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INVEST WITH CONFIDENCE

GLOBAL ASSET ALLOCATION: THE VIEW FROM THE UK

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 "P" 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.

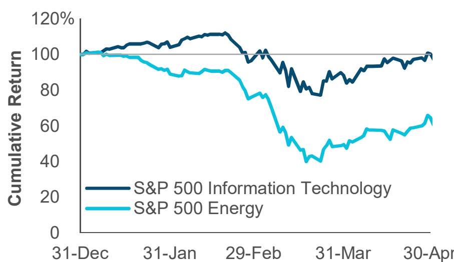
Fed Extinguishing Liquidity Risk, Solvency Smolders

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.

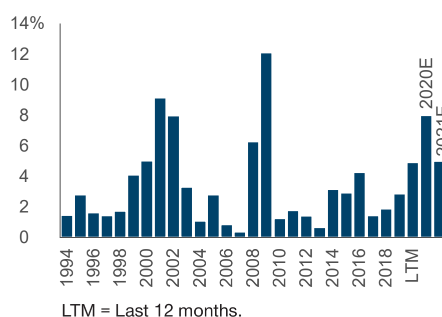
Looking Through

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

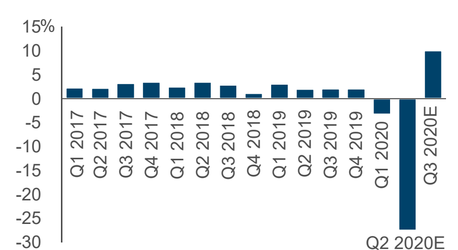


U.S. High Yield Default Rate
Fig. 2: As of April 30, 2020



LTM = Last 12 months.

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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REGIONAL BACKDROP

As of April 30, 2020

	Positives	Negatives
United Kingdom	▪ Slow economy means aggressive quantitative easing, keeping a lid on gilt yields and the British pound ▪ Fiscal and monetary measures support economy	▪ Bigger-than-expected hit on economic activity due to the coronavirus crisis ▪ Concerns over Brexit
Developed 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	▪ Weak economic growth going into crisis ▪ Limited scope for European Central Bank (ECB) to stimulate further ▪ Decentralised government structure means fiscal response is delayed ▪ Banking sector was weak going into the crisis ▪ Political tensions heightened by the crisis
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 mean 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

Japan

Positives

- 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
- 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's 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

Positives

- 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

Negatives

- 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

Positives

- 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
- Equity valuations attractive relative to developed markets

Negatives

- 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

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		Neutral		Overweight	
ASSET CLASSES	Equities					■		Equity prices moved substantially higher on hopes of swift economic rebound, supported by fiscal and monetary stimulus. Impact on earnings dependent on duration of shutdowns.
	Bonds			■				Yields remain near record lows on muted sentiment. Credit spreads wider but no longer at extreme levels. Fed actions to support liquidity providing stability. Increased supply expected.
	Cash				■			Cash yields unattractive, with developed market monetary policy rates near or below zero across the globe.
EQUITIES	*Regions*							
	U.S.	▲			■			Should benefit from more defensive market profile. Magnitude of fiscal and monetary stimulus supportive, but earnings outlook remains uncertain due to impacts of virus.
	Europe ex-UK	▼			■			Regional economies continue to be heavily impacted by virus. ECB remains supportive, and fiscal stimulus is coming but facing political hurdles.
	UK	▼			■			After a heavy sell-off, the price level is compelling. The UK continues to be heavily impacted by the virus. Although stimulus is supportive, Brexit uncertainty remains.
	Japan	▼			■			Facing fallout from virus outbreak and postponement of the Olympics ramps up fiscal support. Extent of economic and trade impacts uncertain, and yen strength a risk.
	Developed Asia ex-Japan*				■			Valuations 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)					■		Vulnerability to the virus is impacting countries lacking health care infrastructure and economic means, except for more established economies like China.
	Style							
	Global Equity Growth					■		Secular growth companies less sensitive to macro environment. Growth-oriented equities held up in sell-off, leading to less attractive relative valuations.
	Global Equity Value			■				Cyclically oriented equities hit hardest amid sell-off, leaving valuations more attractive should economic growth stabilise over the near term.
	Capitalization							
	Global Equity Large-Cap			■				Larger companies better positioned to weather economic downturn. Remain vulnerable to length of shutdown and 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

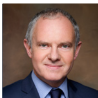
ASSET ALLOCATION COMMITTEE POSITIONING

As of April 30, 2020

Underweight — *Neutral* — *Overweight*; ▼ or ▲ Month-Over-Month Change

		Change	Underweight	Underweight	Neutral	Overweight	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.**
BONDS	UK Gilts	▲		■				UK authorities expect weak economic activity. This is likely to lead to aggressive quantitative easing, keeping a lid on yields for the next 12 months.
	UK Inflation Linked				■			No signs of rising inflation risks yet. Public spending stimulus will eventually be inflationary, but probably not before late 2021/early 2022.
	UK IG Corporates					■		UK credit is preferred over gilts because it offers higher yields, while monetary and fiscal stimulus is supportive.
	U.S. IG Aggregate					■		Coronavirus uncertainty weighs on the sector, but valuations and the Fed's bond purchase program are supportive.
	European IG Aggregate				■			Uncertainty over coronavirus is weighing on the sector. Our preference is to take investment-grade exposure in the UK and U.S. markets.
	Global High Yield					■		Spreads off recent wides but remain near historically attractive levels. Cautious on downgrade/default risks. Impacts of virus outbreak to weigh on consumer-related and energy sectors.
	EM Dollar Sovereigns					■		Relative valuations attractive versus history. Idiosyncratic risks, limited health care infrastructure, and economic means to support growth are sources of uncertainty.
	EM Local Currency					■		EM currency valuation remains attractive; developed market central banks supportive, but vulnerable to further U.S. dollar strength.
	EM Corporates					■		Country-specific risks are elevated, but several cheap assets are not as vulnerable as prices reflect and represent attractive opportunities.
CURRENCIES	GBP vs. USD	▼			■			Concerns about the prospect of a hard Brexit are likely to weigh on the British pound.
	GBP vs. EUR	▼			■			Brexit concerns, a weaker economic outlook for the UK than the eurozone, and unconstrained UK quantitative easing are putting downward pressure on the British pound.
	GBP vs. JPY			■				The JPY remains a safe-haven currency.

UK ASSET ALLOCATION COMMITTEE



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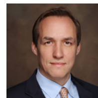

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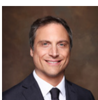

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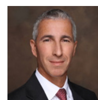

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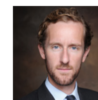

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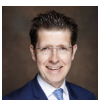

Tomasz Wieladek
International Economist

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