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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

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MARKET INSIGHTS

As of September 30, 2020

Mounting Losses

Although unemployment rates have continued to decline, we are starting to see an alarming increase in permanent job losses, which has moved beyond service sectors. While initial hopes were that the impacts of the coronavirus would be short-lived, reality is setting in, and companies whose business models are most vulnerable to changes in consumer behaviour are starting to cut headcount. With additional fiscal support potentially delayed until 2021, hard-hit areas of the economy may face irreparable damage. However, thus far, consumer spending has remained healthy, and bankruptcies, while rising, have remained relatively modest, at least for now. Although signs of progress toward a vaccine have been promising, the likelihood of broad distribution could take many more months, placing further pressure on vulnerable areas of the economy. Without additional stimulus to bridge the gap, we may see a continued increase in job losses, particularly in the service sectors, reaching deeper into the economy and threatening the nascent recovery.

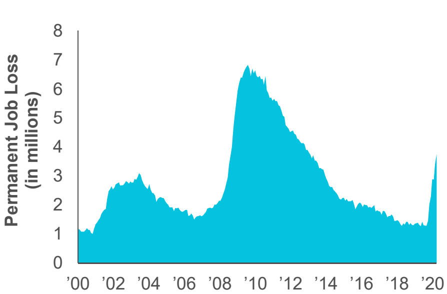
Waves of Uncertainty

After getting through the first surge of coronavirus infections, Europe is now facing a second wave, forcing new restrictions to be imposed in areas that were well into reopening. The UK has been hit particularly hard by the second wave, seeing virus cases creep back up past May levels, reigniting discussions about a national lockdown. The challenges of containing this second wave come at a time when tensions surrounding Brexit are peaking, further complicating the region's outlook. While the UK officially exited the European Union (EU) last year, the two parties have failed to agree on important remaining issues surrounding trade and security, particularly regarding border checks between Ireland and the UK. With the EU being the largest trading partner of the UK, if an agreement is not in place by the end of the year, it could jeopardise an estimated trillion euros worth of annual trade. As the rest of the world recovers, Europe could be at risk of being left behind if it is not able to overcome these issues.

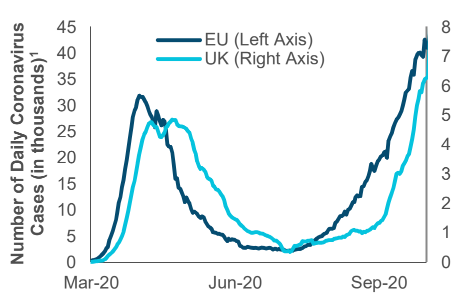
A November to Remember?

With a quickly approaching U.S. presidential election that is too close to call, mounting controversy surrounding mail-in ballots, the potential for a protracted legal battle, and the president's recent coronavirus diagnosis, markets are increasingly pricing in expectations of higher volatility that could last well beyond election day. Some believe that the potential for political chaos and prolonged uncertainty could be a bigger risk to the markets than the actual selection of either candidate. These fears are made evident by the increasing costs of hedging against volatility postelection through November and December VIX futures. The markets' reactions to the more than a month of uncertainty during the 2000 election saw the S&P 500 down over 4%, 10-year Treasury yields falling over 50 basis points, and gold prices soaring over 12%. If the balance of power remains in flux for a longer period this time around, markets could be more vulnerable given extended valuations, a still tenuous economic recovery, and uncertainty around the coronavirus.

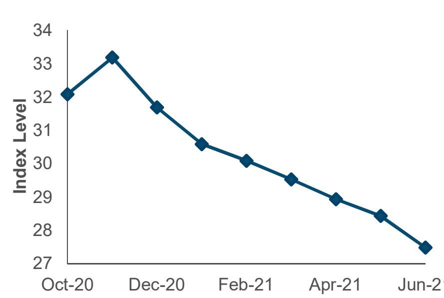
U.S. Unemployment: Permanent Job Loss
As of September 30, 2020



Second Wave in EU/UK
As of September 30, 2020



VIX[2] Futures Curve
As of September 30, 2020



Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Finance L.P., Bloomberg Services Limited, Johns Hopkins University (see Additional Disclosures).

[1] Number of daily coronavirus cases represents the 7-day moving average of the number of daily cases in the region.

[2] VIX represents CBOE Volatility Index (VIX).

	Positives	Negatives
Europe	▪ EU recovery fund provides further fiscal stimulus and is an initial step toward a fiscal union ▪ Monetary policy remains very accommodative ▪ Equity valuations are inexpensive ▪ Strong euro outlook	▪ Lower share of secularly advantaged companies than the U.S. ▪ Banking sector was weak going into the crisis ▪ Weak economic growth going into the crisis ▪ Limited scope for European Central Bank to stimulate further ▪ Second wave of virus ongoing
United Kingdom	▪ The end of furlough scheme will inflict short-run pain but will support higher labour productivity in the medium term ▪ A commitment to fiscal consolidation in 2021 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 the coronavirus 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 sterling, 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 ▪ Elevated corporate leverage going into the crisis ▪ Elevated government debt levels ▪ U.S. dollar strength has faded

	Positives	Negatives
Japan	▪ Smooth political transition signals that reforms may continue, especially in governance and digitisation ▪ Japanese stocks are under-owned; they remain relatively cheap, and earnings have been revised higher, offering optionality to global economic recovery ▪ Economic data appeared to bottom in the second quarter; manufacturing activity has led the recovery as global consumers opt for goods over experiences amid the pandemic	▪ The economic recovery has been muted and slower than other developed economies ▪ Japanese stocks need the global economy to beat expectations in order to outperform developed market peers ▪ Market indicators have signalled a stronger yen, which would reduce companies' competitiveness and profitability
Asia Pacific ex-Japan	▪ The V-shaped economic recovery has continued in China, with recent data better than expected ▪ Retail sales have finally recovered, reflecting China's success in suppressing the pandemic ▪ Australian consumer spending could surprise on the upside given solid data from retail sales, housing, job reports, and cash balances ▪ Fiscal and monetary policy support in Australia is expected to be prolonged further	▪ China's strong economic recovery could lose steam as stimulus fades ▪ U.S.-China tensions could rise ahead of the U.S. elections; dampened sentiment toward Chinese assets reflected by lower northbound trading turnover from Hong Kong ▪ Risk exists that fiscal support measures could be wound down too quickly following worst quarterly gross domestic product since records began in 1959 ▪ With Victoria state already easing coronavirus lockdown restrictions, the Australian market might be less sensitive to positive vaccine developments than other markets yet to contain outbreaks
Emerging Markets	▪ Chinese economy has largely rebounded ▪ U.S. dollar strength has eased ▪ Dovish Fed has helped ease financial conditions ▪ Equity valuations attractive relative to developed markets	▪ Virus spread still increasing in some areas ▪ Limited ability to enact fiscal stimulus (excluding China) ▪ Highly sensitive to global industrial production and trade trends, which have improved but remain muted

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				■			Elevated valuations reflecting optimistic pace in earnings recovery. Fiscal and monetary stimulus are key supports amid still nascent economic recovery.
ASSET CLASSES	Bonds				■			Short-term yields remain anchored amid central bank pledges of support. Longer rates vulnerable to moving higher on improving growth. Spreads attractive within some credit sectors.
	Regions							
EQUITIES	U.S.				■			Defensive sector profile supportive despite extended valuations. Fiscal and monetary stimulus providing backstop and improved sentiment around earnings.
EQUITIES	Europe				■			Cyclically oriented sector profile and fiscal support could provide tailwinds. Second wave, limited tech representation, and poor environment for financials remain reasons for caution.
EQUITIES	UK				■			After heavy sell-off, price level is compelling. Bank of England and fiscal stimulus are supportive, but Brexit uncertainty remains.
EQUITIES	Japan				■			Successful transition to new prime minister signaling continued fiscal and monetary stimulus support and reform efforts remain in place. Trade weakness remains a significant concern.
EQUITIES	Developed Asia ex-Japan*				■			Valuations attractive relative to the U.S. Chinese stimulus and successful containment of virus are supportive. Export- and commodity-driven economies face challenges.
EQUITIES	Emerging Markets (EM)					■		Chinese economic strength and weaker U.S. dollar supportive. Less hampered by low rate environment. Most countries have limited stimulus levers to offset coronavirus weakness.
	Style							
EQUITIES	Global Equity Growth	▼		■				Vulnerability to extended valuations, narrow leadership, and improving growth outlook could drive rotation toward more cyclical companies. Earnings trends remain supportive.
EQUITIES	Global Equity Value	▲				■		Value equities could benefit from early stages of recovery. Relative valuations extremely supportive versus history. Support from higher rates and energy prices remains elusive.
	Capitalization							
EQUITIES	Global Equity Large-Cap			■				Larger companies better positioned to weather weaker growth environment but could lag as recovery advances due to extended valuations.
EQUITIES	Global Equity Small-Cap					■		Relative valuations attractive and could offer upside potential as the recovery advances. Vulnerable to pullback in consumer spending, which could exacerbate bankruptcy risk.

* Includes Australia

ASSET ALLOCATION COMMITTEE POSITIONING

As of September 30, 2020

▼ 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	
BONDS	Government Bonds		■					Yields remain range-bound near record lows with extended duration and are vulnerable to steepening at the long end of the yield curve should growth expectations improve.
BONDS	U.S. Investment Grade					■		Despite signs of improving growth and rising inflation expectations, nominal Treasury yields remain at low levels.
BONDS	European Investment Grade	▼			■			Continued central bank bond buying is keeping spreads somewhat insulated from the raft of uncertainties around both the second wave of the coronavirus and Brexit.
BONDS	UK Investment Grade	▼			■			The market has now reversed much of widening that occurred in the spring. Market technicals are in the driving seat, while uncertainties remain around fundamentals.
BONDS	Inflation Linked				■			Inflation expectations could continue to rise amid improving growth outlook and seemingly unlimited monetary and fiscal support.
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	Floating Rate Loans					■		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.
BONDS	EM Dollar Sovereigns					■		Sector offers attractive yield versus developed markets; however, relative valuations less attractive after recent rally.
BONDS	EM Local Currency					■		Valuations remain attractive with supportive developed market central banks and potential for weaker U.S. dollar.
BONDS	EM Corporates					■		The impact on the asset class of the global recession is difficult to quantify. Country-specific risks are elevated, but there are attractive opportunities.
CURRENCIES	U.S. Dollar			■				We see the dollar as relatively expensive and remain underweight overall from a medium term perspective.
CURRENCIES	Euro	▼			■			Nervousness about growth and risk events have kept the euro in check. However, we retain a positive bias toward the currency over the medium term.
CURRENCIES	UK Sterling			■				We expect UK monetary policy to become more expansionary over the medium term and this, combined with continued Brexit uncertainty, is expected to cap any currency gains.
CURRENCIES	Japanese Yen	▲				■		The outlook for the yen is positive, reflecting expectations of weakness in the broad U.S. dollar over the medium and long term.

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