

# GIC Asset Allocation

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**The Global Investment Committee left its asset allocation unchanged today with global Fixed Income +2% and Global Equities -1%. Cash is 1% underweight.**

We continue to favor assets with the most predictable source of returns, US investment grade coupon payments (especially US Treasuries) and dividends from the most consistent growers.

While little has changed in broadly measured equity indices, heightened volatility in banking and financial markets suggests a turn in the economic cycle is nearing. This may create opportunities to reallocate portfolios for stronger returns in coming months.

**We see the banking emergency as a sign of an advanced stage of monetary restraint.** While each firm impacted in recent weeks had unique problems, it should not be surprising for the weakest industries and firms to face distress. US policy rates surged from 0% to 4.75% in less than a year. US monetary policy swung from Quantitative Easing (QE) to Quantitative Tightening (QT) in a mere three months. Pressures to restrain lending are building and will transmit to non-financial borrowers in time.

**The boom and bust in financial assets – with a likely mild US recession to come – has been driven by historically large swings in fiscal and monetary policy in the past two years. This differs sharply from the 2008/2009 period, which followed a leap in risky mortgage lending.** In that period, weak lending standards and undercapitalized banks drove a financial crisis that is not comparable to the current situation (see our latest [CIO Bulletin](#)). Nonetheless, we would expect sectors of the US economy most dependent on bank credit, particularly office real estate, to see a default cycle ahead.

In the US, a large outflow of deposits from smaller banks appears to have abated. Nonetheless, past outflows should drive weaker lending activity looking forward, particularly for the commercial real estate and small business sectors. Bank lending standards were tightening across every lending category before the latest banking turmoil began. This is a core mechanism for monetary policy tightening to impact the economy.

Bond markets have seen record volatility in recent weeks. We believe the 1.3-percentage-point decline in US 2-year Treasury yields in recent weeks was driven mainly by bank solvency fears. Bond investors started the month assuming Fed policy rates would increase much further before swinging to a belief that rate cuts would begin as soon as May. Unless further systemic risks are revealed, the expectation for near-term rate cuts should fade, pushing up short-term yields somewhat. However, we believe retrenchment in cyclical industries, such as construction and trade, will weaken the case for further Fed rate hikes, particularly as it may revive systemic risk concerns.

While yields may rebound somewhat, we would not expect a return to peak interest rate levels of the past six months. Instead, we believe credit concerns will gradually arise – and from there we expect weakness among the weakest bond and loan market credits. If yield spreads rise significantly – compensating for greater risk – we could move to add to high yield assets. If they do not, we will remain focused on investment grade bond opportunities until interest rates fall meaningfully.

Quite similarly, smaller, more indebted firms in cyclical industries may come under greater market pressure in the months to come. While valuations have improved, in the year-to-date the S&P 600 small cap index has seen returns drop below the S&P 100 large cap index by about 6.5%. If small- and midcap (SMID) shares were to underperform more deeply or conditions to drive their profits higher materialized, we would add to our holdings of SMID shares as they remain a key asset class to drive long-run returns.

History suggests US monetary policy will be more prone to cyclical adjustment (“activist”) than in other currency zones. US broad money (M2) is already posting an annual contraction, the first in 75 years. While this followed rapid money supply growth in 2020, we would expect a weakening US labor market to push Fed policy back toward a neutral setting sooner than elsewhere. This should help drive the US dollar weaker in coming years. As such, we continue to expect higher allocations to non-US equities in the future to earn augmented returns measured in USD. (See our [2023 Outlook](#) for discussion).

ASSET CLASSES | Global USD with Alternatives Level 3



### FIXED INCOME

Developed Sovereign					
Developed Investment Grade Corporates					
High Yield					
Emerging Market Sovereigns					

### EQUITIES

Developed Equities					
Large Cap					
US					
Europe					
Asia ex-Japan					
Japan					
Small and Mid Cap					
US SMID Cap					
Non-US SMID Cap					
Emerging Market Equity					
Thematic Equity*					

### CASH

### COMMODITIES

\*Thematic equities include Cyber security, Pharmaceuticals, and Global Natural Resources. Please refer to the [Portfolio Allocations](#) for a comprehensive breakdown of the portfolios at each risk level.

-2 = very underweight | -1 = underweight | 0 = neutral |  
1 = overweight | 2 = very overweight

**Arrows indicate changes from previous GIC meeting**

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
<b>Not Investment Grade</b>			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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