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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

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MARKET INSIGHTS

As of March 31, 2020

Cushioning the Blow

Pledges of fiscal spending have been quick to follow actions taken by major central banks to combat the looming impacts of the coronavirus pandemic. G-20 countries have pledged more than USD 5 trillion in stimulus through a wide range of avenues to stave off the effects on the global economy. The U.S. has passed a record-setting USD 2 trillion stimulus package, nearly 10% of its gross domestic product, that includes checks paid directly to families as well as loans and guarantees to impacted sectors, including airlines, hotels, and hospitals. Other major countries have followed suit, with a similar emphasis of broad support to both workers and businesses, large and small. While the measures thus far have been quick to be enacted, their effects will take months to come through and positively impact the economy. Only time will tell if these efforts will be enough to offset the damage thus far. The longer the pandemic keeps the global economy on pause, the more support it is going to need to bounce back.

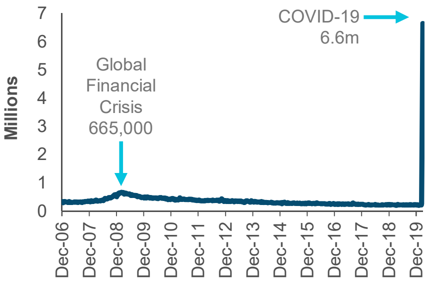
How Low Can It Go?

Oil prices slid more than 60% in the first quarter, while many oil stocks have lost more than half their value. If the demand-destructing impacts of the coronavirus-related shutdowns were not bad enough, already oversupplied markets were challenged by the market share war between Saudi Arabia and Russia, which is now showing signs of healing. While the steep decline in oil prices has resulted in low fuel prices not seen in decades, with current social distancing measures in place, consumers and airlines are unable to take advantage of the low levels. With prices near USD 20 per barrel, many producers are operating well below their break-even levels, notably U.S. shale producers that continue to operate to generate cash flow despite the low levels. The rising risk is evident in the U.S. high yield market—with approximately a 10% exposure to energy—as yields have blown out to more than 10%. While the battle between OPEC+ members may be resolved, lingering structural imbalances and the severity of the economic downturn will further weigh on the sector.

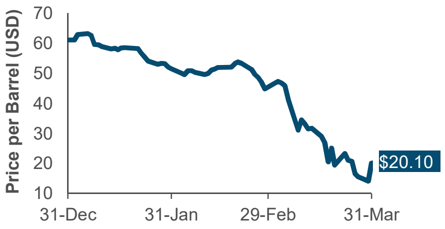
Emergency Plumbing Fix

As markets faced sharp declines in response to the coronavirus outbreak, liquidity strains in bond markets exacerbated the situation as investors flocking out of bonds were unable to find buyers in the open market and forced to sell at unattractive levels. Some of this issue can be attributed to dispersed traders and the sheer magnitude of the outflows coming from bonds, but the crux of the issue lies with the enhanced regulations placed on banks after the global financial crisis–limiting banks' ability to leverage their balance sheets—leaving fewer buyers to step in. In rapid response to the looming liquidity crisis, the Fed swiftly injected a massive amount of liquidity into markets including unlimited, open-ended quantitative easing, as well as corporate and municipal government bond-buying, in hopes to instill a floor in bond pricing. For now, the extreme measures appear to be alleviating some of the pain as credit markets have shown signs of stabilization. However, it remains to be seen if these measures will be enough to get markets through this crisis; otherwise, the Fed may need to show what they meant by "whatever it takes."

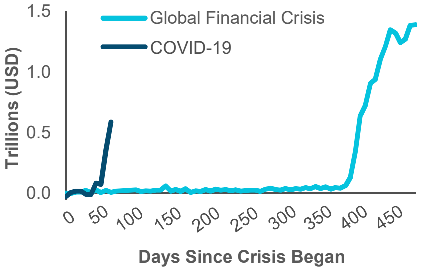
U.S. Initial Claims for Unemployment Insurance
Fig. 1: As of March 31, 2020



WTI Crude Oil Price
Fig. 2: As of March 31, 2020



Fed Balance Sheet Changes Since the Beginning of Crises
Fig. 3: As of March 31, 2020



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REGIONAL BACKDROP

As of March 31, 2020

	Positives	Negatives
Developed Europe	▪ Long-awaited fiscal stimulus measures are finally coming ▪ Monetary policy remains very accommodative ▪ Inexpensive valuations have become even more inexpensive as Europe has born the brunt of the sell-off	▪ Weak economic growth going into crisis ▪ Limited scope for the European Central Bank to stimulate further ▪ Decentralized government structure means fiscal response is somewhat delayed ▪ Banking sector was weak going into the crisis
United Kingdom	▪ Proactive coordination between NHS, fiscal, financial, and monetary policy will help mitigate the coronavirus shock ▪ The trade balance deficit remains in a range that can be sustained by the net excess returns on the UK's external balance sheet ▪ Additional monetary and fiscal easing to resuscitate economy after lockdown is over	▪ UK lockdown to weigh on the country's service-exposed economy heavily ▪ Sterling will continue to make hard yards ▪ Weaker global activity to provide additional headwinds to UK economy ▪ Gilts may sell off significantly in the second half of 2020 after the coronavirus crisis is over
United States	▪ Unprecedented levels of monetary and fiscal support ▪ Healthy consumer balance sheets prior to the crisis ▪ Pause in trade war escalation ▪ Healthcare infrastructure is stronger than in most regions ▪ Greater share of secularly advantaged companies (e.g., cloud computing, internet retail) than the rest of the world	▪ Size of country and freedom of movement mean there is higher potential for continued outbreaks ▪ Elevated corporate leverage going into the crisis ▪ Service-oriented economy means higher economic impact from social distancing ▪ Margins under pressure going into the crisis ▪ Elevated government debt levels

	Positives	Negatives
Japan	Fiscal support is widely expected to increase as economic data further deteriorate Investors with a long-term horizon could potentially benefit from attractive valuations and resilient earnings forecast for domestically oriented companies The yen is likely to continue to provide safe-haven characteristics at times of crisis Yields appear stable relative to other sovereign bond markets given the Bank of Japan policy approach	Technical recession seems inevitable following poor fourth-quarter economic growth and given the current pandemic Earnings will be challenged given domestic companies' high sensitivity to global economic momentum, coupled with a relatively strong currency Possible lockdown measures in Tokyo are clouding the prospects of any imminent rebound in consumer confidence
Asia Pacific ex-Japan	The Chinese policy response to the virus outbreak has been significant, with potentially more to come to support the economy So far, Chinese equity markets appear to be relatively more resilient than the rest of the world as the virus spreads outside China Australian policy measures from the government and Reserve Bank of Australia were deployed quickly and aggressively, helping to dampen the negative economic impact of the pandemic Australia's fiscal position is strong relative to other countries, reducing long-term risks of recent policy support	The full impact of the coronavirus pandemic in China remains unknown Maintaining a tight range on the renminbi for political reasons might prove to be harmful for competitiveness Coronavirus spread has only appeared recently in Australia, suggesting economic data are still due to worsen Australian earnings forecasts still need to be meaningfully downgraded. Dividends might also be cut, reducing the historic appeal of Australian equities
Emerging Markets	Virus outbreak in China appears to be contained Policy response from China has been significant Younger population likely to be less affected by virus Dovish Fed has given emerging markets' central banks flexibility to ease Easing trade tensions Equity valuations attractive relative to developed markets	Weak health care infrastructure in many regions Limited ability to enact fiscal stimulus (excluding China) Highly sensitive to global industrial production and trade trends Commodity prices under pressure Instability in several key markets could weigh on sentiment Potential for elevated currency volatility

ASSET ALLOCATION COMMITTEE POSITIONING

As of March 31, 2020

▼ or ▲ Month-Over-Month Change

		Change	*Underweight*		*Neutral*	*Overweight*		
								These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.
ASSET CLASSES	Equities					■		Equity prices at attractive levels relative to extreme lows in bond yields amid market sell-off. Monetary and fiscal policy efforts supportive; earnings outlook clouded by impacts of virus.
	Bonds			■				Yields near record lows on risk-off sentiment. Credit spreads wider but not at extreme levels. Credit fundamentals at risk; monitoring impacts of virus on vulnerable sectors.
	Cash				■			Cash yields retreat amid central banks' intervention and investor demand; U.S. yields remain higher than other developed markets.
			Regions					
EQUITIES	U.S.			■				Outperforming the rest of the world amid sell-off; magnitude of fiscal and monetary stimulus supportive, but earnings outlook remains uncertain due to impacts of virus.
	Europe					■		After heavy sell-off, price level is compelling; however, region continues to be heavily impacted by virus. European Central Bank remains supportive, and fiscal stimulus is coming.
	UK					■		After heavy sell-off, price level is compelling. The UK continues to be heavily impacted by virus. Bank of England and fiscal stimulus are supportive. Brexit uncertainty remains.
	Japan					■		Facing fallout from virus outbreak and postponement of the Olympics ramps up fiscal support. Extent of economic and trade impacts uncertain, and yen strength a risk.
	Developed Asia ex-Japan*	▲			■			Valuations attractive relative to the U.S. Chinese stimulus and successful containment of virus are supportive. The virus impacts tourism, and commodity-driven economies face challenges.
	Emerging Markets (EM)					■		Increase in stimulus and successful containment of the virus by China will be supportive. However, commodity- and export-driven economies face serious challenges.
			Style					
	Global Equity Growth					■		Secular growth companies less sensitive to macro environment. Growth-oriented equities held up in sell-off, leading to less attractive relative valuations.
	Global Equity Value			■				Cyclically oriented equities hit hardest amid sell-off, leaving valuations more attractive should economic growth stabilize over the near term.
			Capitalization					
	Global Equity Large-Cap			■				Valuations lower but have fared better than small-caps amid sell-off. Vulnerable to further spread of virus, global supply chain disruption, and the potential impact on earnings.
	Global Equity Small-Cap					■		Relative valuations more extreme as small-caps suffered the most amid sell-off. Remain vulnerable to impacts on consumer spending; fiscal stimulus could provide support.

* Includes Australia

ASSET ALLOCATION COMMITTEE POSITIONING

As of March 31, 2020

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

		Change	Underweight	Underweight	Neutral	Overweight	Overweight	**These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.**
BONDS	U.S. Investment Grade (IG)			■				Treasury yields near record lows amid risk-off sentiment. IG corporate spreads wider but not at extreme levels. Impact on fundamentals warrants caution.
	European Investment Grade	▲				■		The swift and aggressive fiscal and monetary response should help avert a prolonged recession. Valuations are attractive given clear policy support.
	UK Investment Grade	▲				■		The swift and aggressive fiscal and monetary response should help avert a prolonged recession. Valuations are attractive given clear policy support.
	Inflation Linked				■			Inflation expectations lower on growth scare. Central banks remain supportive, but longer-term downward pressures on inflation persist.
	Global High Yield					■		Credit spreads at historically attractive levels on risk-off sentiment and growing downgrade/default risks. Impacts of virus outbreak to weigh on consumer-related and energy sectors.
	Floating Rate Loans					■		Offering attractive yields after sell-off. Fed anchored at zero rate level. Relative to high yield bonds, less exposure to energy sector and higher in capital structure.
	EM Dollar Sovereigns					■		Relative valuations attractive amid sell-off. Idiosyncratic risks, liquidity challenges, and trade implications are sources of uncertainty.
	EM Local Currency					■		EM currency valuation remains attractive; lower developed market rates and a weaker U.S. dollar could provide support.
	EM Corporates					■		Country-specific risks are elevated, but several sold-off assets are not as vulnerable as prices reflect and represent attractive opportunities.
CURRENCIES	U.S. Dollar			■				The USD has not been immune from global currency volatility. Successive policy responses from the Fed satiated dollar demand into quarter-end.
	Euro					■		In the near term, poor activity data will likely keep the euro weak, but a V-shaped economic recovery after that should support the currency.
	UK Sterling					■		Sterling has depreciated sharply. However, aggressive monetary and fiscal policy should support a V-shaped recovery, leading to a rise in GBP over the next six months.
	Japanese Yen				■			We expect JPY to perform as a safe-haven asset as global growth turns weaker. Narrowing interest rate differentials with the U.S. are also likely to support the yen over time.

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Even if the asset allocation is exposed to different asset classes in order to diversify the risks, a part of these assets is exposed to specific key risks.

Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Credit risk—a bond or money market security could lose value if the issuer's financial health deteriorates.

Currency risk—changes in currency exchange rates could reduce investment gains or increase investment losses.

Default risk—the issuers of certain bonds could become unable to make payments on their bonds.

Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

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Interest rate risk—when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Real estate investments risk—real estate and related investments can be hurt by any factor that makes an area or individual property less valuable.

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