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GLOBAL ASSET ALLOCATION: THE VIEW FROM THE UK

APRIL 2020

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.

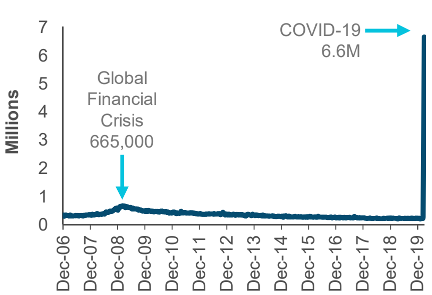
How Low Can It Go?

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.

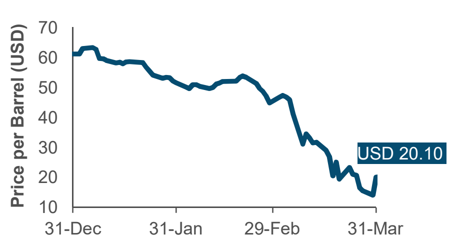
Emergency Plumbing Fix

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 were 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 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, hoping 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."

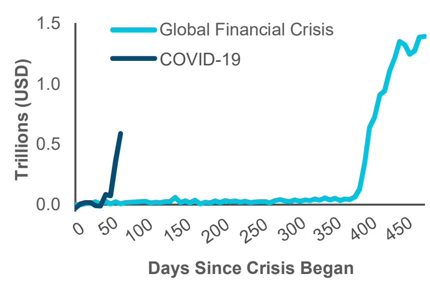
U.S. Initial Claims for Unemployment Insurance
Fig. 1: As of March 31, 2020



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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	Positives	Negatives
United Kingdom	• Despite the coronavirus hit to growth in Q1/Q2, the UK monetary/fiscal/financial policy response provides an environment for growth to rebound in the second half of the year • Bank of England quantitative easing should keep a lid on the rise in gilt yields and government borrowing costs. Fiscal stimulus raises medium-term public investment and is likely to help resuscitate the economy later in 2020 • Brexit is likely to be delayed by six to 12 months, or there will be a BRINO (Brexit in name only) by December 31—probably good news for asset prices short term, supporting both the GBP and rates	• The coronavirus hit the UK and global growth in Q1/Q2, impacting services and trade • The UK lockdown will need to last longer to upgrade health infrastructure • Uncertainty: The large rise in benefits claims in March and weak consumer confidence indicate there will be a significant economic impact
Developed Europe	• Long-awaited fiscal stimulus measures are finally coming • Monetary policy remains very accommodative • Inexpensive valuations have become even more so as Europe has borne the brunt of the sell-off	• Weak economic growth going into crisis • Limited scope for the European Central Bank to stimulate further • Decentralised government structure means fiscal response is somewhat delayed • Banking sector was weak going into the crisis
United States	• Unprecedented levels of monetary and fiscal support • Healthy consumer balance sheets prior to the crisis • Pause in trade war escalation • Health care 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 the 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

Underweight — *Neutral* — *Overweight* ▼ or ▲ Month-Over-Month Change

		Underweight	Underweight	Neutral	Overweight	Overweight	
	Change						**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.
ASSET CLASSES	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.
ASSET CLASSES	Cash			■			Cash yields retreat amid central banks' intervention and investor demand.
	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.
EQUITIES	Europe ex-UK				■		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.
EQUITIES	UK				■		The UK is probably in the strongest position among European economies. Valuations favour UK equities.
EQUITIES	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.
EQUITIES	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.
EQUITIES	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						
EQUITIES	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.
EQUITIES	Global Equity Value		■				Cyclically oriented equities hit hardest amid sell-off, leaving valuations more attractive should economic growth stabilize over the near term.
	Capitalization						
EQUITIES	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.
EQUITIES	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

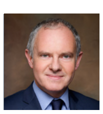
Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.

		Underweight	Underweight	Neutral	Overweight	Overweight	Change	
BONDS	UK Gilts	■						Gilts may stay at low levels three months ahead but sell off to a degree within six months once activity comes back from coronavirus hit.
	UK Inflation Linked			■				No signs of rising inflation risks yet. Public spending stimulus will eventually be inflationary but probably not before late 2021/early 2022.
	UK IG Corporates				■			UK credit is preferred over gilts.
	U.S. IG Aggregate				■			Coronavirus uncertainty weighs on the sector, but valuations and the Fed's bond purchase programme are providing significant support.
	European IG Aggregate			■				Uncertainty over the coronavirus is weighing on the sector.
	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.
	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 USD 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	GBP vs. USD				■			We expect greater easing from the Fed, and the rate advantage of the USD has been nearly eliminated.
	GBP vs. EUR				■			GBP will likely improve versus the EUR over the next six months. The European Central Bank will likely need to provide semipermanent quantitative easing going forward.
	GBP vs. JPY		■					The JPY remains a safe-haven currency.

UK ASSET ALLOCATION COMMITTEE



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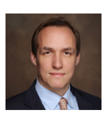

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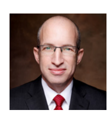

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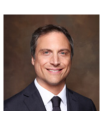

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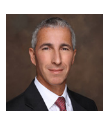

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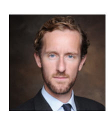

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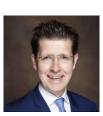

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International Economist

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