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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

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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 behavioral 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.

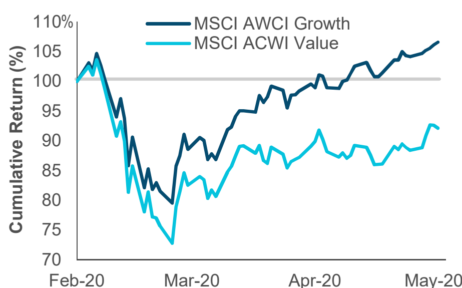
Uneasy Truce?

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.

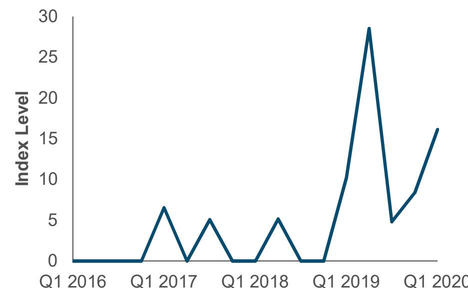
"Coronabonds" to the Rescue?

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.

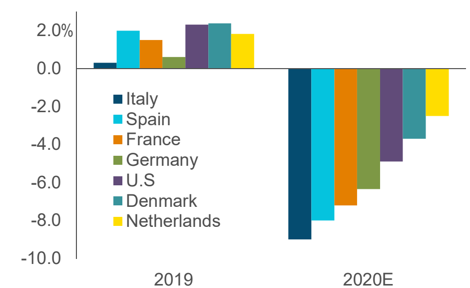
MSCI ACWI Growth vs. Value
Fig. 1: As of May 31, 2020



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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Europe

Positives

- 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

Negatives

- Weak economic growth going into crisis
- Limited scope for European Central Bank to stimulate further
- De-centralized government structure means fiscal response is delayed
- Lower share of secularly advantaged companies
- Banking sector was weak going into the crisis

United Kingdom

Positives

- 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

Negatives

- 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

United States

Positives

- 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

Negatives

- 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

▼ or ▲ Month-Over-Month Change

		Change	Underweight		Neutral	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.
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 stabilization 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.
	Regions							
EQUITIES	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				■			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				■			After heavy sell-off, price level is compelling. The UK continues to be heavily impacted by virus. 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 stabilization 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 stabilize 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

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.

		Underweight	Underweight	Neutral	Overweight	Overweight	
	Change						
BONDS	U.S. Investment Grade		■				Treasury yields at low levels with Fed expected to remain on hold indefinitely. Corporate spreads tighter despite increased supply amid improved liquidity and policy support.
BONDS	European Investment Grade				■		The ECB's recent decision to expand the Pandemic Emergency Purchasing Programme shows it is willing to further support the eurozone's recovery.
BONDS	UK Investment Grade				■		Market technicals remain supportive, but there are still plenty of uncertainties around corporate fundamentals given the size of the economic shock.
BONDS	Inflation Linked			■			Inflation expectations lower on muted growth outlook. Central banks remain supportive, but longer-term downward pressures on inflation persist.
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				■		Yields remain attractive. 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				■		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	U.S. Dollar		■				We continue to see USD valuations as expensive and interest rate differential as no longer supportive. Political risks are likely to remain relatively high as election season looms.
CURRENCIES	Euro				■		Recent weeks have seen some improvement in the policymaker uncertainty that has dogged the euro. Over time, an economic recovery should prove supportive.
CURRENCIES	UK Sterling			■			Progress on dealing with the coronavirus threats and unwinding the lockdown should determine the attractiveness of the GBP to international investors over the second half.
CURRENCIES	Japanese Yen			■			Interest rate differentials imply a stronger JPY, but stronger growth implies the currency will weaken. The JPY will likely be seen as a safe haven asset in a slowdown.

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