Perspectives

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IN SHORT

- Despite slower momentum, the economic recovery is continuing to unfold
- Central banks actions are likely to keep yields contained and bonds well behaved
- Risk assets are likely to remain supported, even if the ride will probably be bumpy.

Staying the course

While momentum has slowed in light of rising cases, in the US in July and in Europe in August, the economic recovery continues to unfold. European PMIs and US consumer confidence dipped in August, but overall data remains relatively buoyant, with a very strong US housing market, a resilient labour market across most of Europe, and an ongoing bounce in Chinese data. In our view, as long as this remains the case, markets can continue their advance as well.

While a rise in cases is concerning, we do not expect renewed generalised lockdowns, suggesting an uneven road ahead, but no sudden stop. In addition, expectations are for a slowdown in growth momentum following the initial V-shaped bounce seen after the spring lockdowns. As such, less robust data is unlikely to surprise markets – it is broadly expected.

Beyond an ongoing recovery, markets also need stimulus measures to continue. Here again, we expect this will be met. Central banks have already stated they would remain ultra-accommodative for a long time (years, in fact), and Mr. Powell's Jackson Hole speech is expected to indicate more flexibility towards inflation, suggesting low rates for even longer than the currently-indicated 2022. Across Europe, unemployment programs are being or likely to be extended. The onus now sits with the US, where Congress must pass the CARES Act 2 to prolong unemployment benefits and support the consumption recovery. While the sense of urgency has clearly passed, we expect pressure to resume and the 'phase 4' package to be agreed.

Finally, technicals remain supportive, with sentiment and positioning not overly aggressive. Short positions have fallen in recent weeks, but they remain short. Sentiment is still more bearish than bullish. And relatively few flows have returned to equity markets compared to the barrage of outflows witnessed during Q1. At the same time, money market flows have slowed but they continue, leaving a trillion dollars of cash sitting on the sidelines. As such, we believe that the risks ahead are likely to lead to higher volatility, but no pronounced sell-off. Moreover, these scenarios, like the slower growth momentum, are known. Tensions between the US and China have risen significantly, but both sides are likely to avoid costly economic consequences that could derail the nascent recovery. And while the upcoming US elections are unlikely to be drama-free, markets do not appear overly concerned with the result, or its medium-term impact on markets.

In this context, we remain slightly overweight equities, admittedly with the expectation that the ride may not be smooth. Conversely, we believe that bond markets will remain well behaved. Sovereign yields are likely to remain contained, but unlikely to fall much, suggesting less performance potential than in credit, where we maintain a preference for investment grade and some exposure to emerging market hard currency corporate debt for potential spread tightening.

Asset class details

Equities

We remain constructive on equity markets as the economic recovery is unfolding, despite slower momentum due to rising cases; fiscal and monetary stimulus is set to continue; sentiment and positioning are not overly bullish; and a more complicated year end is anticipated. Given the amount of cash sitting on the sidelines, geopolitical tensions and US elections are likely to generate headlines and volatility, but we believe the downside remains more limited. Valuations are rich on a number of sectors, but should not prevent the market's advance. As such, we hold a slight overweight to equities.

In the short term, we believe that European assets can play catch-up to their US counterparts. Europe managed the initial COVID crisis well and should be able to deal with the new rise in cases. Fiscal policy is supporting labour markets. Moreover, further integration and cooperation thanks to the European Recovery Fund have helped remove fears of a Eurozone breakup. European financials should additionally benefit from European Central Bank support and continue their recent bounce. Over the longer-term however, a number of structural winners in the US should maintain strong performance there.

We have brought our emerging markets allocation back to neutral, but maintain our preference for emerging Asia.

Fixed Income

Sovereign bond yields continue to trade within a broad range, with expectations for ultra-accommodative policy to last for years to come capping yields. Indeed, Federal Reserve Chairman Powell is expected to highlight a tolerance for above -target inflation, suggesting interest rates will remain at zero for a very long time.

We expect European peripheral yields to continue to benefit from the European Recovery Fund and the upcoming European Commission issuance of common debt, with a preference for Italy, which is navigating the summer rise in cases particularly well so far.

Overall though, we maintain our preference for investment grade credit, where carry is more attractive and spreads can compress further. We remain more cautious on high yield as the extent of the damage from the crisis is still unknown and default risk remains elevated.

We continue to see opportunities in emerging market hard currency corporates debt that has potential for spread tightening. However, given difficult situations in many countries, selectivity is key.

Currencies

We expect the US dollar to continue its recent slide against the euro, but believe the bulk of the move might be behind us. Nonetheless, we expect further weakness to materialise. The dollar should continue to hold up better against safe havens such as JPY and CHF, given resilient risk appetite. Some volatility on sterling is likely as the Brexit deadline approaches and the UK and Europe remain far from an agreement. Emerging market currencies should benefit from a weaker USD, but idiosyncratic risks remain.

Commodities

Oil prices continue to recover as demand gradually picks up and supply cuts have held, but are still likely to eventually be capped by ongoing oversupply and a soft economic recovery. We expect demand for gold to continue given low real yields, rising inflation expectations and ongoing central bank QE programs.

Alternatives

We continue to see a place for alternatives in portfolios, as we look for de-correlating and diversifying strategies to complement traditional asset classes. We believe that real assets can also help provide income in a lower for longer world.

Asset Classes	Negative	Neutral	Positive
Equities			●
Fixed Income		●	
Equities			
US		●	
Europe			●
Japan			●
Asia ex Japan		●	
Emerging Markets	○	●	
Asia			●
Latam	○	●	
Europe	●		
Fixed Income			
Sovereign US			●
Sovereign EUR		●	
IG US			●
IG EUR			●
HY US	●		
HY EUR	●		
EM Hard Ccy			●
EM Local Ccy		●	
Commodities			
Oil		●	
Gold			●
Base Metals		●	

● Current month ○ Previous month (no dot means no change)

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