



Multi-Asset Tactical Asset Allocation update: Q4 2022

Tactical Asset Allocation (TAA) is one of the five stages of the Liontrust Multi-Asset investment process – the others being the Strategic Asset Allocation (SAA), fund selection, portfolio construction and monitoring.

The Multi-Asset investment team has a medium-term view – 12 to 18 months – of the prospects for each asset class and this forms the TAA. Each asset class is assigned a rating from one to five, with one most bearish and five most bullish. TAA is the target (not the actual position) for every asset class and the investment team builds towards this within the funds and portfolios over time. Having a 12 to 18-month view means the team will increase positions when the valuations of the asset classes are attractive; their core approach is to buy low and they will not overpay for assets, however highly they score.

Multi-Asset Tactical Asset Allocation scorecard: Q4 2022



						Direction of travel
	1	2	3	4	5	
Overall			●			↓
Cash		●				↑
UK gilts		●				↑
Global government bonds			●			↑
Investment grade corporate bonds			●			↑
Index-linked bonds		●				↓
High yield				●		↑
Emerging market debt			●			↑
Convertibles			●			↓
Equity overall			●			↓
US equity			●			↑
US small caps			●			↓
UK equity				●		↑
UK small caps				●		↑
European equity		●				↓
European small caps		●				↓
Japanese equity			●			↓
Japanese small caps			●			↓
Emerging markets equity				●		↓
Asian equity				●		↓
Real Assets			●			↑

Source: Liontrust, 17 November 2022. Not all the asset classes are used in all the MA portfolios and funds

The team reviews the TAA every quarter but it is important to stress this does not reflect a quarterly view. The rating is only altered up or down when there is a fundamental change in the assessment of a particular asset class, and by taking a longer-term view, the team is seeking to ignore short-term market noise and avoid trying to time the market. The table above shows the latest TAA and includes all asset classes regardless of whether

they are included across the funds and portfolios. The direction of travel arrow shows the last change in the TAA, whenever this occurred.

Changes in this latest version (highlighted in green) are fairly small. Our overall ranking on markets remained at three but there is a more positive underlying tone to the prevailing environment presently and the team's decision between a three or a four was finely balanced. We are becoming cautiously optimistic but have not yet moved back to a four from a three.

Our main change is to increase the score of high yield fixed income from a three to a four. This section of the fixed income market represents the relatively low credit quality borrowers and, as a result, investors cannot consider it to be a 'safe haven' in the way government bonds have been considered traditionally. The quantum of yields available from this asset class presently, however, offer ample reward in our opinion for the lower credit quality. We have also moved our ranking on investment grade credit back up to three after lowering it earlier this year.

Asset class	Q4 2022 Score	Direction of travel	Commentary
Overall	3	↓	<p>Our overall score remains at three, but this is with a positive lean towards raising it to a four because we feel there is a much more positive tone in markets. A lot of bad news has now been priced in and arguably we are through the worst of the peaking interest rate cycle. There are already some signs of inflation abating and the global economy remains on a fairly solid footing despite the fears of recession. We expect a more technical, small 'r' recession rather than an aggressive, protracted one.</p> <p>Beyond geopolitics and ongoing outbreaks of Covid, particularly in China, the key questions this year have been when we will see peak hawkishness from central banks and how successfully they can engineer a soft landing while also curbing runaway inflation.</p> <p>We continue to believe inflation should fall as the rolling base effects from Covid shutdowns work their way through the system. This should allow central banks to tread carefully and be less aggressive on the hiking front but there also remains a risk of policy surprises or unintended consequences, neither of which are supportive for markets.</p> <p>While current newsflow is broadly negative, equity markets remain attractively valued, particularly after recent indiscriminate selling. The UK is still cheap despite the recent energy rally and value rotation, for example, and even the US is less unattractive after two corrections (falls of 10% or more) in the S&P index so far this year.</p> <p>Within bonds, we appreciate the direction of yields will be upward over time (as interest rates climb) but, as ever, the path will not be linear and we maintain exposure to this asset class for its long-term diversification to equities, some level of inflation protection and increasing income. To raise risk exposure in our funds and portfolios, we are increasing investment in high yield bonds. This reflects the very attractive spreads that are now available versus government bonds. For now, we retain a lower duration position in our</p>

			<p>fixed income allocation as central banks prevaricate over the timing and extent of rate rises and tapering.</p> <p>Finally, we are also merging Property, Commodities, Hedge Funds and Absolute Return sectors into one category of 'Real Assets'.</p>
Cash	2	↑	<p>Cash remains a broadly unattractive asset class but we moved the ranking up to two in Q1 to reflect the fact that, on a relative basis, it looks better as a store of value in a rising interest rate environment. Compared against duration assets such as government bonds, for example, where rising yields will erode capital values, there is a stronger argument for cash, although it is obviously hit by higher inflation.</p>
UK gilts	2	↑	<p>While the excess of Q3 has passed, year to date yields have risen sharply, with the Bank of England's (BoE) Monetary Policy Committee now several hikes through its cycle as it looks to bring inflation under control. Despite its actions so far, there is a sense the BoE has moved from the most hawkish of central banks to a more hesitant hiker, more cognisant of macro risk than some peers.</p> <p>Yields on 10-year gilts have risen from around 0.7% at the start of December to above 3.0% today and could continue to climb in line with base rates. At present yields, there is some prospect of a positive real yield once the inflationary spike abates, which would be more attractive than we have seen from gilts for years. We moved slightly less negative on gilts in Q2 2021 but this asset class remains underwhelming, with the bias of risk still to the upside for yields (or the downside in price terms), especially if higher inflation persists.</p> <p>Gilts still provide a useful function as portfolio insurance in times of market duress but offer little more than a cushion to equities.</p>
Global government bonds	3	↑	<p>We raised our ranking on global government bonds from two to three in Q3. There are attractive benefits now in diversifying beyond the UK. Yields are above 3% in the US, for example, and while that does not offer the prospect of real, inflation-beating yields, it reflects the fact that the Fed is further through its monetary tightening cycle than other developed market central banks. This also achieves greater diversification because of the various interest rate policies pervading around the world. Going forward, monetary policies may be less co-ordinated than they have been historically, so we want to have greater diversity within our fixed income allocation.</p> <p>A global basket of currencies and interest rate risks can result in a differentiated return stream versus UK gilts. Yields have increased and could climb higher, and, for now, the bias of risk remains to the upside (or downside in price terms), especially if higher inflation persists.</p>

			These bonds provide a useful function as portfolio insurance in times of market duress but offer little more than a cushion to equities.
Investment grade (IG) corporate bonds	3	↑	We moved our ranking on investment grade credit back up to three. We had moved it down to two earlier this year in recognition that spreads had narrowed and no longer offered as much cushion for the additional credit risk. However, with spreads now at 150 basis points for global IG, the peak in spreads for this cycle could be behind us. The yield-to-worst range is approximately 500 bps for UK and US IG, which is relatively attractive but there is a risk spreads could go wider in the event of a significant recession.
Index-linked bonds	2	↓	We reduced our rating for Index-linked bonds from three to two in the last quarter. This debt will benefit versus nominal government bonds if inflation continues to run ahead of expectations, although higher levels look to be reflected in elevated prices. Its value relative to gilts is not compelling. Index-linked bonds tend to have longer duration than the same tenor nominals, so duration positioning needs to be considered. It is best to buy inflation protection when the risk is underappreciated, which is certainly not the case today.
High yield (HY)	4	↑	We have raised our rating from three to four in this quarter. This reflects the attractive spreads that are now available versus government bonds. Global HY spreads are presently 500 basis points, which is comparable to levels seen in 2016 and the Covid pandemic. Yields-to-worst levels just shy of 9% for global HY look interesting. Now is an attractive entry point that we believe is sufficiently rewarding to compensate for potentially higher default levels. There is more risk of bankruptcy in this market, especially if conditions worsen, so more cautious and active managers are recommended because of this. But HY assets tend to have shorter durations than government bonds so this will help reduce our interest rate sensitivity at the margin. The running yield is more than sufficient to compensate for the additional risk of credit events that lower quality companies face in a higher interest rate environment.
Emerging market debt (EMD)	3	↑	Hard currency yields to worst levels are around the same as high yield at present: on the positive side, credit ratings in EMD are generally superior to HY, whereas on the negative, the Russia situation shows the political risk inherent in these markets. Our view remains that while spreads look reasonable, the idiosyncrasies of the emerging market environment are potentially better rewarded in EM equities. Dollar strength also represents an economic headwind for many EMD issuers and poses potential repayment affordability problems for hard currency EMD.
Convertibles	3	↓	We continue to see convertibles as providing an attractive risk/return profile thanks to their optionality and bond floor. Our view moved down from four to three in Q4 2021 as we

			took profits after a strong spell of performance and feel the asset class has potentially peaked for this cycle.
Equities overall	3	↓	<p>Our rating for equities fell from four to three earlier in the year to reflect the greater uncertainties that existed with respect to interest rate policies and economic growth. However, we are now likely to add marginally to our equity exposure overall. This will take us to a slightly overweight position but still within our 'neutral' model limits.</p> <p>The obvious risks lie in tightening monetary policy and slowing growth but there is a sense that share prices, via corrections, have already factored in worsening prospects.</p> <p>That said, we expect returns to be lower than seen in the recovery since the sharp Covid shock back in March/April 2020.</p> <p>We are starting to recognise the fact that markets have sold off a lot though and to that end, we are raising exposure to equities and particularly the US because we believe it is fairly cheap in historical terms. This, together with the entrepreneurial spirit in its economy and its energy independence, makes for a positive case.</p> <p>Amid an ongoing value rotation, growth stocks, particularly in the US, have fallen into a bear market, with two 10%-plus corrections in the S&P 500 index already this year, which offers the opportunity to top up growth and quality holdings. We have seen the US as prohibitively expensive for much of the last decade and while still not attractive, it is certainly less unattractive after these corrections. Elsewhere, we continue to favour markets such as the UK, which is still cheap despite a strong run this year.</p> <p>In a reflationary environment longer term, we expect the rest of the world to outperform the US, value stocks to outperform growth and small caps to outperform large. These outperformances will not all come at once, however, so we retain prudent diversification rather than making a significant gamble that one particular thesis pays off. But there are still opportunities to add value through regional and stylistic decisions.</p>
US equity	3	↑	<p>We have long been cautious on the expensive US but recent corrections have brought valuations back to more sensible, and less unattractive, levels.</p> <p>Looking forward, there are a few points to consider: the US has experienced a technology bear market that has taken some of the froth out of the growth end of the market, which may create opportunities; but an inflationary period does not typically support growth (or long-duration) stocks, which the US continues to have in abundance.</p> <p>Value can still be found beneath the technology behemoths and the US economy remains in relatively solid shape,</p>

			<p>potentially benefiting from its isolation in terms of energy policy and agriculture.</p> <p>Overall, history suggests returns from the S&P 500 index are likely to be lower in 2022, with performance after a 20%-plus year tending to sit around 8%. While valuations are looking more attractive and long-term earnings should be solid, active exposure is still definitely warranted, with rotation of styles a risk to market cap-weighted indices.</p>
US small caps	3	↓	<p>Our ranking on US smaller companies fell from four to three earlier this year, bringing it back in line with the overall US market. Smaller companies have suffered in recent selloffs but, longer term, we continue to believe in the small-cap premium and the short-term re-rating that could give us a buying opportunity. Overall, smaller companies in the US should benefit from the same broad themes as the large cap market with additional sensitivity to domestic economic conditions, whether positive or less so.</p>
UK equity	4	↑	<p>UK equities remain cheap despite the recent energy bounce and the overall skew to value. The UK has outperformed other developed markets so far this year but there is still a long way to go, particularly if the value rotation continues: financials, for example, should benefit from a more forgiving yield curve and higher prevailing yields than we have seen for many years.</p>
UK small caps	4	↑	<p>As in the US, smaller companies have suffered amid recent selloffs but, longer term, we continue to believe in the small-cap premium and the short-term re-rating could give us an opportunity. Overall, smaller companies in the UK should benefit from the same broad themes as the large cap market with additional sensitivity to domestic economic conditions, whether positive or less so.</p>
European equity	2	↓	<p>While Europe remains attractively valued, we moved the score down from three to two last quarter, having reduced it from four in Q2. Europe is the region most at risk from a protracted conflict in Ukraine, with all the geopolitical fallout and sanctions that may bring. Parts of the bloc are heavily reliant on Russian energy and the transition away from that will likely prove painful. It is relatively less attractive than the UK or the US. Given our overall equity score has come down from four to three, it makes sense to trim our exposure to Europe in favour of an overweight position in the UK and other, better opportunities we are finding in developed markets.</p> <p>In addition, while the European Central Bank (ECB) looks set to remain on the more dovish side, its one-size-fits all approach to policy means there is greater risk of inflationary hotspots. As in the Global Financial Crisis, the ECB has to act unilaterally and has little room for nuance, meaning prevailing policy could be inappropriate for large parts of the Continent.</p>

			Finally, Europe is heavily dependent on exports, so it is more sensitive to the global economic cycle and any risk of a slowdown.
European small Caps	2	↓	As above, and for the same reasons, we downgraded European small caps from three to two last quarter, having reduced it from four in the previous quarter, based on the risk of recession and inflation overshooting in certain countries if the ECB is reluctant to move aggressively on interest rates.
Japanese equity	3	↓	Our conviction on Japan has fallen over recent quarters (from four to three) but while the market has sold off in line with others year to date, it is largely unaffected by prevailing geopolitical risks. Where current conditions may impact the region is as a market reliant on exports (although yen weakness may be positive here) and, as with Europe, softening global growth could be problematic. The country's central bank is also sitting outside the hawkish camp for now, with rates expected to stay low, and it remains to be seen whether this period results in some imported inflation (after decades of deflation) and how the country's conservative consumers react to that.
Japanese small Caps	3	↓	Again, smaller companies in Japan should benefit from the same broad themes as the large-cap market with additional sensitivity to domestic economic conditions, whether positive or less so.
Emerging markets equity	4	↓	<p>Emerging markets are proving themselves to be much better at dealing with inflation than their developed counterparts. Central banks in EMs are arguably further ahead of the curve and are implementing more appropriate policies. While long-term positive fundamentals remain intact, shorter-term pandemic shocks and recent policy shifts, both centred on China, have hit sentiment. China's zero-Covid policy continues to create uncertainty, but the government retains plenty of firepower to keep the economy on an even keel.</p> <p>Chinese stocks on the CSI 300 index dropped to their lowest level in two years in April as the government shut areas of Beijing and ordered mandatory Covid testing in one district. This came after China's central bank unveiled a suite of measures designed to support the economy and the billions in yuan wiped off stock prices over the month was clearly not in the script. Chinese equities are now off their April lows, although they are down year to date and have sold off since June amid ongoing uncertainty. They are not looking well-supported.</p> <p>EM equities remain highly geared into sentiment shifts – both positive and negative – and are also sensitive to domestic and international politics.</p>

Asian equity	4	↓	<p>As with EMs, Asia is benefiting from the reflation trade and loose monetary policies and a weak US dollar provides a supportive environment. These economies have, on the whole, fared well through Covid but a lot clearly rests on China and how it supports its economy in the months ahead. Risks remain from the perspective of global sentiment as well as regional political tensions, although Asia has performed well recently thanks to its commodity links.</p>
Real assets	3	↑	<p>Property still offers a reasonable yield pick-up compared to other asset classes, as well as some protection against inflation. However, there is also uncertainty surrounding several property types in a post-Covid world: the anticipated demise of the office and high street retail sectors could be overstated but current pressures on tenants will have long-term repercussions. We tend to favour more specialist parts of the property market enjoying structural growth, such as healthcare, logistics and digital infrastructure.</p> <p>Commodities have rebounded strongly off their lows and are not as attractive a value play today, although the situation with Russia and Ukraine has created short-term volatility in energy and soft commodity prices. Brent crude has fallen by more than a quarter from its March high of \$127, however, and has settled in a mid-\$90s range today.</p> <p>Over the medium to long term, commodities should remain correlated to global economic activity. Broad allocations to commodities should also provide some protection if inflation surprises on the upside. Conversely, downward price pressure could resume if growth disappoints.</p> <p>Given time, the right hedge fund strategy can provide a diversified return stream compared to more traditional asset classes. These funds are unlikely to keep up with a raging bull market but should post reasonable returns in a constructive environment for risk assets. We have recently moved towards real assets in our 'alternatives' allocation, which also offer an element of inflation protection.</p> <p>Well-chosen absolute return vehicles can be a useful diversifier to overall portfolio risk thanks to their low correlation with traditional asset classes. But they are unlikely to keep up with ultimate safe havens such as government bonds in times of market duress. We have recently moved towards real assets in our 'alternatives' allocation, which also offer an element of inflation protection.</p>

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