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Investment Event

Adapting to a volatile environment

Global risk assets have sold off sharply and volatility has surged amid the global outbreak of COVID-19

The current environment suggests that a global recession is now the most probable scenario. The main question is how long and how deep it is likely to be

Our views

We believe it makes sense to adopt a more neutral tactical view on developed market equities in such a highly uncertain and volatile environment

However, we maintain a strategically pro-risk stance in the context of hugely improved relative valuations for risky assets

The current environment

Global risk assets have sold off sharply and volatility has surged amid the global outbreak of COVID-19. The current environment is characterised by the following:

- **COVID-19 has gone global.** In a little over seven weeks, the COVID-19 outbreak has developed from what was perceived to be localised problem with 278 recorded cases in Mainland China on 20 January this year to a global health emergency with over 135,000 cases currently reported across developed and emerging economies.
- **Global economic activity is deteriorating.** PMI data from China has already provided some indication of the extent of the damage to country's economy with a sharp deterioration in the manufacturing and services sectors highlighting that both the supply and demand sides of the economy have been heavily affected. There is likely to have been significant global spillover effects from this.
- **US is a source of risk.** After having been a main driver of global economic growth in recent years, the US is now a major source of downside risk. The low rate of testing may mean cases there have been under-recorded, increasing the chances that the US authorities need to adopt more stringent containment measures, as has been seen in Europe. Furthermore, a quick and forceful fiscal response could be complicated by a split Congress and the partisan divide in presidential election year.

Macro outlook

The sharp sell-off in risky assets is creating further challenges to the macro outlook. The widening of corporate spreads and equity selloff can create a vicious cycle where the corporate sector is put under further pressure and defaults spike, which risks damaging the macro outlook further.

Taking these factors together suggests that a global recession is now the most probable scenario. The questions now are how long and how deep it is likely to be. This is highly uncertain, there are four key metrics that are likely to be important determining factors:

- How quickly and how widely COVID-19 spreads through major economies
- How disruptive the containment measures taken by authorities are
- Whether labour markets deteriorate substantially
- Whether financial systems will be compromised

The spread of the disease, the associated containment measures and the first-round economic impact are beyond the control of monetary and fiscal policy makers. Their focus is on limiting the damage to corporate and household finances and to the financial system. It is critical that policy makers prevent a medical crisis triggering significant financial stress; recessions associated with high levels of financial stress tend to be deeper, longer and followed by a slower recovery.

Avoiding such outcomes is likely to require a broad and innovative mix of policy comprising lower central bank interest rates, large-scale liquidity provision and fiscal measures to support private sector cash flow and guarantee some private sector debt. Interest rate cuts and liquidity measures are now well underway, as is fiscal easing in some economies. Significant fiscal stimulus is now being floated in the US and eurozone, but as yet the plans lack much detail. We are monitoring developments in this area closely.

Higher prospective returns are a silver lining

Even with substantial policy easing, the economic outlook is likely to remain unusually uncertain and volatility in markets unusually elevated. Consequently, we believe a more cautious strategy is warranted in the short term. As part of this, we advocate a more neutral tactical view on developed market equities (1-3 months view).

However, while the environment is very challenging, there is a silver lining. Recent market moves have incorporated a lot of bad news which has materially increased prospective returns for risky asset classes.

The key question for investors is if this price action is in line with the expected deterioration in fundamentals or if emotions have run ahead of themselves and excess pessimism is being embedded in market prices. Although it is difficult to judge this at present, strategically (6-month+) we remain pro-risk, even allowing for higher perceived levels of volatility. Our latest views are summarised in Table 1.

A summary of our latest strategic and tactical House Views

Table 1: Latest House Views

<table>
<tr><th>Asset class</th><th>Strategic View (6+ months)</th><th>Rationale</th><th>Tactical view (1-3 months)</th><th>Rationale</th></tr>
<tr><td>Global equities</td><td rowspan="5">Overweight</td><td>Recent market performance has materially increased prospective returns - our measure of the global equity risk premium (excess return over cash) is very attractive.

A much looser global policy setting means there is scope for a recovery in risk assets once global economic conditions stabilise.</td><td>Neutral</td><td>Volatility is high and a global recession now seems probable on the back of the COVID-19 pandemic.

Global corporate earnings growth is expected to significantly deteriorate.</td></tr>
<tr><td>US</td><td>Corporate earnings have been outperforming other regions.

The Fed has more room than other central banks to ease policy.</td><td>Neutral</td><td>The risk of a US recession has significantly increased. Corporate earnings are likely to come under significant pressure and defaults will increase.</td></tr>
<tr><td>Eurozone</td><td>The European Central Bank has been proactive in supporting bank lending to the real economy and increasing asset purchases.</td><td>Neutral</td><td rowspan="2">Monetary policy support is constrained relative to other countries. There are political hurdles to meaningful fiscal support in the eurozone.

The eurozone and Japan’s export-dependent and globally-integrated manufacturing hubs makes them vulnerable to a weaker global growth environment</td></tr>
<tr><td>Japan</td><td>Japanese authorities have implemented policy easing, including a sizeable fiscal stimulus package and liquidity measures/asset purchases by the Bank of Japan.</td><td>Neutral</td></tr>
<tr><td>Emerging Markets</td><td>Emerging market equities tend to outperform on the back of Chinese stimulus. We continue to prefer Asian markets to other equity markets</td><td>Overweight</td><td>Emerging markets have more policy space to help stabilise economic conditions relative to developed markets.

Fed policy easing and lower oil prices is significant tailwind to many EM, particularly in Asia. Nevertheless, we acknowledge lower oil prices is a major headwind to EM petro-economies.</td></tr>
<tr><td>Developed market government bonds</td><td>Underweight</td><td>Prospective returns look very low and the market is already pricing in a very pessimistic growth scenario.</td><td>Underweight</td><td>At current valuations, it is uncertain if this asset class can act as a reliable portfolio diversifier.

We prefer other diversifiers.</td></tr>
<tr><td>Global investment grade (IG)</td><td>Underweight</td><td>Corporate fundamentals are beginning to come under pressure and valuations are relatively unattractive.</td><td rowspan="2">Neutral</td><td rowspan="2">Rising spreads already reflect increasing risks of a global recession and deterioration in earnings.
However, downside risk continues to be high as downgrades and defaults pick up. We recommend a defensive positioning within credits, looking for higher quality issuers, and avoiding impacted sectors</td></tr>
<tr><td>Global high-yield (HY)</td><td>Overweight</td><td>Recent spreads movements have increased the credit risk premium to a level that supports a move to overweight. We continue to prefer Asia credits to DM</td></tr>
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