July 2020

Multi-Asset Indicator

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Previously Investec
Asset Management

At a glance — our asset class views

Equities	--	-	0	+	++
North America		›	■		
Europe ex UK		■			
UK			■		
Japan			›	■	
Asia ex Japan				■	
Emerging markets				■	

Government Bonds	--	-	0	+	++
North America			■		
Europe ex UK			■		
UK	›	■			
Japan			■		
Emerging Markets Hard Currency			›	■	
Emerging Markets Local Currency			›	■	
Investment Grade Corporate Bonds		›	■		
High Yield Corporate Bonds		›	■		

Currencies	--	-	0	+	++
US dollar		›	■		
Euro			■		
Sterling		■	‹		
Japanese yen			■	‹	
Asia ex Japan				■	
Emerging markets			›	■	

■ View for the coming 6 to 12 months › Previous quarter's view

Views of Ninety One's Multi-Asset team and reflect preferences within respective asset class. As at 30.06.20.

Market review

After suffering a major decline in the first quarter of the year, markets staged a significant rebound through the second quarter as investors looked beyond dire unemployment numbers and shorter-term activity falls and became increasingly hopeful that the global economy could recover from its severe, sudden recession relatively quickly. Positive momentum in the markets was driven by slowing growth rates of COVID-19 cases in Europe and Asia and the reopening of economies. However, tension entered asset markets towards the end of the review period as new virus cases arose across the US, as well as a string of localised outbreaks in China and Germany. Nevertheless, the significant amount of liquidity in the financial system and a steady drip of improving data ultimately outweighed any concerns. Elsewhere, tensions between the US and China escalated, albeit to date without much meaningful impact on markets.

All Growth assets performed strongly. Global equities generated a return of almost 20%, led by the US, which having suffered the biggest quarterly decline since the financial crisis in Q1, enjoyed the largest quarterly percentage gain in more than two decades as waves of liquidity outweighed fears of virus exposure broadening in the US. Chinese and UK equities were the relative laggards, though the former leads year-to-date returns. After having been in negative territory in April, oil went on to have the best quarter in thirty years, although the market remains the worst performer year-to-date as producers continue to tackle the supply glut and waning demand. Rising markets and further stimulus policies announced resulted in renewed appetite in fixed income; high yield bonds in both the US and Europe performed strongly, as did emerging market debt which also benefited from a weaker US dollar.

Although they underperformed their Growth counterparts, Defensive assets also generated positive returns as developed market sovereign bonds benefited from the liquidity surge. Similarly, investment-grade spreads compressed during the quarter which saw prices rise. Given the risk-on environment, the Japanese yen was broadly flat against the US dollar, with these two currencies along with sterling lagging in Q2 against other G10 and emerging market currencies. Gold — also regarded as a 'safe-haven' asset — ended the quarter at a seven-year high.

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The value of investments, and any income generated from them, can fall as well as rise.
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A letter from Philip Saunders
Co-Head of Multi-Asset Growth

Just when it seemed the eurozone was coming apart at the seams under the pressure of the COVID-19 triggered recession, a major German policy 'pivot' has sewn it back together again. Chancellor Merkel may have had her mind on her pending retirement when, deftly, she took a leaf out of Winston Churchill's book, using the political capital gained from Germany's particularly effective confrontation of the pandemic to aggressively and speedily offset the impact of the crisis at both EU and national levels.

Historically, Germany seemed hidebound by fiscal austerity and populist opposition to the 'mutualisation' of debt in the eurozone, resulting in unbalanced growth and a euro continually undermined by the threat of an eventual breakup. While the current proposed measures fall short of a full fiscal union, they represent a firm step in that direction.

> "Never let a good crisis go to waste"
>
> —
>
> **Winston Churchill**

Germany has supported the European Commission's plans for an uplift to the EU's budget for 2021-2027 and an EU Next Generation Fund of €750 billion. This will result in the issue of common EU debt on an unheard-of scale. That a large amount of the debt will be issued in long maturities signals a strong commitment to the future of the union. Germany's proposed anti-COVID-19 boost for 2020, which includes fiscal spending and loan guarantees, amounts to over 27% of 2019 GDP, or some €130 billion – exceeded only by Italy in the eurozone.

So why has Germany done such a major volte-face and embraced demand stimulus? Put simply, self-interest. The realisation that the reliance on export demand had become excessive and was unsustainable might have something to do with it. In particular, the degree to which the German economic cycle had become synchronised with (and dependent on) China – a customer rapidly morphing into a competitor – had become all too apparent over the last decade.

At the same time, fiscal consolidation in the weaker southern European states after the global financial crisis had not been offset by fiscal expansion in Germany and the other northern creditor nations, leading ultimately to higher unemployment in the South than was necessary. Coupled with poor and deteriorating demographic conditions, this had indeed become a politically toxic combination. Underlying this policy revolution has been the emergence of a younger group of increasingly influential policymakers in Germany who understand the challenges their country has to confront in a broader European context, and are therefore less influenced by traditional German fiscal dogma.

What can we expect? Much greater fiscal flexibility across the EU, a focus on achieving higher nominal growth rates, green industrial agendas at national and EU levels aimed at accelerating the energy transition and a renewed focus – on the part of Germany in particular – on completing the single market. Should this occur, the eurozone could sustain a higher rate of domestic and hence overall nominal GDP growth than is reflected in current consensus expectations, which remain anchored and extrapolative. This in turn should increase the return on investment which has remained depressed in the post-2008 cycle, lending support to the euro and European equities.

Yet Europe will continue to face strong structural headwinds in the form of negative demographics, high government debt levels and, as the very pertinent Japanese example indicates, excessive reliance on fiscal measures without sufficient supply-side reform, which simply results in ballooning fiscal deficits. A return to traditional European 'dirigiste' top-down capital allocation at the expense of difficult supply-side reform may yet prove too tempting, although the negative impact of this might take time to manifest itself.

What are the investment implications? If achieved, higher nominal growth rates and higher spending on infrastructure would improve prospects for certain categories of large-cap cyclical businesses that have struggled in recent years and domestically-focused European mid caps more generally.

However, the accompanying financial repression – necessary to keep the cost of government borrowing low – would continue to be a severe headwind for banks and other financial businesses. This highlights the importance of defining beta through 'bottom-up' selectivity. Aggressive monetary measures have already driven peripheral credit spreads and eroded the available risk premia and, in an environment characterised by higher nominal growth rates and inflation, real interest rates on euro bonds would fall further.

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For further information on investment teams, please see the Important information section.

Portfolio positioning snapshot

An overview of our positioning in a selection of regions and currencies

Equities

Equities	--	-	0	+	++
North America		›	■		
Europe ex UK		■			
UK			■		
Japan			›	■	
Asia ex Japan				■	
Emerging markets				■	

US: 3

The rapid and aggressive policy response to the COVID-19 growth shock in the US has cushioned the blow. Excess liquidity conditions favour higher-quality and growth businesses, which are overwhelmingly found in the US, but valuations of these companies have reached such elevated levels that only a neutral allocation is now justified. Additional risks come from high leverage levels and capital allocation sustainability given the amount of capital that has been orientated towards expensive acquisitions and the accumulated goodwill that has resulted. Cash balances are low and shareholder return policies are highly procyclical.

Europe ex UK: 2

The large growth shock has been met with an aggressive policy response and provided new impetus to structural reform. The green deal will provide a further boost to companies facilitating decarbonisation, but the region also needs to find ways to address chronic issues of over-indebtedness, a lack of competitiveness in digital technologies and to revive a financial system which is hampered by the interest rate environment and by an excess of capital relative to attractive lending opportunities. Overall, corporate fundamentals remain under pressure with weak profitability, high leverage and the need to prioritise capital preservation over shareholder returns. In particular, high typical pay-out ratios make the dividend sustainability picture in Europe concerning. Valuations have returned to expensive levels and medium-term momentum remains very weak.

UK: 3

The joint shocks of COVID-19 and Brexit have struck a domestic economy with stubborn supply-side and productivity issues and an equity market overly concentrated in structurally-challenged industries, particularly energy and banks. Historic valuations are a less useful guide for these parts of the market and we expect investors to continue to demand a higher risk premium for these sectors than has been the case before. The near-term fundamental outlook is also weak, with a sharp fall in profitability at a time where the market in aggregate was already paying out over 100% of earnings to shareholders, forcing many of the largest dividend payers to cut these back drastically.

Japan: 4

Domestic disruption has so far been much lower than in other regions, setting the scene for a strong rebound as activity returns first in Asia, then in the rest of the world. Profitability has seen a down cycle, but the trough may be near and the trend of improved capital allocation has not wavered. Balance sheets are very defensive with cash balances increasing even with rising dividend payouts. The unwinding of cross holdings, improved shareholder returns and better corporate governance are long-term positive drivers that continue to be supported by government policy.

Asia ex Japan: 4

The growth shock hit Asia first and hard, but activity is returning rapidly. Demand from developed markets remains weak, but as it returns capacity utilisation can recover sharply. Valuations are reasonable and with the growth cycle bottoming before other regions, they will look increasingly attractive on a relative basis as cashflows and earnings recover. The rise of the Asian middle class continues to offer substantial domestic growth opportunities as the demand for consumer, financial and healthcare products and services increases sharply with higher incomes. There are long-term improvements in capital intensity and research and development (R&D) caused by the shift towards consumption and service-based sectors. Financial risk and the capital allocation outlook are positive given strong balance sheets and low payout ratios.

Emerging Markets: 4

The management of the health and economic crises brought about by the COVID-19 pandemic has, in many cases, been more effective in emerging markets than in developed markets, creating a stronger base for economic recovery. Corporate fundamentals have also proven more resilient, assisted by stronger balance sheets, more conservative capital allocation and durable shareholder returns. This is particularly true of the larger Asian markets which make up the majority of EM market capitalisation. Domestic growth opportunities remain more abundant in emerging markets and as these countries seek to move further up the value chain, local companies should be able to capture an increasing share of the fastest growing end markets. The positive fundamental outlook is further enhanced by very attractive relative valuations.

Fixed Income

Government Bonds	--	-	0	+	++
North America			■		
Europe ex UK			■		
UK	›	■			
Japan			■		
Emerging Markets Hard Currency			›	■	
Emerging Markets Local Currency			›	■	
Investment Grade Corporate Bonds		›	■		
High Yield Corporate Bonds		›	■		

North America: 3

Despite US growth rebounding and the prospect of higher inflation as base effects suppressing prices wash out, the US Federal Reserve's aim to raise inflation expectations by keeping real yields low for the foreseeable future is likely to pressure the yield curve to steepen. Valuations, both structural and cyclical remain very expensive. We therefore score this market as neutral.

Europe ex UK: 3

Valuations are less expensive in the eurozone, where they are supported by the persistent and lacklustre growth outlook. We are neutral, however, as the unique nature of the eurozone's social security safety net protects citizens from the worst of the economic fallout from the downturn and so economic growth should prove to be more resilient. This will be further strengthened by the extraordinary fiscal and monetary easing in the region, which is in excess of that seen in the US.

UK: 2

The modestly negatively score is based on the extent of the overvaluation of gilts. This is being driven by the market pricing-in a small probability of a negative Bank Rate, and fears about a hard Brexit at the end of the year. With growth and inflation likely to rise in the coming months, and the Bank of England seemingly reluctant to increase quantitative easing further, there appears little reason to recommend UK government bonds.

Japan: 3

Japanese government bonds are modestly cheap on our shorter-term cyclical valuation assessment but remain expensive on a structural basis. With a market repressed by huge Bank of Japan buying and explicit control of the yield curve, any cyclical uptick and bounce back in growth will have a limited impact on the market. We remain neutral, especially as one of the principal attractions of Japanese government bonds – their attractive yields when swapped into US dollars – is not available at the moment due to an ample supply of US dollars in the financial system.

Emerging Markets Hard Currency: 4

The sell-off seen in March has left emerging market hard currency bonds cheaply valued. Monetary policy in developed economies will support a search for yield, and thus support hard currency debt of higher-quality countries. While the overall macroeconomic backdrop is a headwind, and market price behaviour is still negative, Mexico, Israel and Qatar are markets that look attractive.

Emerging Markets Local Currency: 4

We are positive on emerging market local currency debt as yield curves are steep and real yields are relatively high, with real effective exchange rate depreciation helping to shoulder the economic burden resulting from COVID-19. We favour those markets that have a significant yield advantage over developed market bonds, such as Mexico, Russia, Indonesia and South Africa.

Investment Grade Corporate Bonds: 3

We score investment grade corporate bonds as neutral. Despite markets being close to fair value, our assessment of quality is negative driven by a deterioration of corporate fundamentals, in particular rising net leverage and a deterioration in interest coverage, while momentum remains negative. Monetary policy, however, is a clear positive for investment grade debt, with large scale asset purchases supporting prices, despite the economic headwinds corporates face. We have a preference for the eurozone over the US, due to the quality score in the former being driven by stronger corporate fundamentals and market price behaviour being less negative.

High Yield Corporate Bonds: 3

While we believe high yield corporate bonds are modestly cheap, this is offset by our assessment of fundamentals and market price behaviours leading us to be neutral. In particular, weak economic growth is a big negative especially for highly geared corporate borrowers and our quality scores reflect this; pointing towards a deterioration in corporate fundamentals, led by rising leverage and lower interest coverage. Negative momentum also remains a drag. However, significant policy easing is clearly supportive as investors search for yield and central banks increase purchases.

Currencies

Currencies	--	-	0	+	++
US dollar		›	■		
Euro			■		
Sterling		■	‹		
Japanese yen			■	‹	
Asia ex Japan				■	
Emerging markets			›	■	

US dollar: 3

The US dollar is torn between an expensive valuation and a US Federal Reserve that is attempting to engineer deeply negative interest rates, versus a more dynamic structural economic backdrop than other major developed market currency blocs. Coupled with a global shortage of US dollars outside the US border, the greenback is currently behaving defensively. Looking forward, if current reflationary efforts are successful, risk seeking behaviour will reassert itself and the dollar's expensive valuation will likely see it drift down. However, for now, we are neutral.

Euro: 3

The single currency scores poorly on our FX framework, with an unstable monetary union and negative interest rates seeing savings flow out of the eurozone in search of higher returns. It is possible that this negative backdrop is already reflected in the euro's valuation, where we see it at fair value. We therefore remain neutral.

Pound sterling: 2

Sterling is cheap, investors are negative but the twin challenges of a poor response to COVID-19 and the prospect of a messy and final exit from the EU at the end of 2020 will keep sterling under pressure.

Japanese yen: 3

Japan faces massive structural disinflationary headwinds which the Bank of Japan and Ministry of Finance are attempting to offset with extraordinarily loose policy. However, Japan is a competitive economy and the yen is modestly cheap. We are therefore neutral given no obvious large differentiation between it and the US dollar or euro.

Asia ex Japanese yen: 4

The Chinese renminbi is attractive as China continues to reform its economy in order to achieve more sustainable growth, has eased less than other major economic blocs in response to COVID-19 and flow dynamics are positive. However, these positives are reflected in renminbi valuation, which is quite expensive. We therefore also express our regional preference in the Korean won and Taiwanese dollar.

Emerging market currencies: 4

The backdrop for emerging markets has improved given the recent turn in global growth and very aggressive developed market central bank policy. The repression we are seeing elsewhere will be supportive for high real yield emerging market currencies with cheap spot rates/ real effective exchange rates. We favour Indonesian rupiah, Mexican peso, Russian ruble and South African rand.

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