



GLOBAL ASSET ALLOCATION: THE VIEW FROM THE UK

October 2020

MARKET INSIGHTS

As of 30 September 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

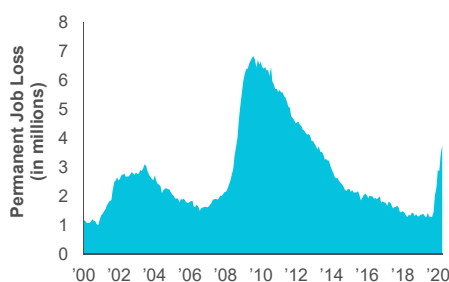
After getting through the first surge of coronavirus infections, Europe is now facing a second wave, forcing new restrictions to be imposed in areas that were well into reopening. The UK has been hit particularly hard by the second wave, seeing virus cases creep back up past May levels, reigniting discussions 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 US 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.

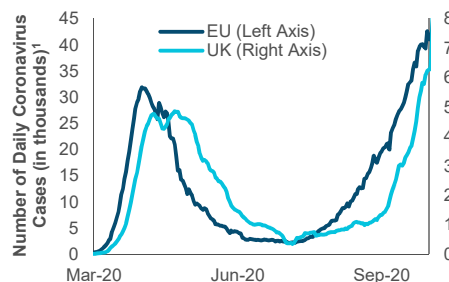
US Unemployment: Permanent Job Loss

As of 30 September 2020



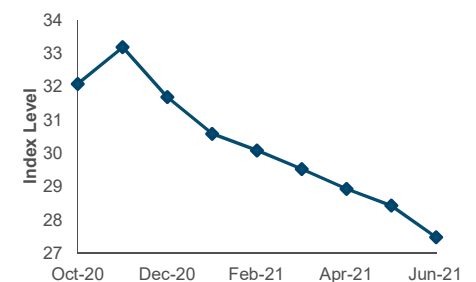
Second Wave in EU/UK

As of 30 September 2020



VIX² Futures Curve

As of 30 September 2020



Past performance is not a reliable indicator of future performance.

Sources: Bloomberg Finance L.P., Bloomberg Services Limited and 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

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

Developed 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 US
- 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 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
- US 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

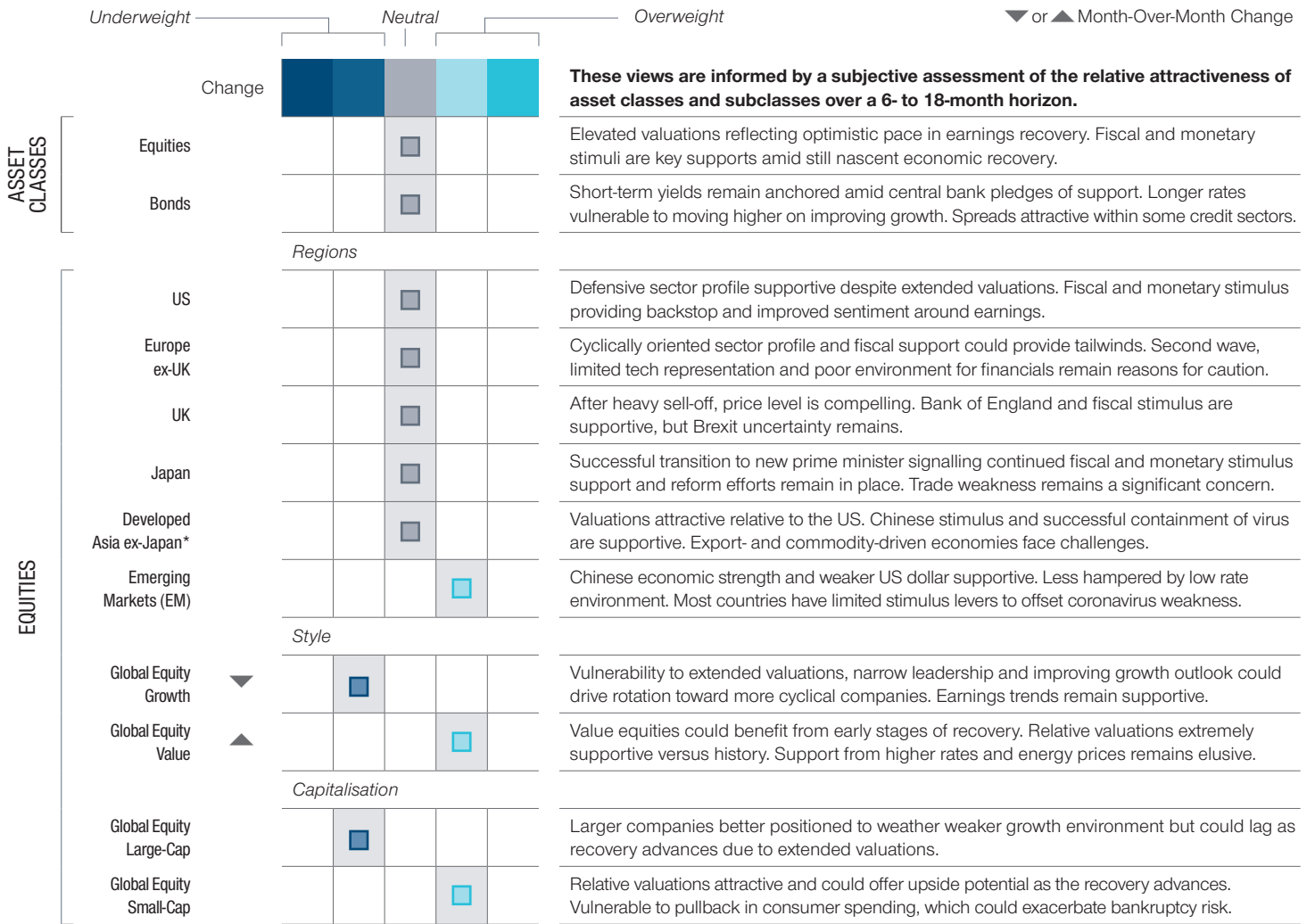
- The economic recovery has been muted and slower than other developed economies
- Japanese stocks need the global economy to beat expectations in order to outperform developed market peers
- Market indicators have signalled a stronger yen, which would reduce companies' competitiveness and profitability

- 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

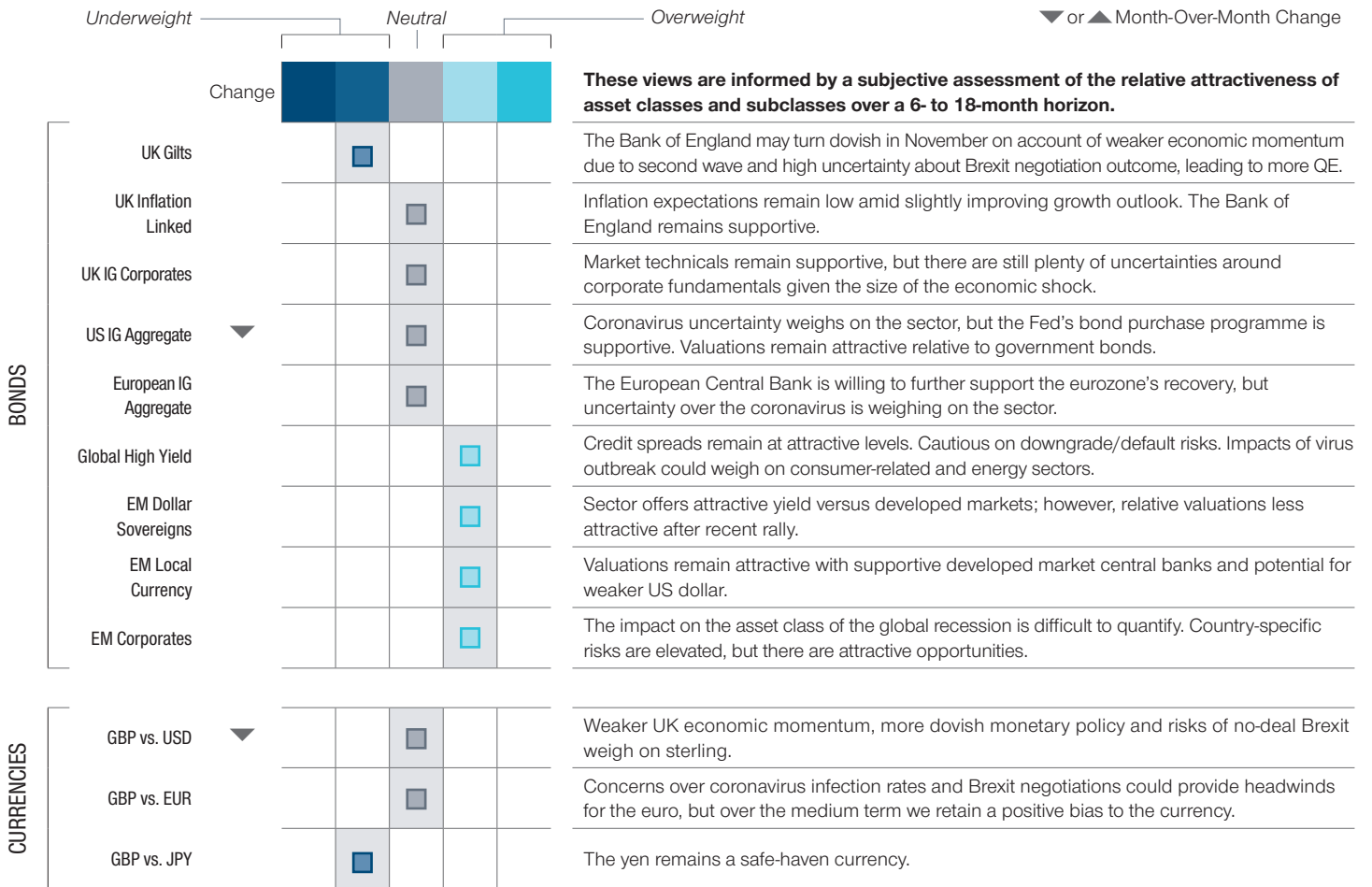
- China's strong economic recovery could lose steam as stimulus fades
- US-China tensions could rise ahead of the US elections; dampened sentiment toward Chinese assets reflected by lower northbound trading turnover from Hong Kong
- Risk exists that fiscal support measures could be wound down too quickly 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
 - US 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



* Includes Australia



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