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GLOBAL ASSET ALLOCATION: THE VIEW FROM THE UK

June 2020

MARKET INSIGHTS

As of May 31, 2020

Melt Up

Global markets are up nearly 40% off March lows, as countries ease restrictions on businesses and resume some level of economic activity. Although the rapid rebound in the equity market appears to price in returning to some sense of "normalcy," the economic reality may be a gloomier picture, as many furloughed workers in sectors most directly impacted by the virus face the potential for permanent job loss and more businesses struggle to remain afloat as a result of the crisis. At the crux of this disconnect between economic data and stock valuations are growth stocks, which have proven resilient by being on the right side of behavioural changes that have occurred due to social distancing guidelines such as shopping online and watching streaming services. Prior to the crisis, value stocks had lagged growth stocks persistently, and they are likely to require clear evidence of economic improvement before they can stage a meaningful rebound. In the meantime, many investors continue to bet on growth stocks at the expense of cyclicals.

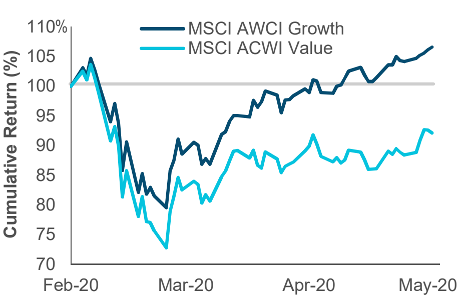
Uneasy Truce?

Relations between the U.S. and China have quickly turned fragile again amid controversy surrounding the coronavirus and China's political influence on Hong Kong. Recent turmoil has reignited tensions that markets had hoped were resolved following last year's Phase One trade deal. Recent escalations include U.S. sanctioning of Chinese companies, threats of breaches to the Phase One trade deal, and the U.S. suggesting it could remove Hong Kong's special status. With the U.S. presidential election only months away, the Trump administration is likely to keep pressure on China and maintain a tough stance on trade as it angles for reelection. While markets ended 2019 hopeful that the relationship between China and the U.S. was mended, with the return of recent tensions, a more volatile environment for markets could lie ahead.

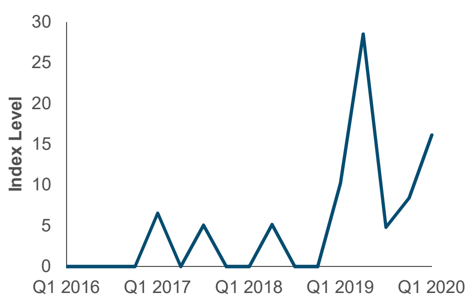
"Coronabonds" to the Rescue?

The European Union (EU) is planning to announce an unprecedented fiscal stimulus package worth as much as EUR 750 billion as the economic bloc attempts to lift itself out of recession. The package could consist of EUR 500 billion in loans and EUR 250 billion in grants, funded by issuing pan-European bonds. All members must approve the proposal, and as the details of the plan continue to be negotiated, resistance is expected from more austere members, such as the "Frugal Four"—Austria, Sweden, Denmark, and the Netherlands—who believe the recovery plan should be based solely on loans. Although this recovery plan marks an important step toward shared debt and fiscal ties among EU members, it is unclear whether the stimulus will be enough to lift the region out of this pandemic-led recession and what the longer-term implications of the potential fiscal ties could be.

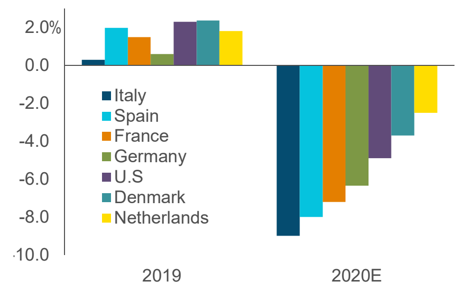
MSCI ACWI Growth vs. Value
Fig. 1: As of May 31, 2020



China Trade Uncertainty Index
Fig. 2: As of May 31, 2020



Real GDP Growth
As of May 31, 2020



Past performance is not a reliable indicator of future performance.
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	Positives	Negatives
United Kingdom	▪ A generous furlough scheme, keeping employees ready to go, will support economic rebound and social stability ▪ The trade balance deficit remains in a range that can be sustained by the net excess returns on the UK's external balance sheet ▪ A long lockdown will lead to a very large government deficit of 17% to 20%, but aggressive quantitative easing will keep a lid on yields	▪ UK lockdown to weigh on UK's service-exposed economy heavily ▪ Sterling will continue to make hard yards ▪ Weaker global activity to provide additional headwinds to UK economy ▪ Fears over year-end Brexit risks will weigh on asset prices
Developed Europe	▪ Long-awaited fiscal stimulus is coming ▪ Monetary policy remains very accommodative ▪ Inexpensive valuations have become even more inexpensive as Europe has borne the brunt of the sell-off	▪ Weak economic growth going into crisis ▪ Limited scope for European Central Bank to stimulate further ▪ De-centralised government structure means fiscal response is delayed ▪ Lower share of secularly advantaged companies ▪ 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 ▪ Health care infrastructure is stronger than most regions ▪ Greater share of secularly advantaged companies (e.g., cloud computing, internet retail) than rest of the world	▪ Size of country and freedom of movement means there is higher potential for continued outbreaks ▪ Elevated corporate leverage going into the crisis ▪ Margins under pressure going into the crisis ▪ Elevated government debt levels ▪ Heightened political tensions

	Positives	Negatives
Japan	▪ Multiple rounds of massive fiscal stimulus, coupled with an extremely accommodative stance from the Bank of Japan, provide a solid backdrop for an economic rebound ▪ Japanese stocks seem to be fairly priced and could benefit from the ongoing rotation to cyclicals ▪ The JPY is likely to continue to provide safe haven characteristics at times of crisis	▪ Containment of the virus happened at a later stage compared with other Asian countries, delaying the subsequent rebound ▪ With no clear rebound in global trade in sight, companies might decide to reduce shareholder returns by cutting dividends or reducing share buybacks ▪ The JPY could appreciate if trade tensions resurface, reducing companies' competitiveness and profitability
Asia Pacific ex-Japan	▪ Chinese policy measures are more targeted than in previous crises. However, the stimulus package is still large enough to support future growth indirectly ▪ China's infrastructure spending is likely to increase, with a focus on the "new infrastructure" supporting the technology-related sectors ▪ Policy meaures from the Australian government and the Reserve Bank of Australia were deployed quickly and aggressively. The JobKeeper program has proven to be effective ▪ Equity underperformance relative to global markets does not reflect Australia's crisis response and containment efforts. A catch-up rally is possible, especially amid the rotation to cyclicals	▪ Geopolitical tensions on multiple fronts could dampen foreign sentiment toward Chinese investment ▪ China's "back to work" policy appears easier to take effect than "back to spending," given social distancing rules impacting consumer activity ▪ In Australia, there are risks to the downside for consumer spending as saving rates typically increase during crisis and social distancing rules prevent normal spending from resuming ▪ Australian equities are at risk of earning downgrades, cuts in capex and dividends, and elevated valuations
Emerging Markets	▪ Younger population likely to be less affected by virus ▪ Dovish Fed has given central banks flexibility to ease ▪ Equity valuations attractive relative to developed markets	▪ Number of new cases is accelerating in most of emerging 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 May 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.

		Change	Underweight	Underweight	Neutral	Overweight	Overweight	
ASSET CLASSES	Equities	▼			■			Equity rally extends as economies reopen, supported by fiscal and monetary stimulus despite weakness in economic data and uncertain earnings impact.
	Bonds			■				Yields near record lows despite risk rally. Credit remains attractive as spreads have narrowed amid liquidity stabilisation and monetary/fiscal support while digesting increased supply.
	Cash	▲				■		Cash yields remain anchored at low levels as developed market monetary policy rates remain near or below zero across the globe.
EQUITIES	*Regions*							
	U.S.				■			More defensive market profile supports outperformance versus the rest of the world. Magnitude of fiscal and monetary stimulus supportive, but earnings outlook remains uncertain.
	Europe ex-UK				■			Regional economies continue to be heavily impacted by virus. European Central Bank (ECB) remains supportive, and increased possibility of fiscal stimulus on the horizon.
	UK				■			The price level is compelling. The UK continues to be heavily impacted by the virus. Although the Bank of England and fiscal stimulus are supportive, Brexit uncertainty remains.
	Japan				■			Ramps up fiscal support facing fallout from virus outbreak and postponement of the Olympics. Extent of economic and trade impacts uncertain, and yen strength a risk.
	Developed Asia ex-Japan*				■			Valuations are attractive relative to the U.S. Chinese stimulus and successful containment of virus are supportive. Tourism and export- and commodity-driven economies face challenges.
	Emerging Markets (EM)					■		China stabilisation supportive for EM broadly. However, many countries remain vulnerable to virus with insufficient health care infrastructure and economic means to support growth.
	Style							
	Global Equity Growth					■		Valuations of growth-oriented equities further extended as they have continued to outperform. Sector benefits from less sensitivity to macro environment.
	Global Equity Value			■				Cyclically oriented equities hit hardest amid sell-off, leaving valuations more attractive should economic growth stabilise over the near term.
	Capitalization							
	Global Equity Large-Cap			■				Larger companies better positioned to weather economic downturn. Remain vulnerable to global supply chain disruption.
	Global Equity Small-Cap					■		Despite more attractive valuations relative to large-cap, remain vulnerable to impacts on consumer spending with less balance sheet flexibility.

* Includes Australia

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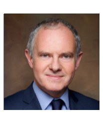
As of May 31, 2020

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	UK Gilts			■				Despite large issuance, weak economic activity, Brexit concerns, and aggressive quantitative easing likely to keep gilt yields low.
BONDS	UK Inflation Linked				■			No signs of rising inflation risks yet. Public spending stimulus will eventually be inflationary, but probably not before an economic recovery.
BONDS	UK IG Corporates					■		UK credit is preferred over gilts because it offers higher yields, while monetary and fiscal stimulus is supportive.
BONDS	U.S. IG Aggregate					■		Coronavirus uncertainty weighs on the sector, but valuations and the Fed's bond purchase programme are supportive.
BONDS	European IG Aggregate				■			Uncertainty over coronavirus is weighing on the sector. Our preference is to take investment-grade exposure in the UK and U.S. markets.
BONDS	Global High Yield					■		Credit spreads remain at attractive levels. Cautious on downgrade/default risks. Impacts of virus outbreak could weigh on consumer-related and energy sectors.
BONDS	EM Dollar Sovereigns					■		Relative valuations attractive versus history. Select opportunities among distressed areas.
BONDS	EM Local Currency					■		EM currency valuation remains attractive; developed market central banks supportive but vulnerable to further U.S. dollar strength.
BONDS	EM Corporates					■		Country-specific risks are elevated, but several cheap assets are not as vulnerable as prices reflect and represent attractive opportunities.
CURRENCIES	GBP vs. USD				■			Weak economic activity, Brexit concerns, and quantitative easing are likely to weigh on the British pound.
CURRENCIES	GBP vs. EUR				■			Brexit concerns, a weaker economic outlook for the UK than the eurozone, and more unconstrained UK quantitative easing are putting downward pressure on the British pound.
CURRENCIES	GBP vs. JPY			■				The JPY remains a safe-haven currency.

UK INVESTMENT COMMITTEE



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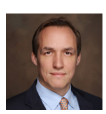

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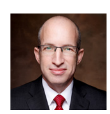

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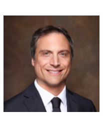

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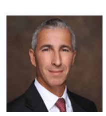

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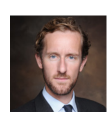

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