Insights
Multi-Asset Solutions

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Inflation, Interest Rates, and the Russia-Ukraine War: Tactical Portfolio Positioning in Q1 2022

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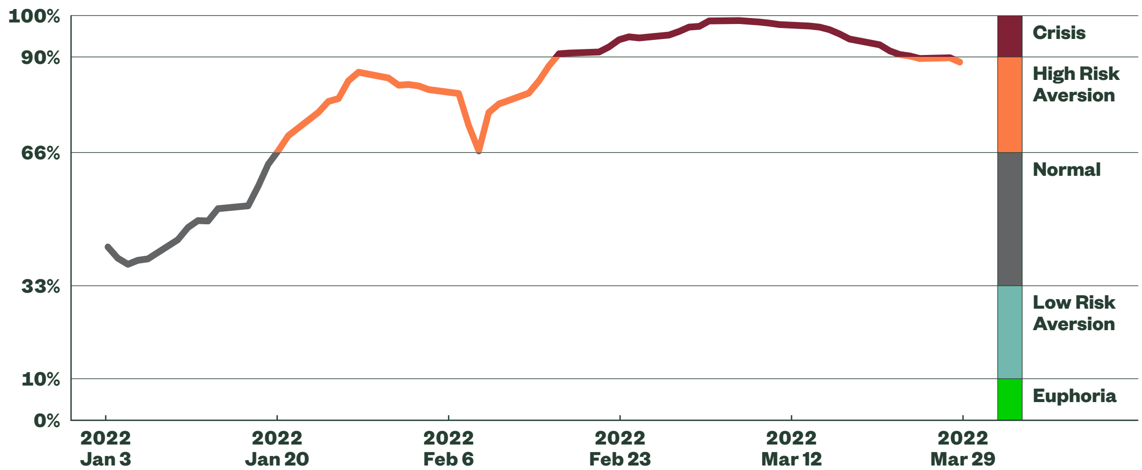
In the first quarter of 2022, when investors were confronted with a rapidly shifting risk environment, the Investment Solutions Group relied on its propriety measure of investor risk sentiment to make tactical trading decisions on behalf of our clients.

Collective investor attitudes toward risk can signal either headwinds or tailwinds for financial assets. For this reason, our Investment Solutions Group (ISG) continuously measures investor risk appetite and incorporates it into our tactical asset allocation (TAA) investment process. ISG's proprietary measure of risk sentiment, the Market Regime Indicator (MRI), combines measures of implied equity volatility, implied currency volatility, and spreads on risky debt to determine investors' overall level of risk aversion. This global, multi-asset class tool classifies collective investor sentiment into five discrete risk regimes, and each regime provides specific historical context for, and guidance about, our TAA investment decisions (i.e., our research shows that investors favor or shun specific asset classes during specific risk regimes).

Since the start of the year, all three components in the MRI have been trending higher, pushing the indicator into a High Risk regime in January and a Crisis regime in February and March (see Figure 1).

Figure 1
Investor Risk Aversion, YTD 2022
Market Regime Indicator



Source: State Street Global Advisors, as of March, 29, 2022. The data displayed is not indicative of the past or future performance of any SSGA product. All data shown above does not represent the results of actual trading, and in fact, actual results could differ substantially, and there is the potential for loss as well as profit. The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. These factors are combined to create a single measure and used to identify one of five risk regimes: Euphoria, Low Risk, Normal, High Risk, and Crisis.

Evolution of Q1 Tactical Positioning

In **January** the MRI moved into High Risk, signaling that investors were becoming especially cautious. Typically, in High Risk, investor sentiment is a headwind to risk assets like equities. *We therefore moved our tactical positioning to a more defensive posture in January, reducing risk by taking an underweight position in global equities and purchasing long government bonds, gold, and cash.*

In **February**, investor fears were further fueled by the Russian invasion of Ukraine. A spike in both implied equity volatility and implied currency volatility pushed the MRI reading to its highest level, Crisis, where it remains. A Crisis regime signals that investors have become overly pessimistic, and we consider it a contrarian signal, supportive of risk assets like equities. *After this move into Crisis, we added back to global equities and shifted to an overweight position.*

In **March**, the MRI has remained in Crisis, as investors have struggled to digest numerous points of uncertainty. Risk appetite appears to have been soured by the ambiguous tightening plans of central banks, decades-high inflation prints, and of course daily war dispatches. These events have driven inflation fears and challenged central banks to successfully balance higher inflation, potential disruptions to economic growth, and financial instability. Although the Crisis regime is typically a contrarian signal, indicating an opportunity to favor equities, the Russian invasion of Ukraine introduced several discrete new tail risks that also must be considered, such as the economic implications of a protracted conflict and the potential for escalation. *In light of these tail risks, we have modestly de-risked our portfolios by reducing our equity allocations in favor of gold.*

Attractive Asset Classes

We do see opportunities in specific asset classes and sectors. As just mentioned, our outlook for gold remains strong, with both fundamental and technical factors supporting the precious metal. The Russian invasion has increased levels of credit risk, which typically imply positive future performance for gold. On the technical side, all of the price-trend signals we consider suggest higher prices ahead for gold.

Within equities, we continue to see meaningful improvements in our US forecasts and deterioration in our non-US forecasts. During our latest rebalance, we reduced positions in Europe and Asia-Pacific to neutral and underweight, respectively, in favor of US equities (both large and small caps). This represents a change from the trends we were observing in the latter half of 2021, when the prospects for US equities began to deteriorate while those in Europe and Asia-Pacific began to improve.

Valuations for US equities have improved, but still remain challenging, while constructive price trends persist. One of the biggest drivers of our improved US outlook is better earnings expectations along with better macro indicators, which both now heavily favor the US on a relative basis. We now hold modest overweights to both large- and small-cap US equities.

At a sector level, we continue to favor Technology, a long-time stalwart near the top of our rankings, and Energy, which benefits from healthy demand, low inventories, and the effects of the Russia-Ukraine War.

In the first quarter of 2022, investors were confronted with numerous developments that were difficult to digest. Rising inflation, uncertainty regarding central-bank action and the path of rates, and the tragic war in Ukraine and its grave consequences all contributed to a rapidly shifting risk environment. During Q1 we relied on our propriety measure of investor risk sentiment to make tactical trading decisions on behalf of our clients. In the coming weeks, we'll monitor the path of inflation, rates, war, and risk sentiment closely as we continue to adjust our tactical portfolios. Please check back for further updates.

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* Pensions & Investments Research Center, as of December 31, 2020.
† This figure is presented as of December 31, 2021 and includes approximately $61.43 billion of assets with respect to SPDR products for which State Street Global Advisors Funds Distributors, LLC (SSGA FD) acts solely as the marketing agent. SSGA FD and State Street Global Advisors are affiliated.

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Marketing communication

State Street Global Advisors Worldwide Entities

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