



Global Asset Allocation: The View From The UK

April 2021

1 Market Perspective

As of 31 March 2021



- The rollout of vaccines is likely to lead to easing lockdowns, continued economic recovery and release of pent-up demand. However, the recovery may be uneven and choppy because of concerns about virus variants, the economy overheating, rising inflation—particularly in the US—and elevated valuations of most risk assets.
- Monetary policy is likely to remain supportive, as is fiscal stimulus. These two combined should help provide a bridge between lockdowns and economic reopening.
- Inflationary pressures as well as more positive views on the economic recovery are leading to higher government bond yields.

2 Portfolio Positioning



- We shifted to a modest underweight to equities relative to bonds and cash as the risk/reward profile of equities looks less attractive after a strong multiple-driven rebound since last March's lows.
- As we sell stocks, we continue to lean into value versus growth. The valuation case for small-caps is not as strong as for value. Hence, we reduced the small-cap exposure.
- The British pound is at an attractive valuation relative to the euro. The vaccine rollout in the UK is progressing quicker than in the EU. This should support a stronger British pound, but the path is likely to be bumpy.

3 Market Themes

Closing the Gap

As investors grew more optimistic late last year about the global economic recovery, small-cap stocks took off with a parabolic snapback, up over 100% since the lows of last March. While smaller companies tend to lead early in an economic recovery given their higher sensitivity to growth, the fast and furious pace of performance stands out. Meanwhile, cyclically oriented value stocks, which are also highly reliant on the trajectory of economic growth, have just begun to make up ground from the sell-off. While smaller companies may continue to benefit from reopening and stimulus in the US, a lot of the outperformance may be behind small-caps, while value stocks are likely to continue to benefit from the recovery, stimulus, higher rates and the potential for infrastructure spending. After nearly a decade of underperformance, perhaps this cyclical rally may be enough for value to close the gap versus growth stocks.

Small-Cap and Value Relative Performance¹

From 23 March 2020 to 31 March 2021



Reason to Worry?

Equity markets are riding higher on unwavering optimism, which has driven the S&P 500 up over 20% above its pre-COVID-19 levels. Despite higher valuations, bouts of risk and pockets of froth in the market—such as in bitcoin, home prices and special purpose acquisition companies—investors appear to have little concern. Perhaps there is no alternative to investing in equities with bond yields on the rise, but it's hard to ignore events such as the retail investor GameStop short squeeze and enormous losses at Archegos Capital, a large private family office, which may have historically shaken the confidence of equity investors. While recent bad news is largely viewed as idiosyncratic, market valuations continue to get more extended, and the risk of one of these events sparking a more systemic sell-off could increase. But perhaps the systemic risk is already here, with the threat of even higher rates, inflation and now taxes.

S&P 500 and US 10-Year Treasury Yield

From 18 February 2020 to 31 March 2021



Past performance is not a reliable indicator of future performance.

¹ Small-cap represented by Russell 2000 Index. Large-cap represented by Russell 1000 Index. Value represented by Russell 1000 Value Index. Growth represented by Russell 1000 Growth Index.

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 **Positives**

 **Negatives**

United Kingdom

- Rapid vaccination means that the economy could return closer to normal by the autumn, potentially two to three months ahead of eurozone countries
 - The lockdown exit strategy appears to be firmly on course
 - The recent Budget provided greater fiscal stimulus focused on the near term
 - Bank of England appears very hawkish
- Brexit transition and third lockdown could slow down the pace of the economic recovery
 - UK will face significant fiscal consolidation on current plans
 - Negative rates remain a possibility in case there are any other shocks to growth in the next two years

Developed Europe

- Higher exposure to more cyclically oriented sectors that should benefit from economic recovery
 - Monetary and fiscal policy remain accommodative
 - Equity valuations remain attractive relative to the US
 - Stronger long-term euro outlook
- Lockdowns back on due to third wave of COVID-19
 - Vaccination effort facing supply shortages
 - Limited long-term catalysts for growth
 - Limited scope for European Central Bank (ECB) to stimulate further
 - Brexit likely to negatively impact trade

United States

- More fiscal support on the way
 - Pace of vaccinations has been strong
 - Monetary policy remains very accommodative
 - Healthy consumer balance sheets and high savings rate
- Elevated stock and bond valuations
 - Corporate and government debt at high levels
 - Corporate taxes likely to rise
 - Unemployment remains elevated

 **Positives** **Negatives**

- Japan**
- Leading economic indicators are finally breaking through the expansion levels; the recovery should likely accelerate in upcoming months
 - Domestic stocks are a global reflation play, with positive correlations to Purchasing Managers' Indexes and bond yields
 - Earnings revision ratios are close to record levels; a weaker yen doesn't hurt

- Price momentum in equity markets is calling for a pause in the appreciation trend in the near term
- COVID-19 vaccines are being administered late relative to other countries, while the pandemic is still not yet under control
- Bank of Japan dropped the annual exchange-traded fund buying target, causing some concerns regarding its ability to remain the buyer of last resort

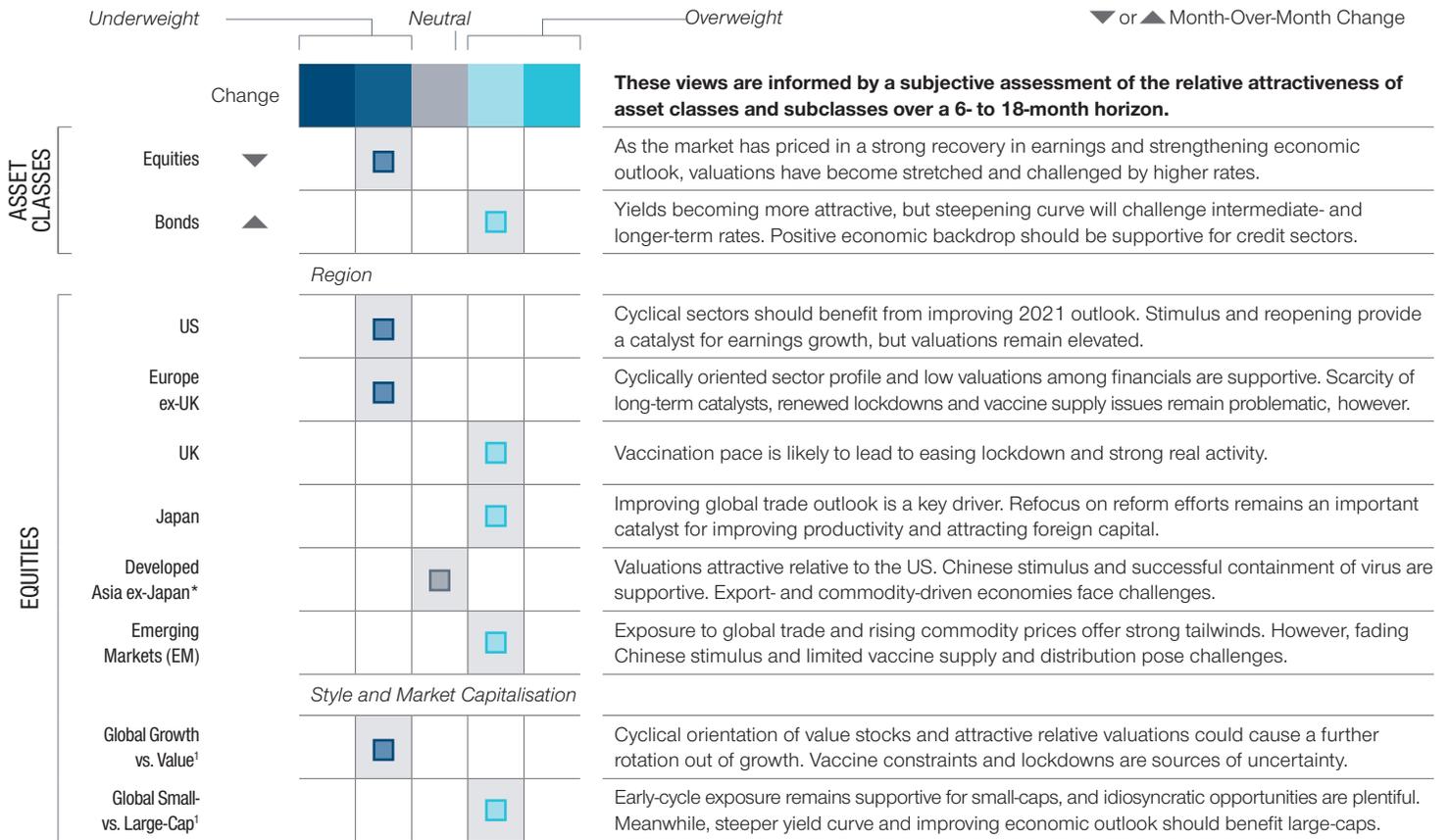
- Asia Pacific ex-Japan**
- Chinese economic growth remains solid, supported by strong exports and the potential for domestic consumption to follow through
 - Demand for Chinese assets is expected to attract significant inflows, adding pressure to bond yields and supporting the renminbi
 - The Australian economy is roaring, evidenced by a broad range of indicators on business activity, consumer spending and employment
 - Australia's central bank was extremely dovish, indicating that any policy normalisation may be a long way off

- Early signs of inflationary pressures in China and supply bottlenecks are concerning
- Chinese policymakers made clear statements that they want to avoid asset bubbles in the stock market and property sector
- Early signs of inflationary pressures seen in Australian housing and construction markets
- Yields have risen, challenging the Reserve Bank of Australia's policies; valuation gap between stocks and bonds is not as attractive anymore

- Emerging Markets**
- Exposure to cyclical areas of economy should benefit from broad global recovery
 - Commodity prices rising
 - Chinese economy remains strong
 - Equity valuations attractive relative to developed markets

- Stimulus from China likely to fade going forward
- Limited ability to enact fiscal stimulus (excluding China)
- Vaccine supply and distribution infrastructure are well behind developed markets
- Inflationary pressures are rising in some countries

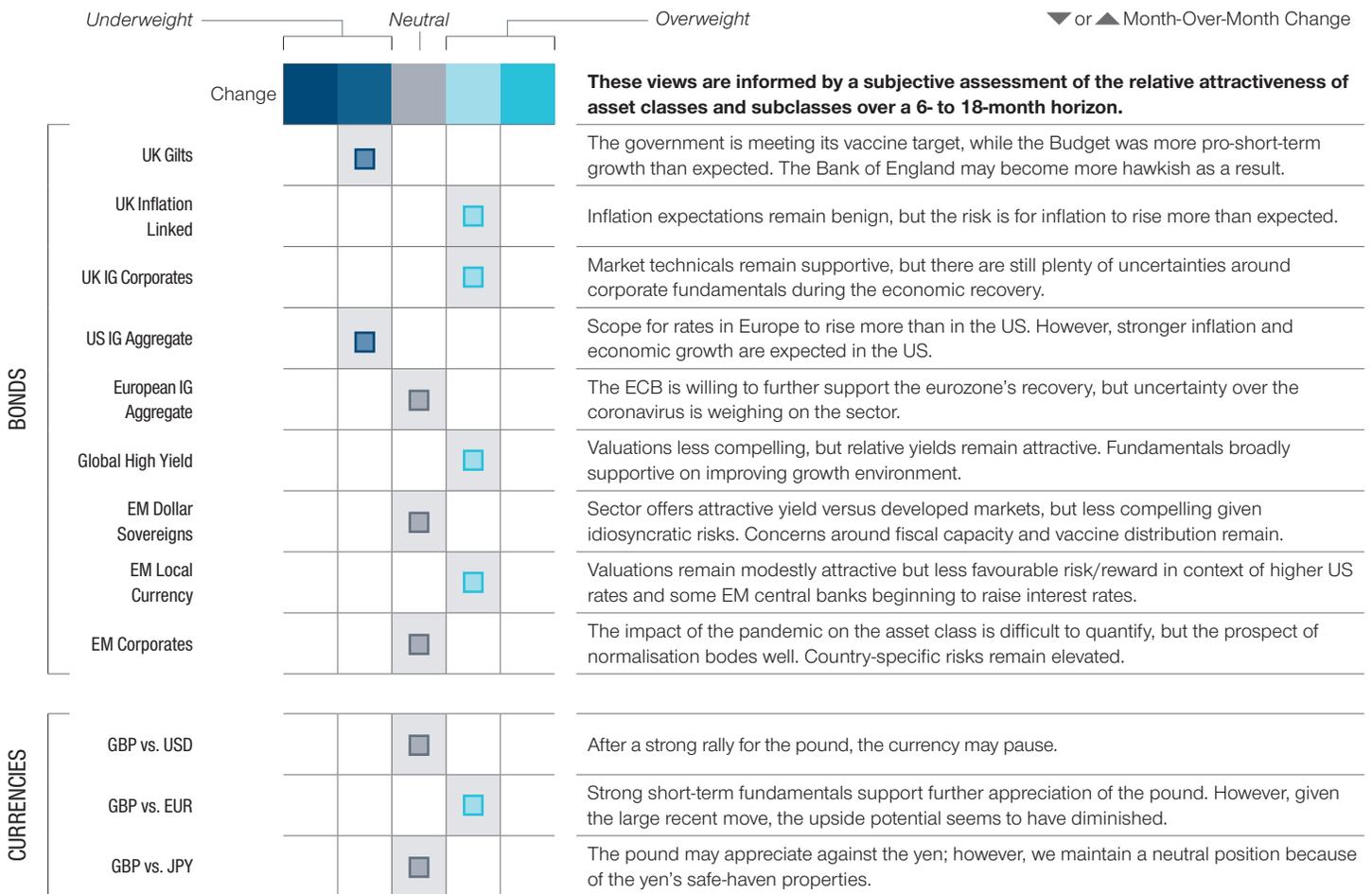
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* Includes Australia.

¹ For pairwise decisions in style and market capitalisation, positioning within boxes represents positioning in the first mentioned asset class relative to the second asset class.



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