



# GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

May 2020

## MARKET INSIGHTS

As of April 30, 2020

### Price Discovery

Trying to put a price on the stock market in the current environment is extremely challenging. The velocity of the market decline and subsequent recovery are unparalleled, with day-to-day price swings that can look more like returns for a full year. Similar to the “E” in price-to-earnings measures, the “E” is challenging to pin down as estimating earnings is hampered by uncertainty around the duration of the global shutdown and the postcrisis environment. First-quarter earnings reports are starting to shed some light, and the broad picture shows a steep decline with S&P 500 earnings down nearly 15%. In this environment, there have been winners and losers, with the technology and communications sectors resilient, while other more cyclical sectors have been hard hit, including energy and industrials. Compared with previous crises, today’s crisis is not normal and the speed of the recovery may not be normal either. What may be very different, though, are the winners and losers, making it ever more important to watch what you’re paying for “normalised” earnings for companies that will likely be facing an abnormal world.

### Fed Extinguishing Liquidity Risk, Solvency Smolders

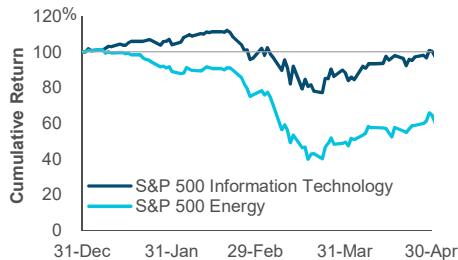
Global central bankers have unleashed unprecedented monetary policies to help offset contracting growth and ease widespread liquidity strains. In the U.S., the Federal Reserve has launched several lending and asset purchase programs that have provided much needed stability within the commercial paper, U.S. Treasury debt, corporate bond, municipal bond, mortgage-backed, and money market sectors. The most direct support will come through the launch of the Main Street Lending Program under which the Fed is directly providing loans through its network of banks to small and mid-size businesses that are too large to participate in the Treasury’s Paycheck Protection Program (PPP). However, these loans will need to be paid back, whereas the PPP lending converts to grants if used directly to fund employee wages. While these actions by the Fed provide much needed liquidity, eventually these businesses must be able to stand on their own. Given the uncertain future for many industries postcrisis, markets are likely to shift their focus to solvency risk, where some companies may not be able to sustain their debt obligations.

### Looking Through

First-quarter gross domestic product (GDP) growth rates around the world are showing levels of contraction not seen since 2008, with the U.S. slipping 1.2% quarter over quarter (down 4.8% on an annualized basis) and the eurozone down 3.3% quarter over quarter. The steep declines were largely due to the extensive lockdown measures implemented worldwide, which hampered the previously resilient consumer and severely impacted services industries such as entertainment, health care, and food. As bad as these first-quarter numbers were, the data only reflected economic closures that started around the second week of March, indicating that next quarter’s data will be much worse, with nearly the entire economy impacted by lockdowns in April and significant portions of May. Despite the alarming economic growth, unemployment, and manufacturing data, global stock markets have shrugged off the weakness as temporary in hopes that recovery will not be too far off once economies reopen. With a headline second-quarter GDP number in the U.S. that could be as low as -40%, we’ll see if markets will continue to look through the negative data or begin to react in a different direction.

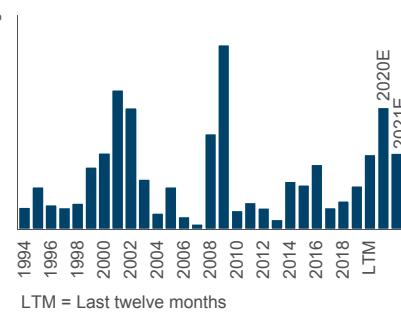
### S&P 500: Information Technology vs. Energy

Fig. 1: As of April 30, 2020



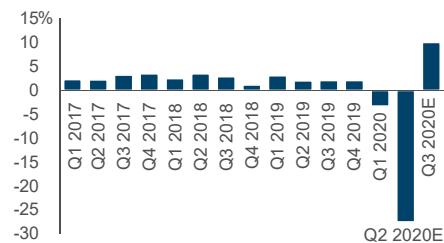
### U.S. High Yield Default Rate

Fig. 2: As of April 30, 2020



### U.S. Real GDP Growth (Annualized)

Fig. 3: As of March 31, 2020



**Past performance is not a reliable indicator of future performance.**

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 **Positives**

- Europe**
- Long-awaited fiscal stimulus is coming
  - Monetary policy remains very accommodative
  - Inexpensive equity 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 (ECB) to stimulate further
- Decentralized government structure means fiscal response is delayed
- Banking sector was weak going into the crisis
- Political tensions heightened by the crisis

- United Kingdom**
- Proactive coordination between the National Health Service, fiscal, financial, and monetary policy will help mitigate the coronavirus shock
  - The trade balance deficit remains in a range that can be sustained by the net excess returns on the UK's external balance sheet
  - Additional monetary and fiscal easing to resuscitate economy after lockdown is over

- 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
- Gilts may sell off significantly in the second half of 2020 after the coronavirus crisis is over

- United States**
- Unprecedented levels of monetary and fiscal support
  - Healthy consumer balance sheets prior to the crisis
  - Pause in escalation of trade war with China
  - 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

- Size of country and freedom of movement means there is higher potential for continued outbreaks
- Inconsistent policies from state to state
- Elevated corporate leverage going into the crisis
- Service-oriented economy means higher economic impact from social distancing
- Margins under pressure going into the crisis
- Elevated government debt levels



## Positives

### Japan

- Fiscal support is widely expected to increase as economic data further deteriorate
- Investors with a long-term horizon could potentially benefit from attractive valuations and resilient earnings forecast for domestically oriented companies
- We believe the Japanese yen (JPY) is likely to continue to provide safe-haven characteristics at times of crisis
- Yields appear stable relative to other sovereign bond markets given the Bank of Japan policy approach



## Negatives

- Technical recession seems inevitable following poor fourth-quarter economic growth and given the current pandemic
- Earnings will be challenged given domestic companies' high sensitivity to global economic momentum, coupled with a relatively strong currency
- Possible lockdown measures in Tokyo are clouding the perspectives of any imminent rebound in consumer confidence

### Asia Pacific ex-Japan

- The Chinese policy response to the virus outbreak has been significant, with potentially more to come to support the economy
- Chinese equity markets appear to be relatively more resilient so far than the rest of the world as the virus spreads outside China
- Australian policy measures from the government and Reserve Bank of Australia were deployed quickly and aggressively, helping to dampen the negative economic impact of the pandemic
- Australia's fiscal position is strong relative to other countries, reducing long-term risks of recent policy support

- The full impact of the pandemic in China remains unknown
- Maintaining a tight range on the renminbi for political reasons might prove to be harmful for competitiveness
- Coronavirus spread has only appeared recently in Australia, suggesting economic data are still due to worsen
- Australian earnings forecasts still need to be meaningfully downgraded. Dividends might also be cut, reducing the historic appeal of Australian equities

### Emerging Markets

- Virus outbreak in China appears to be contained
- Younger population likely to be less affected by virus
- Dovish Fed has given central banks flexibility to ease
- Easing trade tensions
- Equity valuations attractive relative to developed 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

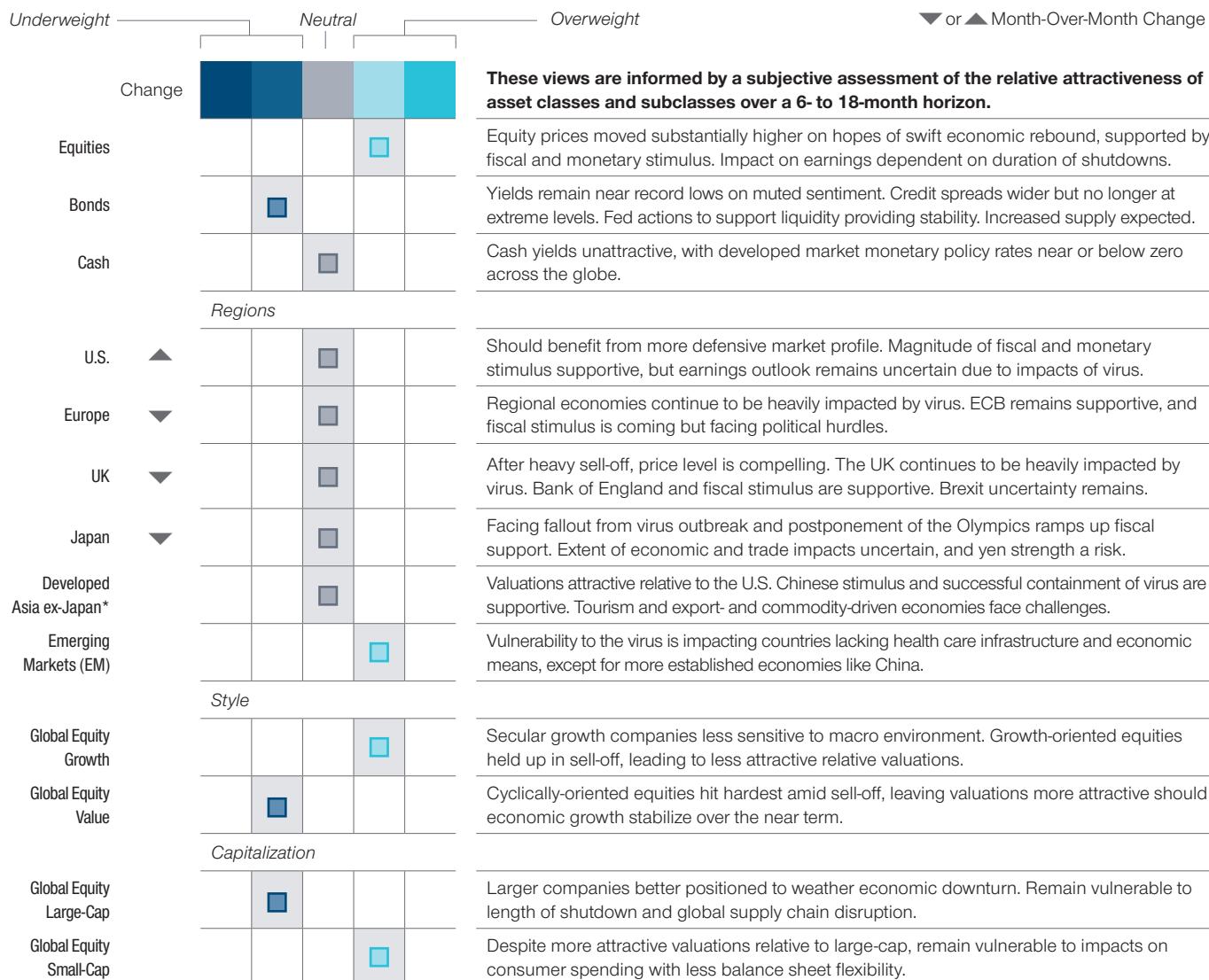


## ASSET ALLOCATION COMMITTEE POSITIONING

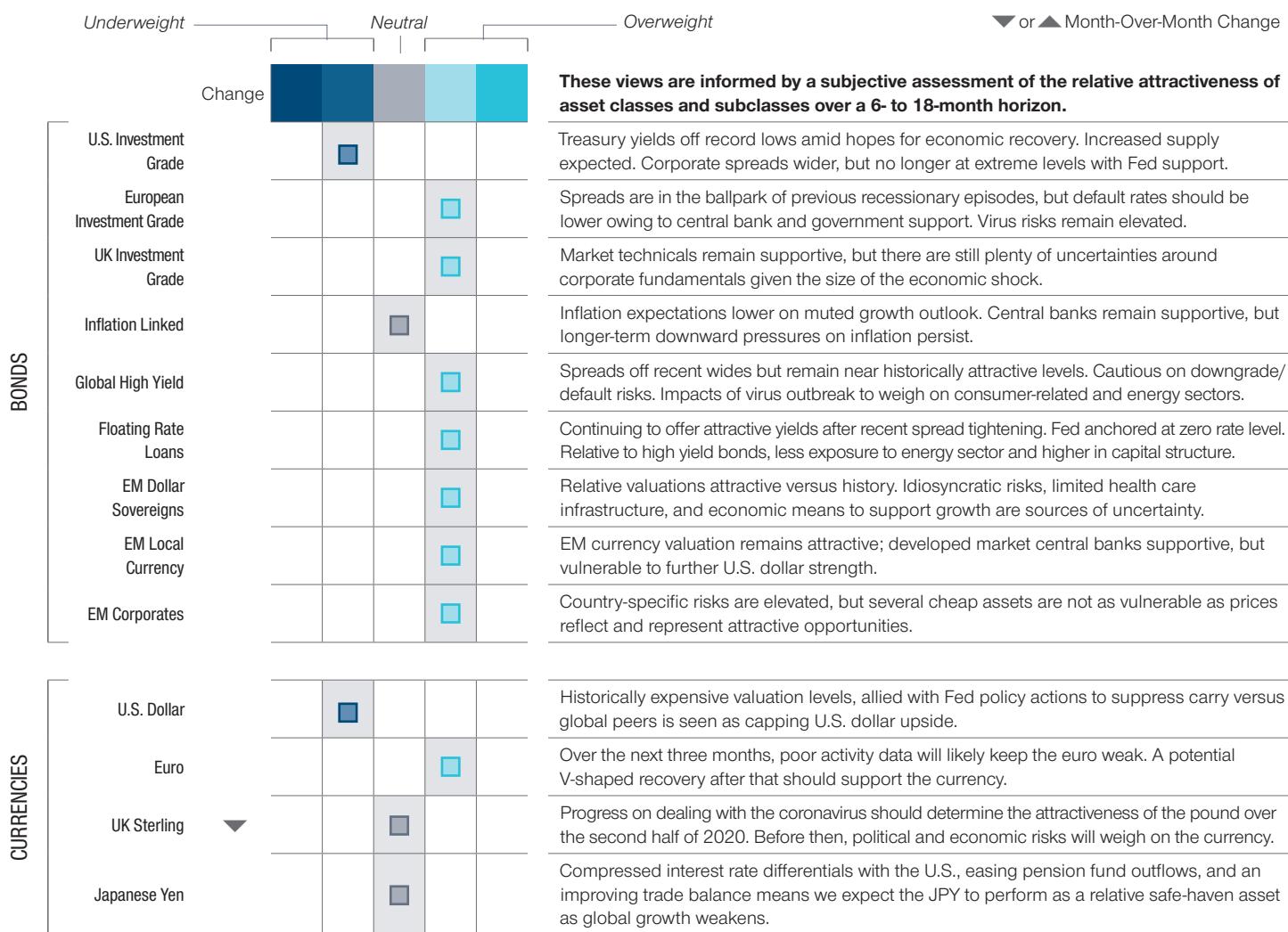
As of April 30, 2020

ASSET CLASSES

EQUITIES



\* Includes Australia



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