Key themes and their investment implications for Q3 2023

	Asset Allocation	Equities	Fixed income	Private credit	Real estate
Resilience now, fragility later	▪ We are positioned cautiously, underweight (UW) equities and credit. Economic activity remains relatively robust in DMs, but leading indicators of earnings are falling, while tightening credit conditions remain a headwind to the medium-term outlook. ▪ We are moving up in quality across asset classes. In equities, this means allocating to minimum volatility equities and defensive sectors over cyclical sectors. In fixed income, we prefer government bonds and investment grade (IG) over riskier high yield (HY).	▪ We are increasingly cautious and favour a quality and defensive bias as risks mount. ▪ Strong US performance led by mega cap tech stocks has created concentration risk, which could falter if artificial intelligence (AI) hype fails to meet expectations and/or the US Federal Reserve (Fed) keeps rates higher for longer. ▪ In Europe, the macro backdrop is deteriorating, but valuations, particularly in cyclicals, have been slow to react, which could spell a period of weak price performance.	▪ US inflation is well placed to continue its decline given the sharp contraction we have seen in Fed money supply growth (a leading inflation indicator). ▪ IG credit markets are relatively well priced for a recession, especially in Europe - but high yield and European equity markets are not.	▪ Now is a time to be defensive and seek certainty of returns. ▪ Given the current instability of the current economic environment, the predictable returns offered by an all-weather asset class like private credit may prove beneficial.	▪ Unusually tight demand/supply balance in Europe is providing short term resilience. ▪ Fragility later would come primarily from greater-than-expected interest rate rises which would have a negative effect for both investment and occupier markets. ▪ As is typical in real estate cycles, individual property re-pricing moves long before wider market indices, and so H2 represents a good buying opportunity in European real estate markets.
The long game in China	▪ Recent data from China has indicated the initial momentum of the re-opening recovery is waning. However, we believe that China and many emerging markets (EM) more broadly are facing fewer headwinds than many DMs, and China in particular could represent a good diversifier for portfolios. ▪ Global luxury equities are a beneficiary of increased spending and tourism related to China's re-opening. The sector should also offer some downside protection.	▪ Although the China recovery and policy stimulus have underwhelmed, we believe there are positive signals from the region. Regulatory uncertainty may have peaked, earnings are trending up and valuations are attractive both historically and relatively.	▪ We believe that China's recovery is not over, but the path will be slower and bumpier, and the net growth impulse will not reach previous cycle levels. The property sector may not be close to a turnaround yet given the underwhelming sales recovery. ▪ The weakness in business and household investments will be the key signs to monitor for policy support. However, barring a crisis, it is unlikely to reach the previous all-out easing cycle levels. The bearish views have been reflected in China HY valuations.		
Corporate health	▪ The inflation and growth outlook looks better in select EMs. For example, there are opportunities in Indonesian and Brazilian equities and Brazil and South Africa local government bonds. ▪ We have tilted away from US equities given the tighter lending standards following the banking crisis. We believe Europe small caps represent an opportunity as they are at a large discount to those in the US.	▪ We expect 2023 to be a year of earnings contraction with pressure particularly acute in the US and Europe as companies continue to contend with inflation and tight monetary policy. Defensive sectors such as consumer staples and healthcare are better placed. ▪ There are bright spots in Japan, with its trend of shareholder friendly action, and China's more responsible capital allocation.	▪ Falling liquidity and tightening credit conditions are concerning. In the US HY market, our calculations show the implied one year forward default rate is just 2.6 per cent. If we incorporate adjustments, we can say investors expect, at most, a 4.6 per cent default rate. But this is still only half the default rate that we have seen in previous recessions.	▪ The higher cost of debt will make it harder for companies to invest in growth. Firms will look to control costs, and falling interest rate coverage ratios will drive a (limited) increase in defaults. ▪ Industries are broadly sanguine heading into H2 but credit specific challenges may rise. Some weakness in the chemicals sector could be the canary in the coal mine, but more likely a symptom of some destocking across the market.	▪ Structural move to sustainable offices and hybrid working, providing opportunity for green building strategies and bifurcating the market. ▪ Weak demand for 'unsustainable buildings' / strong demand for more sustainable buildings.

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