relatively low volatility and beta characteristics should mitigate the downside, in the event of further volatility.

US Equities Enhanced Value

We removed our position in an ETF and moved to Russell 1000 Value futures to take exposure to the value sector more broadly and make room for more focused allocations to other ETFs or mutual funds, for portfolios which have an allocation restriction.

Brazilian equities

We moved from overweight to neutral Brazilian equities. We had moved overweight in April, but the investment case is weakening. Terms of trade have likely peaked in the short term, while prospects for two key exports have deteriorated; soybean prices could come under pressure from higher global supply in 2022/23, while China's continued zero-Covid policy is likely to hit iron ore demand.

Commodities

We have increased total exposure to commodities, for portfolios which permit, while changing their composition. Within this we have reduced gold, and added a position in an agriculture fund ETF, to gain exposure to agricultural commodity futures. We aim to hedge upside risks to agricultural commodity prices, due to supply disruptions from the conflict in the Ukraine, which is leading to growing food protectionism and rising input costs such as fertiliser, all of which pushes food prices higher.

Emerging Market Local Debt

We moved from overweight to neutral emerging market short-duration commodity-exporter high-yielder countries, implemented through a bond securities basket. Both the key drivers, real yield and terms of trade have deteriorated since we put on the position.

US 10-year Treasuries

We have removed the US 10-year Treasuries underweight. Inflation risks are more balanced, given tentative signs of stabilising wage growth, especially as the global growth outlook dims. Expectations of 50bps Fed hikes in the near term, with several 25bps hikes thereafter, are priced in, leaving little room for a hawkish surprise.

Investment Grade Corporates

We removed our US Investment Grade Corporates underweight and moved to neutral. After recent rates and spreads adjustments, risk-reward in future forward is more balanced as monetary tightening is largely priced in and we see tentative signs of sequential inflation plateauing. Even if recession risks are rising, our analysis suggests higher spreads can be offset by lower rates, leaving an attractive yield. At the same time, we maintained our underweight in European Investment Grade Corporates, as high duration of Investment Grade and compressed spreads are likely to result in poor total returns when yields/spreads rise.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results. See Disclosure section for index definitions.**

Tactical Positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Energy				■	
US High Dividend				■	
US Value				■	
Eurozone		■			
UK				■	
European Energy				■	
Japan			■		
Asia ex Japan			■		
Emerging Markets			■		
Brazil			■		
Global Growth		■			
Global Infrastructure			■		
Global Property			■		

Asset Class	--	-	=	+	++
Fixed Income					
US IG Credit			■		
European IG Credit		■			
High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
Commodity Exporting EMD			■		
US Treasuries			■		
US Inflation			■		
German Bunds			■		
EU Peripheral Bonds			■		
JGBs			■		
Commodities					
Broad Commodities				■	
Gold				■	
Agriculture Commodities				■	
Currencies					
Euro		■			
JPY		■			

Source: MSIM GBaR team, as of 31 May 2022. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation, or specific needs of any individual investor.

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Exchange-traded fund (ETF): A basket of securities that tracks an underlying index.

MSCI ACWI Energy Index includes large and mid cap securities across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries*. All securities in the index are classified in the Energy as per the Global Industry Classification Standard (GICS®).

MSCI Emerging Markets Index: The MSCI Emerging Markets Index (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

MSCI Europe Index: The MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

MSCI USA Enhanced Value Index: captures large and mid-cap representation across the US equity markets exhibiting overall value style characteristics. The index is designed to represent the performance of securities that exhibit higher value characteristics relative to their peers within the corresponding GICS® sector. The value investment style characteristics for index construction are defined using three variables: Price-to-Book Value, Price-to-Forward Earnings and Enterprise Value-to-Cash flow from Operations

Russell 1000 Value Index: Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX©: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear ndex or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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