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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

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MARKET INSIGHTS

As of July 31, 2020

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.

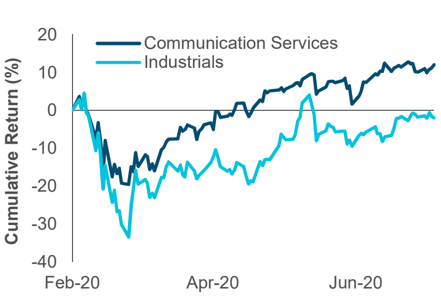
Not So Fast on That "V"

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.

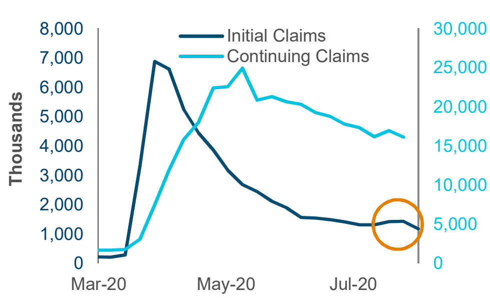
Dollar Can't Buy EM Relief

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.

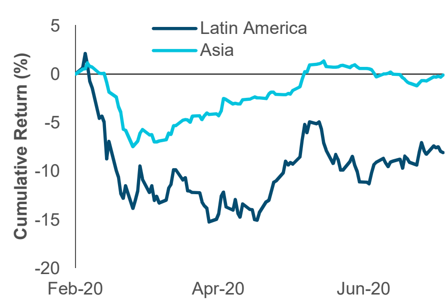
S&P 500: Communication Services vs. Industrials
As of July 31, 2020



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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[1]FAANGs 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

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	Underweight	Neutral	Overweight	Overweight	
ASSET CLASSES	Equities				■			Limited upside to equities as market has outpaced still uncertain economic recovery. Fiscal and monetary stimulus efforts are key supports, as earnings outlook remains clouded.
ASSET CLASSES	Bonds				■			Yields anchored at low levels amid central bank pledges of unlimited support and elevated risks around growth and coronavirus resurgence. Yields attractive within pockets of credit sectors.
	Regions							
EQUITIES	U.S.				■			Defensive sector profile supportive despite extended valuations. Fiscal and monetary stimulus providing backstop, while earnings recovery timetable remains uncertain.
EQUITIES	Europe				■			EU recovery fund significantly improves fiscal and political outlook. However, cyclically-oriented sector profile remains unfavorable given the low rate and low growth environment.
EQUITIES	UK				■			After heavy sell-off, price level is compelling. Bank of England and fiscal stimulus are supportive, but Brexit uncertainty remains.
EQUITIES	Japan				■			Fiscal and monetary stimulus could provide a solid backdrop for economic recovery. Remains highly sensitive to trade, and yen could strengthen if global risk aversion spikes again.
EQUITIES	Developed Asia ex-Japan*				■			Valuations attractive relative to the U.S. Chinese stimulus and successful containment of the coronvirus are supportive. Export- and commodity-driven economies face challenges.
EQUITIES	Emerging Markets (EM)					■		China stabilisation and weaker USD supportive for EM broadly. However, most countries are unable to provide the same level of stimulus as developed markets.
	Style							
EQUITIES	Global Equity Growth	▼			■			Valuations of growth-oriented equities further extended as pandemic has accelerated secular growth trends in key industries. Sector benefits from less sensitivity to macro environment.
EQUITIES	Global Equity Value	▲			■			Cyclically-oriented equities trailing in recovery, leaving valuations more attractive with potential upside should economic growth stabilize over the near term.
	Capitalization							
EQUITIES	Global Equity Large-Cap			■				Larger companies better positioned to weather economic downturn but offer limited upside due to full valuations.
EQUITIES	Global Equity Small-Cap					■		Relative valuations attractive and offer upside potential in periods of economic recovery. Remain vulnerable to impacts of virus on consumer and access to capital.

* Includes Australia

ASSET ALLOCATION COMMITTEE POSITIONING

As of July 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.

		Change	Underweight	Underweight	Neutral	Overweight	Overweight	
BONDS	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.
BONDS	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.
BONDS	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.
BONDS	Inflation Linked				■			Inflation expectations remain low amid slightly improving 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					■		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.
BONDS	EM Dollar Sovereigns					■		Relative valuations less attractive after recent rally. Still offer attractive yield versus developed markets.
BONDS	EM Local Currency					■		Improving sentiment on EM currency; valuations remain attractive with supportive developed market central banks and weaker USD.
BONDS	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.
CURRENCIES	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.
CURRENCIES	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.
CURRENCIES	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.
CURRENCIES	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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