



GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

September 2020

MARKET INSIGHTS

As of August 31, 2020

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Inflated Expectations?

After more than a decade of below-target inflation in the U.S., some investors are speculating that inflation may finally rise due to the magnitude of monetary stimulus coinciding with fiscal stimulus supporting the economic recovery from the coronavirus-induced recession. Historically, inflation and money supply have been highly correlated—with increased money supply leading to more money chasing fewer goods—ultimately leading to higher prices. However, despite increased stimulus following the global financial crisis (GFC), over the past 10 years, inflation in consumer prices has remained muted, while only asset prices have increased. An uptick in inflation could provide a long-awaited boost to cyclically oriented companies at the expense of highly valued growth stocks, especially highflying tech stocks that have led the stock market. The Fed's recent policy change emphasising “average” inflation of 2% suggests lower rates for longer and a willingness to overshoot on inflation. Could a return of inflation be the catalyst needed to get a sustained rotation from growth to value stocks?

A Trillion Here, a Trillion There

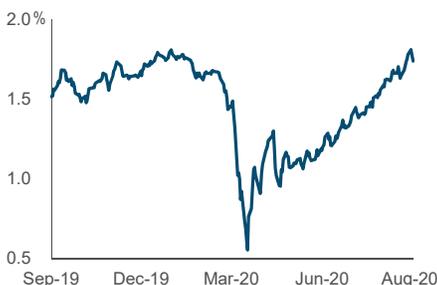
Democrats in Congress and the Trump administration remain at a stalemate over additional fiscal support for American workers after earlier stimulus measures expired in July. Consumer spending received a boost in recent months from the nearly USD 2.8 trillion in fiscal measures passed in March, but it may begin to falter if additional support isn't agreed upon soon. In early August, the president signed executive orders to extend enhanced employment benefits and halt evictions as the sides had made little progress. About a trillion dollars still separates the two sides, and aid to state and local governments continues to be the biggest sticking point. While the consequences of not acting quickly could surely have a negative impact on the economy, further stimulus measures could cause U.S. public debt to reach USD 30 trillion next year, pushing the ratio of U.S. debt to gross domestic product to levels not seen since World War II. While there is no doubt that additional stimulus may be necessary to lift the economy out of the current crisis, Americans can only hope that Washington is getting the best bang for the trillions it is spending.

Home Improvement

As many businesses and households continue to struggle amid the coronavirus pandemic, one surprising bright spot in the economy has been the U.S. housing market. Demographic trends, ultralow interest rates, tight supply, work-from-home capabilities, and urban flight have driven demand for existing and new home sales higher, leading to bidding wars and soaring home prices. A strong housing market could provide a boost for the economy as home purchases often lift other sectors through lending and spending on furniture, appliances, and renovations. The stock market has cheered the news, with the Home Builders Index up 120% since March lows. The irony is that while housing is surging, we're in the midst of recovering from the deepest recession in U.S. history, with unemployment still at high levels. Is it possible that the coronavirus has created structural changes in the way homeownership is viewed going forward?

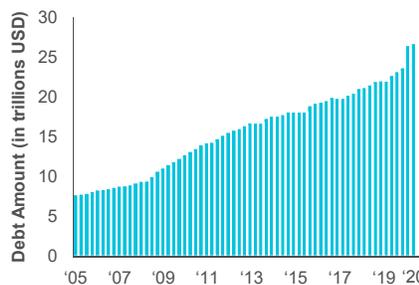
U.S. Inflation Expectations

As of August 31, 2020



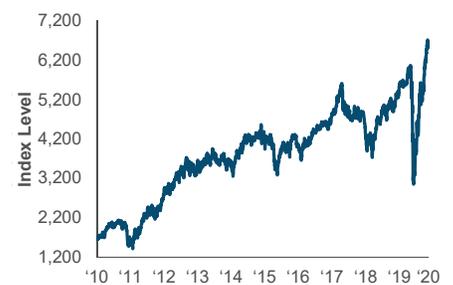
U.S. Debt Outstanding

As of August 31, 2020



Home Builders Index

As of August 31, 2020



Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Finance L.P., Bloomberg Services Limited, Standard & Poor's. (See Additional Disclosures.)

U.S. Inflation Expectations are represented by Bloomberg Barclays U.S. 10 Year Breakeven. S&P Home Builders Index is represented by the S&P Home Builders Industry Select Index.



 **Positives**

 **Negatives**

- Europe**
- EU recovery fund provides further fiscal stimulus and is the first step toward a fiscal union
 - Monetary policy remains very accommodative
 - Equity valuations are inexpensive
 - Strong euro outlook

- Lower share of secularly advantaged companies
- Banking sector was weak going into the crisis
- Weak economic growth going into the crisis
- Limited scope for European Central Bank to stimulate further

- United Kingdom**
- The end of furlough scheme will inflict short-run pain but support higher labor productivity in the medium term
 - The prospect of fiscal consolidation in 2020 will support public debt sustainability in the medium term
 - An exuberant housing market, driven by stamp duty cuts and pent-up demand, will support consumption for now

- Second wave of COVID-19, the disease caused by the coronavirus wave, could lead to weaker confidence
- Hard Brexit risks to raise uncertainty
- End of furlough scheme and fiscal consolidation will weigh on activity in the short term
- All these risks will lead to dovish Bank of England communications tilt, weighing on the pound, but bullish on gilts

- United States**
- Unprecedented levels of monetary and fiscal support
 - Greater share of secularly advantaged companies (e.g., cloud computing, internet retail) than rest of the world
 - Healthy consumer balance sheets prior to the crisis

- Heightened political tensions
- Substantial corporate leverage going into the crisis
- Elevated government debt levels
- U.S. dollar strength has faded

 **Positives** **Negatives**

- Japan**
- Economic data appeared to bottom in the second quarter and have continuously improved since
 - Manufacturing activity is leading at the moment amid the pandemic as global consumers opt for goods over experiences
 - Japanese stocks remain relatively cheap and earnings have been revised higher, offering optionality to global economic recovery

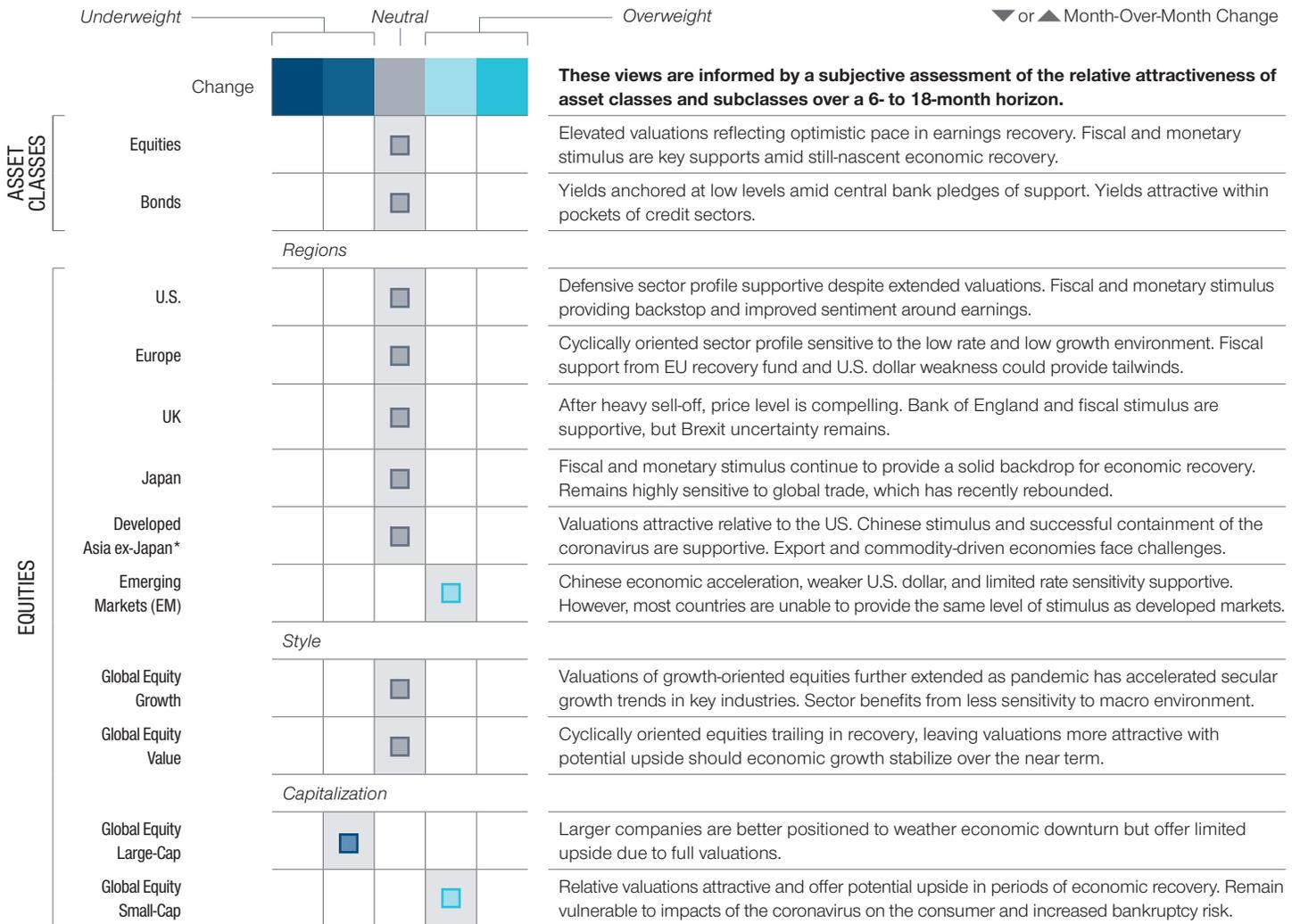
- Prime Minister Abe's resignation has resulted in political uncertainty regarding his successor and future of Abenomics
- Japanese stocks need the global economy to beat expectations in order to potentially outperform developed market peers
- JPY could appreciate in light of broad USD weakness, reducing companies' competitiveness and profitability

- Asia Pacific ex-Japan**
- Although the Chinese V-shaped recovery is losing steam, economic data still point to further growth
 - Wealth effects from stock market gains and rising housing prices could lift up weak consumer demand
 - Australian economic data are currently well supported by fiscal measures and higher commodity prices
 - Consumer spending in Australia could continue to surprise on the upside in the near term given high savings rates, more fiscal support for housing and pent-up demand

- Geopolitical tensions on multiple fronts could dampen foreign sentiment toward Chinese investment
- Elevated Chinese equity valuations in local markets suggest future returns could be modest
- A risk exists that Australian fiscal measures could be wound down too quickly
- Both employment and capex data in Australia could be at risk in light of recent business surveys

- Emerging Markets**
- Chinese economy has largely rebounded
 - U.S. dollar strength has eased
 - Dovish Fed has given central banks flexibility to ease
 - Equity valuations attractive relative to developed markets

- Coronavirus spread still increasing in some areas
- Limited ability to enact fiscal stimulus (excluding China)
- Highly sensitive to global industrial production, trade trends, and natural resource prices, which have improved but remain low



* Includes Australia



		Positioning					Change
		Underweight		Neutral		Overweight	▼ or ▲ Month-Over-Month Change
		Change					
BONDS	Government Bonds	▲					
	U.S. Investment Grade					▲	
	European Investment Grade					▲	
	UK Investment Grade					▲	
	Inflation Linked			▲			
	Global High Yield					▲	
	Floating Rate Loans					▲	
	EM Dollar Sovereigns					▲	
	EM Local Currency					▲	
	EM Corporates					▲	
CURRENCIES	U.S. Dollar		▲				
	Euro					▲	
	UK Sterling	▼	▲				
	Japanese Yen			▲			

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

Yields near record lows with heightened interest rate risk as duration is extended, vulnerable to long end steepening should growth expectations improve.

Despite signs of improving growth and rising inflation expectations, nominal Treasury yields remain at low levels.

Technicals remain in the driving seat, and the path of least resistance is tighter; nonetheless, positioning and liquidity concerns mean the asset class is vulnerable to volatility.

Market technicals remain supportive, but there are still plenty of uncertainties around fundamentals given the size of the economic shock as well as looming Brexit risks.

Inflation expectations rising amid improving growth outlook and seemingly unlimited monetary and fiscal support.

Credit spreads remain at attractive levels. Cautious on downgrade/default risks. Impacts of the coronavirus outbreak could weigh on consumer-related and energy sectors.

Yield spreads remain attractive, although Fed anchored at zero rate level. Relative to high yield bonds, less exposure to energy sector and higher in capital structure.

Relative valuations less attractive after recent rally. Still offer attractive yield versus developed markets.

Improving sentiment on EM currency; valuations remain attractive with supportive developed market central banks and weaker U.S. dollar.

The impact of the global recession on emerging markets is difficult to gauge. Country-specific risks are elevated, but several cheap assets are not as vulnerable as prices reflect.

Signs that the second coronavirus wave may be stabilizing may support the dollar in the near term. Valuations are relatively expensive, however, and we remain underweight overall.

Concerns over coronavirus infection rates and Brexit negotiations could provide headwinds for the euro, but over the medium term, we retain a positive bias to the currency.

The end of coronavirus support schemes and uncertainty over a potential no-deal hard Brexit will likely rise, supporting a more dovish Bank of England.

Yoshihide Suga is favorite to replace Shinzo Abe as leader, and recent comments imply that expansionary fiscal policy will continue, indicating an unchanged outlook for the yen.

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