



GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

August 2020

MARKET INSIGHTS

As of July 31, 2020

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Don't Fight the FAANGs?¹

Year-to-date growth stocks have outperformed value by over 30%, not only in the downturn given their defensive characteristics, but also during the recovery. While growth stocks have benefited from secular trends, as well as asset-light business models and less cyclical exposure, for more than a decade, the recent shutdowns have actually benefited many growth companies due to accelerated trends in areas such as online shopping, video streaming, and cloud computing. With S&P 500 earnings expected to be down close to 35% in the quarter, the FAANGs are expected to report an average growth of 20% in earnings. Although growth stock valuations appear stretched, fundamentals remain strong and many expect the current low growth and low rate environment to continue, which has historically favored growth stocks. While value stocks have been written off by the market, progress on a coronavirus vaccine or signs of a rebound in global growth could have them poised for a much overdue rally—but it is unlikely to be the start of a new value cycle.

Not So Fast on That “V”

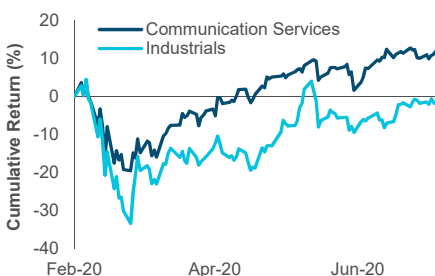
Global growth came in at record-low levels in the second quarter, with output in the U.S. contracting by nearly 33% and the eurozone down over 40% (on an annualised basis). While the headline gross domestic product numbers were not unexpected, hopes in the U.S. that the rapid recovery that we saw in May and June would continue through the rest of the year have been called into question by the recent mixed jobs data. The two consecutive weeks of increasing initial jobless claims in July challenged the labour market recovery, although the most recent week’s initial jobless claims data showed a bit of a reversal. If this “muddle through” environment continues and the federal government reduces additional support for unemployed Americans—which has kept many Americans afloat during the crisis—the equity market’s hopes for a V-shaped recovery in the back half of the year may be dashed.

Dollar Can't Buy EM Relief

In July, the U.S. dollar (USD) and U.S. Treasury yields both fell to multiyear lows, pressured by a resurgence in coronavirus cases and the Fed’s pledge to keep monetary policy loose. Normally, this backdrop would be supportive for higher-yielding emerging markets (EM) amid a low yield environment and provide a boost to their currencies. However, continued economic impacts of the current crisis and limited capacity for fiscal and monetary stimulus, except for China, have weighed on sentiment despite the slump in the USD. This has been evident in the divergence in EM regional currency performance during the virus-related sell-off and recovery. Idiosyncratic issues including financial instability continue to hinder some Latin American countries, leading to significant underperformance versus their more stable, Asian EM counterparts. While a lower USD removes a significant headwind for EM assets, bigger risks abound for broader EM as they continue to weather the crisis.

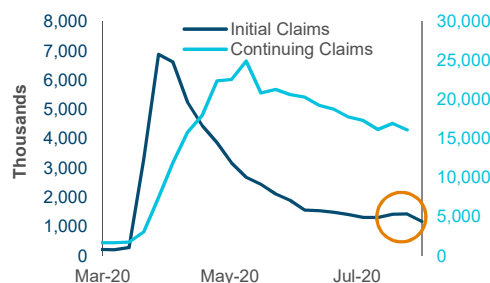
S&P 500: Communication Services vs. Industrials

As of July 31, 2020



U.S. Unemployment Insurance

As of July 31, 2020



EM Currencies: Latin America vs. Asia

As of July 31, 2020



Past performance is not a reliable indicator of future performance.

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¹FAANGs refer to Facebook, Amazon, Apple, Netflix, and Alphabet (parent company of Google). The specific securities identified and described are for informational purposes only and do not represent recommendations.



Positives

Negatives

- Europe**
- Virus containment and reopening strategies have been successful
 - EU recovery fund provides further fiscal stimulus and is the first step toward a fiscal union
 - Monetary policy remains very accommodative
 - Equity valuations are inexpensive
 - Strong euro outlook

- Lower share of secularly advantaged companies
- Banking sector was weak going into the crisis
- Weak economic growth going into crisis
- Limited scope for the European Central Bank to stimulate further

- United Kingdom**
- 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 a very large government deficit of 17%–20%, but aggressive quantitative easing will keep a lid on yields

- UK lockdown to weigh on UK's service-exposed economy heavily
- Changes to Bank of England negative rate communication could weigh on the pound
- Weaker global activity to provide additional headwinds to UK economy
- Fears over year-end Brexit risks will weigh on asset prices

- 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

- Size of country, freedom of movement, and inconsistent policies mean there is higher potential for continued outbreaks
- Heightened political tensions
- Elevated corporate leverage going into the crisis
- Elevated government debt levels
- USD strength is fading

 **Positives** **Negatives**

- Japan**
- Fiscal stimulus, coupled with an accommodative monetary stance, provides a solid backdrop for an economic rebound
 - Economic data may have bottomed in May, and mobility data have stayed higher versus other countries
 - Japanese stocks remain relatively cheap and have cash on their balance sheets, while also offering optionality to global economic recovery

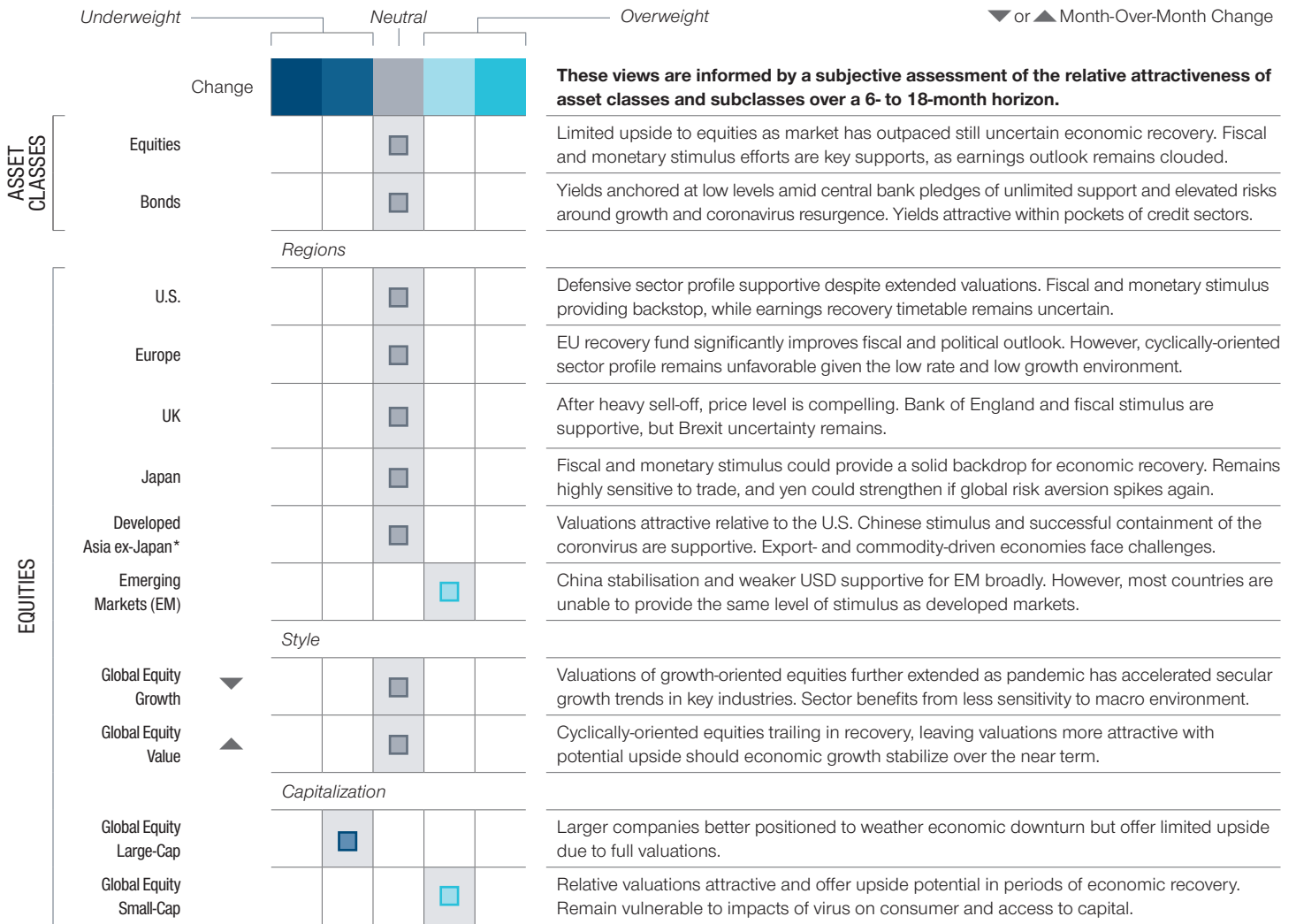
- A high level of risk aversion persists given abundant liquidity and elevated savings rate
- Japanese stocks need the global economy to beat expectations in order to outperform developed market peers
- The yen could appreciate in light of broad USD weakness, reducing companies' competitiveness and profitability

- Asia Pacific ex-Japan**
- Chinese economic data and higher yields have signaled a V-shaped recovery as the world reopens from coronavirus lockdowns
 - Chinese policy measures remain targeted and measured in size, with employment and livelihood replacing growth and investment as this year's economic goals
 - The Reserve Bank of Australia is on hold and ready to follow the leads from the Fed and other central banks if needed
 - Consumer spending could surprise on the upside given high savings rates, pent-up demand, and resilient employment data

- Geopolitical tensions on multiple fronts could dampen foreign sentiment toward Chinese investment
- Recent economic data point to a slowing pace in the recovery, with weakness in retail sales concerning
- In Australia, lockdowns in Victoria are not boding well for other states given the spread of the coronavirus
- A risk exists that Australian fiscal measures could be wound down too quickly

- Emerging Markets**
- Demand from China has largely rebounded
 - USD strength has eased
 - Dovish Fed has given central banks flexibility to ease
 - Equity valuations attractive relative to developed markets

- Weak health care infrastructure in many regions
- Limited ability to enact fiscal stimulus (excluding China)
- Trade tensions have been reignited
- Highly sensitive to global industrial production and trade trends
- Commodity prices under pressure



* Includes Australia



		Positioning					Change
		Underweight		Neutral		Overweight	▼ or ▲ Month-Over-Month Change
		Change					
BONDS	U.S. Investment Grade		■				
	European Investment Grade					■	
	UK Investment Grade					■	
	Inflation Linked			■			
	Global High Yield					■	
	Floating Rate Loans					■	
	EM Dollar Sovereigns					■	
	EM Local Currency					■	
	EM Corporates					■	
CURRENCIES	U.S. Dollar		■				
	Euro					■	
	UK Sterling			■			
	Japanese Yen			■			

Asset Class	View
U.S. Investment Grade	Treasury yields remain anchored at low levels amid low inflation expectations. Cautious on IG given spread levels near fair value with weaker fundamentals and earnings trends.
European Investment Grade	Technicals remain in the driving seat, and the path of least resistance is tighter; nonetheless, positioning and liquidity concerns mean the asset class is vulnerable to volatility.
UK Investment Grade	Market technicals remain supportive, but there are still plenty of uncertainties around fundamentals given the size of the economic shock as well as looming Brexit risks.
Inflation Linked	Inflation expectations remain low amid slightly improving growth outlook. Central banks remain supportive, but longer-term downward pressures on inflation persist.
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.
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.
EM Dollar Sovereigns	Relative valuations less attractive after recent rally. Still offer attractive yield versus developed markets.
EM Local Currency	Improving sentiment on EM currency; valuations remain attractive with supportive developed market central banks and weaker USD.
EM Corporates	The impact of the global recession on emerging markets is difficult to gauge. Country-specific risks are elevated, but several cheap assets are not as vulnerable as prices reflect.
U.S. Dollar	USD valuations are expensive and interest rate differentials are no longer supportive. There is uncertainty over the presidential election, but the second coronavirus peak is stabilizing.
Euro	We see ongoing improvement in economic outcomes; however, after recent strength against the USD, we see more room for the euro to tread water near term.
UK Sterling	We remain neutral on sterling. Economically, the unwinding of the furlough scheme and risks of a second wave are likely to continue weighing on activity and the currency.
Japanese Yen	The outlook is somewhat balanced. An improving growth trend allied with narrowing global interest rate differentials are both supportive factors for the currency.

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