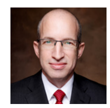
Investment Ideas for the Next 12 Months

Positioning your portfolio for the risks and opportunities ahead.

May 2020

KEY INSIGHTS

- We believe five themes will drive investments over the next 12 months: recession, low oil prices and yields, stimulus, recovery, and active edge.
- For each of these themes, we have identified three key investment ideas.
- Other insights focus on strategies for uncertain times: buy on the dips, keep a clear head, and identify and use skill.



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Although we have not yet reached its halfway point, we can already say with confidence that 2020 has been an extraordinary year. The coronavirus outbreak prompted the fastest-ever bear market as the MSCI All Country World Index plummeted 33.6% from February 20 until March 23. Then, after stimulus was announced, the index rallied 27.8% to the end of April despite deteriorating economic data.[1] Implied volatility is still high, reflecting that we remain very much in unknown territory.

Investors now face some difficult questions. Is the recent stock market recovery sustainable, or is it merely a bear-market rally? Which investments are the likely winners and losers as the global economy recovers? And how should portfolios be positioned given there is so much uncertainty about the future?

To help answer these questions, we have identified five key themes that we believe will drive the performance of investor portfolios over the next year. Our themes are based on how we believe the global economy will perform over time and the investment implications arising from that. For each theme, we offer three investment ideas. The five themes are (1) recession, (2) low oil prices and yields during the recession and until the economy recovers, (3) stimulus, (4) the recovery that follows the stimulus, and (5) the need at all times to use an active edge.

1. Recession

The global economy is expected to severely contract in the first half of 2020 at a magnitude not seen since the Great Depression in the 1930s, then either sharply expand in the second half of the year or recover more gradually into 2021. It is challenging to make money in recessions, but some investments—such as nominal bonds—tend to perform much better than others.

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[1] MSCI (see Additional Disclosures).

Investment Theme No. 1: Recession

Investment Idea	Nominal Bonds	Winning Sectors	Cash, the King of Beggars
Rationale	The fall in economic activity is deflationary. Bond purchasing programs are likely to keep yields low. While the term premium is meager, nominal bonds are unlikely to lose. High-quality credit may outperform government bonds.	Some sectors are winners when people endure lockdowns. Technology enables working from home. Health care is in the spotlight during a global pandemic. People need the basics, and going to the supermarket is a hunting expedition.	Cash is likely to generate scanty income. However, when other assets might fall, cash is king.
E.g. Examples	▪ Long-duration government bonds. ▪ IG corporate bonds.[1]	▪ Technology. ▪ Health care. ▪ Consumer staples.	▪ Cash. ▪ Ultra-short-duration strategies.

[1] IG is investment grade.

> Policymakers are all in—they are unlikely to be able to reverse their policies until the economy finds a strong footing.

Although money-printing quantitative easing could be inflationary, inflation is unlikely to rise in the short term, not only because of the recession, but also because secular forces including low energy prices, demographics, and technology keep it low. Central banks have been struggling to lift inflation to meet their targets.

Some sectors are likely to continue to be winners. If the recovery stalls and lockdowns and social distancing remain in place for a longer period, technology may benefit, allowing for remote connectivity, online shopping, and cloud computing. This is on top of ongoing technology-led disruption, where investors should be on the side of the disruptors, not the disrupted. If the coronavirus makes a comeback after the summer before a vaccine is developed, health care will remain critical.

2. Low Oil Prices and Yields

Overshadowed by the coronavirus crisis, the other drama in 2020 has been the fall in the price of oil. The challenge with oil is not just the fall in demand—when was the last time you filled your car with fuel?—but also oversupply. A low price of oil typically means low inflation.

Bond yields are low and are likely to remain so for the next 12 months. Low yields make it harder for banks to make a profit. Growth stocks in the U.S. may continue to outperform value stocks

Investment Theme No. 2: Low Oil Prices and Yields

Investment Idea	Inflation/Deflation	Growth/Value	Winners/Losers
Rationale	Inflation is unlikely to rise in the short term. Deflation and yields of more government bonds turning negative are risks.	Growth stocks have been outperforming value stocks for over a decade and during 2020. Overweight U.S. growth, but keep a balance between growth and value because the cycle might turn around.	Low oil prices means winners and losers. Emerging market equity has some winners and losers, so selectivity is key.
E.g. Examples	▪ IG corporate bonds. ▪ Defensive stocks. ▪ Dividend-paying stocks.	▪ U.S. growth equity. ▪ Balance between growth and value while overweighting growth.	▪ Winners: Emerging market commodity importers (e.g., China). ▪ Losers: Energy sector, emerging market commodity exporters (e.g., Brazil, Russia).

Investment Theme No. 3: Stimulus

Investment Idea	Yield Scarcity	Piggybacking Central Banks	Risk Assets
Rationale	In a low-yield environment, income-seeking investors will buy income-generating assets.	Central banks are buying IG corporate bonds, fallen angels, high yield ETFs, and equity ETFs in some cases.[1] Buy what they buy.	On a 12-month horizon, risk assets are supported by valuations, ample liquidity, and potential economic recovery.
Examples	▪ Stocks paying high dividends. ▪ IG corporate bonds, high yield, EMD.[2] ▪ Multi-asset and active income-oriented strategies.	▪ IG corporate bonds. ▪ High yield. ▪ Use active management to select issuers and fallen angels with relative low default risk.	▪ Global equities. ▪ High yield bonds. ▪ EMD. ▪ Use active management since selectivity is key when uncertainty is high.

[1] Fallen angels are issuers that have had their debt recently downgraded from investment grade to high yield. ETFs are exchange traded funds.
[2] EMD is emerging market debt.

because 40% of the Russell 1000 Growth Index is technology while 20% of the Russell 1000 Value Index is financials and 5% is energy (0% in the Russell 1000 Growth Index).[2] Low oil prices and low yields mean there will be some losers and some winners.

3. Stimulus

The unprecedented amount of stimulus injected into the global economy over the past few months has offered a lifeline for individuals, businesses, and economies. While policymakers may have kicked the can down the road, leaving themselves with a mountain of public debt and possibly inflation to deal with another day, the situation would have been much worse without the stimulus they provided.

Policymakers are all in—they are unlikely to be able to reverse their policies until the economy finds a strong footing. These policies have created both challenges and opportunities for investors. The three investment ideas here focus on (1) yield scarcity—when cash and government bonds yield close to nothing, (2) piggybacking central banks—buy what they buy, and (3) risk assets—in a flood, everything floats.

> "This environment is an opportunity for skilled active managers to make a difference...

Investment Theme No. 4: Recovery

Investment Idea	Diversification	Offense and Defense	Flexibility
Rationale	Diversify equity risk with investments that exhibit low correlation with equities when risk assets sell off.	Balance between a barbell of offensive assets aiming to generate growth and defensive assets aiming to offset drops in aggressive assets.	Markets can quickly go in either direction based on news.
Examples	▪ High-quality duration risk (government bonds of the U.S., Germany, and the UK). ▪ Multi-asset investing.	▪ Offense: Equities, high yield, EMD. ▪ Defense: High-quality, long-duration government bonds, safe-haven currencies (e.g., U.S. dollar, yen), defensive derivative strategies.	▪ Stay attentive and ready. ▪ Use trusted active managers to keep track of developments and adapt. ▪ Focus on liquid assets.

[2] FTSE/Russell (see Additional Disclosures).

4. Recovery

Crises typically go through three phases: meltdown, bear-market rally, and recovery. The meltdown is behind us. However, it is unclear whether the rebound of risk assets from their March lows is a dead cat bounce, meaning markets are likely to go through periods of significant ups and downs, or a sustainable recovery.

For the recovery to be sustainable, markets needed three things: (1) the peak infection rate to have passed, (2) a convincing and aggressive monetary and fiscal stimulus, and (3) receding volatility. Although all three are in place, many unknowns linger: a risk of a second wave of infections, the ability of a scarred economy to recover, and the pace of returning to a new version of normality. One scenario is for a steep and strong economic recovery in the second half of 2020; another is for a gradual recovery into 2021. One thing is sure: The crisis will end, and a recovery will begin.

The three investment ideas here are (1) diversification—true diversification, not perceived diversification, as some assets (e.g., corporate bonds, commodities) might exhibit low correlation with equities in good times but high correlation in bad times; (2) balancing offense and defense; and (3) flexibility—portfolios must be nimble, ready to adjust.

5. Active Edge

The dispersion in returns among markets, sectors, and securities has widened considerably. Recessions bring a process of constructive destruction through which corporations that should fail do so. This environment is an opportunity for skilled active managers to make a difference by selecting markets and sectors that are likely to fare better and differentiate between corporations with strong balance sheets, viable businesses, and sustainable cash flows and those with weak businesses. The zombification process—through which cheap money enables corporations that should have perished to survive through cheap loans—may come to its end. In a process of survival of the fittest, the fittest active managers can select the survivors.

The three investment ideas here are about the appropriate behavior for actively managing your portfolio.

Investment Theme No. 5: Active Edge

Investment Idea	Buy on the Dips	Keep a Clear Head	Identify and Use Skill
Rationale	Do not be hasty. Patiently wait for pullbacks to potentially buy on the dips. Sentiment drives short-term volatility and market movements, creating opportunities when fundamentals are sound.	Volatility and uncertainty are likely to remain high. This is the time to neither panic nor to be a hero, taking large active positions. Rather, consider time as your friend, taking a long investment horizon and trying to look beyond the clouds of the crisis.	There are now more opportunities for active management to add value than in the relative calm of the last decade. Identify and use skilled active managers.
E.g. Examples	▪ When risk assets correct, consider buying and resist selling at possible lows. ▪ Assess whether the fundamentals make sense over a long investment horizon.	▪ Do not panic because of volatility. ▪ Use common sense to select likely winners and avoid likely losers. ▪ Prepare for regret risk. We are all likely to make mistakes.	▪ Top-down tactical asset allocation. ▪ Bottom-up security selection. ▪ Use fundamental research to identify inefficiencies and mispricings.

Additional Disclosures

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