

Regime shift: Asset allocation implications for global portfolios

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Caution is the name of the game when it comes to allocation between global asset classes today, in the current complex transition period from a higher to lower inflation and interest rate environment, says Stuart. He explains why M&G holds this view and how their active valuation-based investment approach takes cognisance of these conditions and has successfully add value for clients by incisively exploiting market mispricing.

Over the past two years or so, amid the recovery from the Covid-induced lockdowns around the world, global equities have rallied as economic growth and corporate earnings have proved broadly stronger than expected, while bond yields have risen in response to higher interest rates and inflation. We now find ourselves at a juncture where most investors appear to believe earnings, especially in the US, will remain resilient, as reflected in the relatively expensive equity valuations in that market. Meanwhile, interest rate markets are expecting central banks to start cutting their policy interest rates eventually, with some having already done so. Bond yields, in aggregate, have been falling from their attractively high levels, although uncertainty does remain around both the timing of rate cuts and the possibility of inflation staying above central bank targets, with resulting “higher for longer” interest rates.

A tricky period for investing

In our view, this is a relatively complex period for investing given the unprecedented nature of the economic recovery from Covid, with unexpected trends having emerged including deglobalisation, local sourcing, work-from-home, and broadly higher supply-side costs. It is possible that these factors, and others, could continue to stoke inflationary pressures such that the world may be unable to return to the exceptionally low inflation and interest rate levels of the past, undermining growth, company margins and investment.

Yet US equity valuations are not pricing in these risks, we believe, with market sentiment seeming to be largely sanguine around the threats of “higher for longer” rates and slower-than-expected growth. At the same time, volatility has been muted and there have been growing signs of risk-taking, although not to the point of euphoria. Investor expectations appear to be anchored to the past environment of 2% inflation, without considering that the world could be moving into a new inflation regime.

Are equity markets being over-optimistic about future prospects? Are we experiencing a regime shift? Since we can't see into the future, and macroeconomic forecasts are very unreliable, we cannot claim to know. We prefer to use fundamental, bottom-up analysis to determine our asset allocation positioning, and from a valuation perspective, US equities are relatively expensive compared to our assessment of their long-term fair value – they are not offering us adequate compensation for the risks involved. As such, we are cautious on the US and our multi-asset portfolios are underweight the US equity market. However, certain other global equity markets like China and Mexico are more attractive, and we are holding overweights in a variety of these, so that our overall global equity positioning in our portfolios is broadly neutral and diversified.

Adding extra value to client portfolios

In addition to our long-term strategic asset allocation approach, we also aim to add above-market value (alpha) to client portfolios on a shorter-term basis by taking advantage of unexpected market sell-offs or rallies that result in

asset mispricing. We term these share price moves “episodes” and aim to buy or sell during them when we determine the market has overreacted to swings in sentiment, with the extreme move often caused more by sharp changes in share prices themselves than by the original event or news, as investors get scared by losses or chase returns through overexcitement.

This episode approach is underpinned by our strong belief in valuation being the best guide to prospective returns from any asset over a five to 10-year period. However, value signals can be illusory or unhelpful at times, acting as value traps, for example. Therefore, in order for us to participate, they must be accompanied by symptoms of “episodic” behaviour such as investor panic or overexcitement and euphoria, which can be signalled by rapid price moves. Also important are the depth and breadth of the market move and how correlated it is, where in our view the market is not making a considered assessment of fundamentals and is buying or selling indiscriminately.

Covid panic and China pessimism

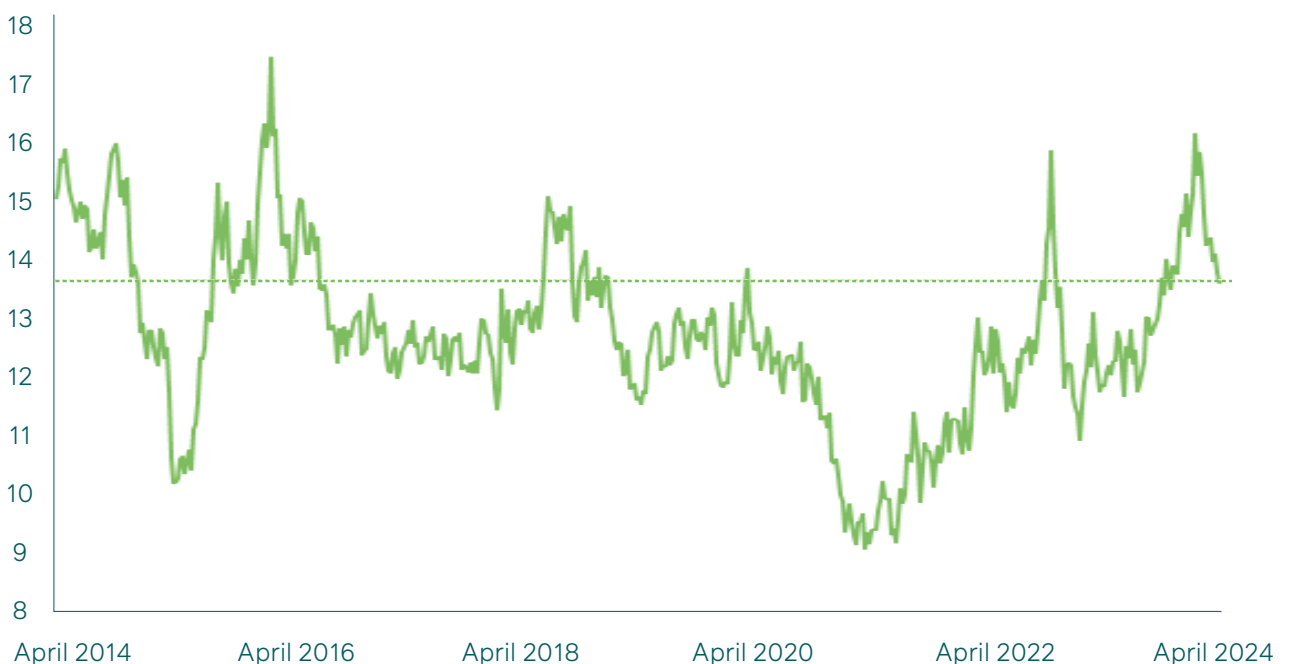
Such an episode occurred in 2020 during the initial Covid-related panic, for example. In such cases we force ourselves to be contrarian and buy assets when others are panicking, usually buying a tracker fund or other passive vehicle due to their liquidity and ability to gain exposure to a specific entire market or sector. We have also found that allocating to an actively managed fund, where the underlying portfolio is less transparent, can be ineffective as the manager might also fall prey to extreme market sentiment.

Another more recent episode we have been able to take advantage of, as illustrated in Graph 1, has been the extreme negative sentiment toward Chinese equities in 2023 and early 2024. The broad consensus that developed was that China was “uninvestable” due to weak economic growth, ineffective pro-growth policies, and instability in the financial and property sectors, and conditions sparked extreme investor comments such as “bargain-basement Chinese stocks still aren’t cheap enough”. This was accompanied by sharp and indiscriminate equity selling – clearly signalling a buying opportunity for us. In early 2024 Chinese H shares reached an earnings yield of over 16% compared to their longer-term average of around 13.6%, and in December 2023 we used the opportunity to build our Chinese equity holdings. Then, with ongoing market losses in January, we doubled our exposure. But by February and March the market rallied, with share prices rising by over 20% and creating very respectable value added to our client portfolios.

Graph 1

Episodic/tactical opportunity: Long Chinese equity

Value: China (H Shares) Earnings Yield, %



Source: Bloomberg, Refinitiv Datastream, 7 April 2024

Conviction and patience

This tactical approach of adding value through active, shorter-term mispricing episodes requires not only a strong conviction around asset valuations, but also patience in waiting for the correct opportunity. Markets are most often very efficient, but humans are sentient beings and do fall prey to emotion at times. This is when we aim to be contrarian and buy up assets at attractive valuations, those with the greatest potential to produce market-beating returns as they recover.

South African investors can gain exposure to this strategy through the [M&G Global Balanced](#) and [M&G Global Inflation Plus Funds](#) (in US\$) and their rand Feeder Fund equivalents, which are all managed by the London-based team.

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