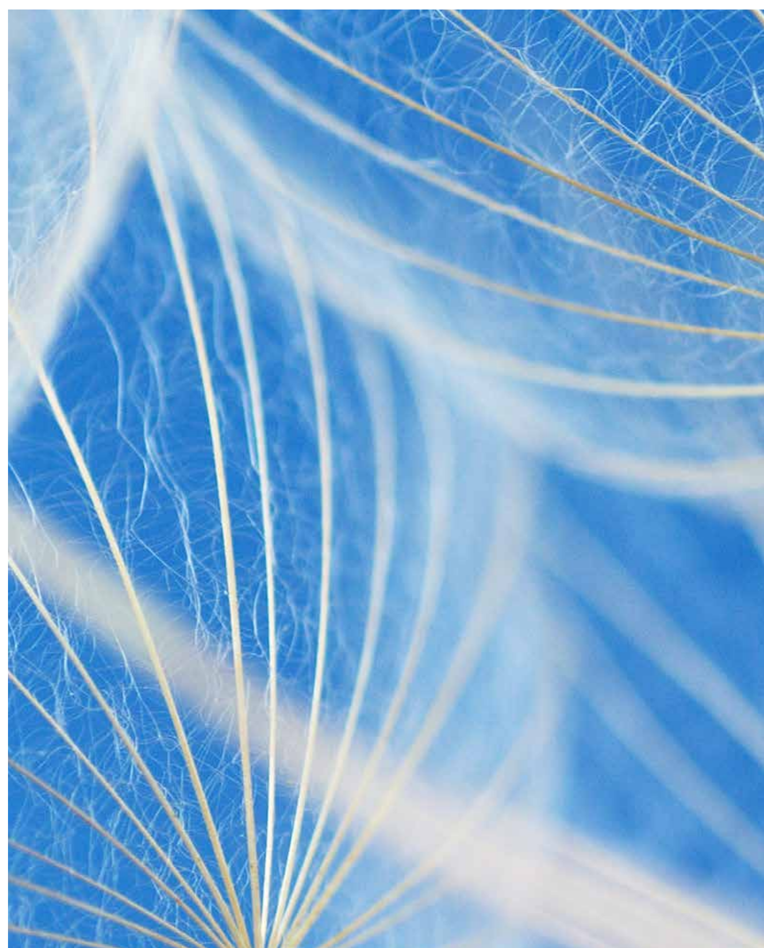
For professional clients only.
Not to be distributed to retail clients.

CIO outlook:

Time for healing

Legal & General
INVESTMENT MANAGEMENT



Foreword:
A fresh start

Despite the ongoing challenges, we see next year as a time for healing – for the economy, environment and society.

After contending with the terrible human and economic toll of a pandemic, as well as market volatility reminiscent of the financial crisis, investors could well be forgiven for wondering anxiously: what could 2021 possibly have in store for us?

We cannot, of course, predict the outcome of risk events already on the horizon, let alone identify any black swans fluttering menacingly. But based on our research and the available information, we can sketch out the contours of next year's macro and market landscape. Pleasingly, we believe it is one in which investors can thrive, albeit with the right approach.

In this outlook, we offer views from across LGIM that inform this optimism, grounded in our assessment that even though the world economy's immediate prospects may have darkened, 2021 could still be a strong year for growth. Other key points include:

- The bull case for equities at this point in the cycle
- How a Biden administration could create ripples in the bond market
- The role of cashflow-driven investing in tackling market gyrations
- Why 2021 could be a pivotal year for battery technology and renewable power
- How China's financial sector is opening up potential opportunities for investors

As we noted in our autumn update, COVID-19 has accelerated a number of long-term investment themes that were previously underway. The global energy transition is an obvious example, as the shock of coronavirus has focused attention on the looming threat of climate change just as it has shaken up carbon-intensive industries.

At the same time, environmental regulations are likely to tighten under the incoming US administration, whose climate policies will have a worldwide impact. The changing of the guard in Washington, meanwhile, brings us to another long-term trend: populism.

While Donald Trump lost the 2020 US election, the result was not a repudiation of everything he stood for. We will need to continue monitoring the way our politics have changed forever as a result of the forces that propelled the outgoing president, and other populists around the world, to power and sustained them in office.

It's also clear that many Americans continue to view China unfavourably, despite the election result, with the uneasy relationship between the world's two largest economies likely to be a key driver of geopolitics for the foreseeable future.

In Europe, even though a UK-EU trade deal now looks probable, much else remains to be decided after the Brexit transition period ends. Expect the UK's long divorce from the bloc never to stray too far from the headlines, or the radar of investors, next year.

And while we look forward to a post-pandemic world, we are still living with coronavirus and the dramatic steps taken to contain it. As such, expect further debates over fresh monetary and fiscal stimulus to be a prominent feature of the coming months – even as we contemplate the ultimate cost of such measures.

Despite these challenges, we see next year as a time for healing – for the economy, environment and society – in which we can play an important role on our clients' behalf, by seeking to create a better future through responsible investing.

Sonja Laud
Chief Investment Officer

Economics: **Unlocking growth**

The immediate economic outlook may have darkened, but there are reasons to believe 2021 could be a strong year for global growth

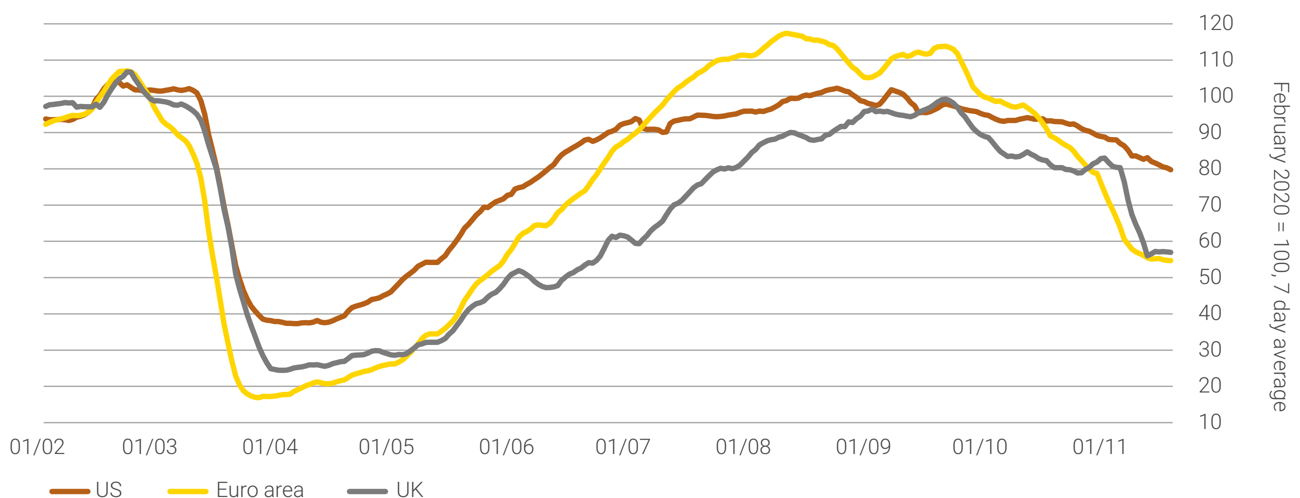
The primary downside risk we saw for the economy – further waves of COVID-19 leading to renewed lockdowns – has sadly materialised across many parts of the northern hemisphere. While we don't expect the impact on the economy to be as severe as it was during the spring, the measures taken by European governments during the autumn and winter are likely to lead to another significant fall in output following the strong summer rebound.

The US has been slower to respond and, as pressures build on hospitals, the approach taken to tackle the virus across different states is likely to toughen.

The US probably has sufficient momentum into November to avoid an outright contraction in the fourth quarter, but the holiday season will now be far from normal.

After rapid progress to reduce unemployment, the improvement in the labour market could stall or even reverse heading into 2021. The US election outcome, discussed by Jason on page 8, has reduced the chance of a radical shift to sustained fiscal expansion, but we still expect some additional support to emerge in the coming months in response to the deteriorating virus news.

Fresh lockdowns reduce mobility across major economies



Source: Apple mobility data, as at 17 November

Vaccine change

Offsetting the gloom are several positive developments. First, China has largely eradicated the virus and so has a much greater chance of successfully deploying track, trace and testing programmes to prevent future outbreaks. Second, we have seen how quickly activity can recover once restrictions are eased. But most crucially, progress on developing safe and effective vaccines has continued, bringing forward a potential return to normality – or something approaching that condition – by one or two quarters.

We still await more comprehensive data, and there will be logistical and public-relations battles ahead before the world can reach herd immunity – or at least reduce the threat of the virus – to allow most people to resume normal activity.

Yet although the precise timeline remains uncertain, we expect more widespread distribution of vaccines to begin in the spring. As restrictions ease from the winter and confidence builds that the end is in sight, activity could rebound strongly through the course of 2021.

Aiding the recovery will be exceptionally loose monetary policy as central banks focus on preventing inflation from dipping further below target. There is also an understanding from fiscal authorities that next year is not the time to address the large budget deficits caused by the response to the pandemic.

Bringing all this together, our central view expects global GDP to finish 2021 around 3% below its pre-virus trend, but there remains huge uncertainty around this outcome, with risks skewed to the downside should a vaccine be delayed.

Beyond this horizon, there is a concern the pandemic is causing lasting economic damage through capital stock obsolescence and belief scarring, which leads to increased saving and caution around future investment. However, it is also possible to see the potential for creative destruction and increased dynamism, accelerating change and boosting productivity.

Tim Drayson
Head of Economics

Asset allocation:

The year of hope

We believe the economic outlook is positive for equities, but investors will probably need to think carefully about their allocations to fixed income.

My takeaway from Tim's economic outlook is that 2021 will be the year of hope. The fundamental backdrop he describes should boost equity markets in particular as investors start to see a potential end to the economic and social hardship of the past year.

But this isn't just about optimism. We are only early in the economic cycle, with a meaningful output gap that can still be closed, while recession risk is low and there are limited inflationary pressures. Risk-adjusted equity returns from this point in the cycle have historically been strong.

Valuations are not a troubling headwind either. Equities may look expensive in absolute terms, but on a relative basis the equity risk premium – the equity earnings yield minus bond yields – remains attractive, in our view.

All things considered, our base case would therefore be that equities are among the best-performing asset class in 2021; we would not be surprised to see double-digit returns.

One point to note is that we are obviously not alone in this view. Sentiment has turned bullish for the first time since the pandemic, and at some point in 2021 it is very likely that markets will price in too much optimism. For now, though, we think this is too early to be a dominant factor.

Low pressure

We continue to believe in our 'lower for longer' theme in fixed income, seeing limited upside potential for bond yields from their current levels. We expect inflation dynamics will become more important than growth dynamics in determining bond yields once we get past the recession phase. That has been true for the past four cycles, but should be even more important now that the Federal Reserve (Fed) has indicated it will not react pre-emptively.

That should mean positive news on the vaccine rollout is unlikely to be enough to put sustained upward pressure on bond yields. We will also need evidence that inflation is moving sustainably above 2%, which is very unlikely to happen in 2021 with unemployment still extremely high.

On the corporate side, investment-grade credit is in our view less attractive than other risky assets like equities, given the compression in spreads seen since March. Today's tight spreads are partly a reflection of subdued corporate bond defaults thanks to fiscal support, cheap financing and the prospect of a vaccine in 2021.

Our core views for the medium term

Risk stance: slightly positive overall

Economic cycle

Coming out of recession is most positive phase of cycle

Valuations

Relative valuations now less attractive

Systemic risk

Concerns around both political and credit risk

Economic cycle

- High conviction on the vaccine by mid 2021 at the latest
- Coming out of recession is most positive phase of cycle
- We see the economic impact of the latest round of lockdowns as short term

Valuations

- Relative valuations less attractive post market rally
- Credit spreads now below average
- Relative valuations more relevant than absolute

Systemic risk

- Troubled relationship between US and China
- Chinese credit risk now less of a concern
- Focus on downgrades and defaults in the US

Source: LGIM. Views current as at November 2020.

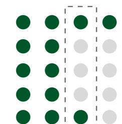
Returns from credit do not typically accrue evenly; instead, and perhaps understandably, they tend to be higher when starting spreads are wider. That suggests to us there is potential value in having space in portfolios to add significantly to credit in extreme selloffs. Admittedly, that comes at a cost – namely the returns given up by patiently waiting for a better entry point – but we believe it's the right framework for thinking dynamically about credit for the medium term.

A low yield environment provides challenges for investors both from a return and a risk mitigation perspective. Though there is no single panacea, one of the measures we believe investors can take is to look at smaller, non-traditional fixed income markets to find better risk-off hedges. Smaller rates markets with higher yields that could still fall become more interesting and important, for example. At the time of writing in mid-November, these include South Korea 10-year bonds yielding over 1.5% and Australian 30-year yields over 1.8%[1]

Asset class views

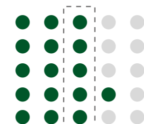
Overview

Equities
Duration
Credit
Inflation
Real estate



Equities

US
UK
Europe
Japan
Emerging markets

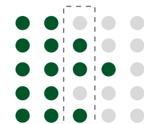


Fixed income

Government bonds
Investment grade
High yield
EM USD debt
EM local debt

Currencies

US dollar
Euro
Pound Sterling
Japanese Yen
EM FX



= Strategic allocation

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of November 2020.

The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point.

Emiel van den Heiligenberg
Head of Asset Allocation

1. Source: Bloomberg, as at 16 November, 2020. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

US politics and policy:

Biden, bonds and the limits of presidential power

Despite its limited room for manoeuvre, we expect the Biden administration to make some ripples in the fixed income market.

Somewhat lost in all of the noise surrounding the 2020 presidential election is the fact that control of the Senate remains undecided: in order to reclaim the upper chamber of Congress, the Democrats need to win both Georgia seats in a runoff election on 5 January.

Betting markets imply about a 30% chance of this happening, as at the time of writing. Yet even if the Democrats do succeed in Georgia, it would be difficult to characterise this victory as looking anything like the 'Blue Wave' outcome expected before the November election.

Democrats look to have lost about 10 seats in the House of Representatives, which means Speaker Nancy Pelosi will operate with the slimmest margin in that body for 20 years. A 50-50 split in the Senate could be even more difficult to navigate, particularly as Senator Joe Manchin (D-WV) has expressed opposition to ending the filibuster – a tool to delay legislation and appointees. As such, President-elect Joe Biden's agenda will likely need to be scaled back significantly.

That said, the last two years of the current administration have demonstrated the power of executive orders to circumvent Congress. A newly elected President Biden will probably use the same tools to tackle immigration, trade, energy and housing policy.

Different journeys for energy and managed care sector spreads (bps)

Source: Bloomberg and LGIM America, as at 13 November, 2020. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

And yet there are likely to be legal setbacks along the way, much as President Trump encountered. Consider energy: while rejoining the Paris Climate Accord should be relatively straightforward, the President-elect's plans for a green energy policy could hit considerable resistance in courts, where the previous administration was able to appoint more conservative judges.

Biden's signature agenda items – taxes, healthcare and infrastructure – will face even longer odds. Without being able to circumvent the Senate filibuster, it will be nearly impossible to reverse the Trump tax cuts. As a result, corporate and personal tax rates will stay at current levels at least until 2022, which will in turn lower the likelihood of an expansive infrastructure deal.

Lower for even longer

Meanwhile, it is quite likely that components of the Affordable Care Act (ACA) will be found unconstitutional by the Supreme Court and require legislative fixes. Rather than expanding the ACA as he would like, the new president may find himself fighting to preserve the existing platform.

For bond markets, the failure of the Blue Wave to materialise decreases the likelihood of an imminent shift away from the theme of lower for longer, as less expansive fiscal policy implies there will be less upward pressure on interest rates.

There are equally important implications at the sector level for corporate credit. While US energy companies will remain in focus as investors increasingly consider ESG themes, the pressure on the industry is likely to be less acute with the control of government more divided.

The risks around a wholesale change to the healthcare reimbursement ecosystem seem to have waned, meanwhile, but the managed care and pharmaceutical sectors could yet face headwinds even if they are less severe than previously anticipated.

In short, we believe 2021 is shaping up to be a year of opportunities for fixed income investors, where the policy backdrop will probably remain supportive and the Biden administration will make some ripples in the market – despite the President-elect's limited room for manoeuvre.

Jason Shoup
Head of Global Credit Strategy,
LGIMA Fixed Income

Energy:

Batteries charge up the renewable agenda

We believe battery technology is the key to unlocking the potential of renewable power, and 2021 could be a pivotal year for this market.

220 years have passed since Alessandro Volta paired copper and zinc discs separated by a layer of cardboard and salted water. Now, thanks to some recent breakthroughs, the battery technology market is again in an early growth phase, ready to power the next technological revolution in 2021 and beyond.

Of course, battery technology has not been static through those two centuries, as is evident from how electronic devices have become ever smaller and able to go for longer without charging.

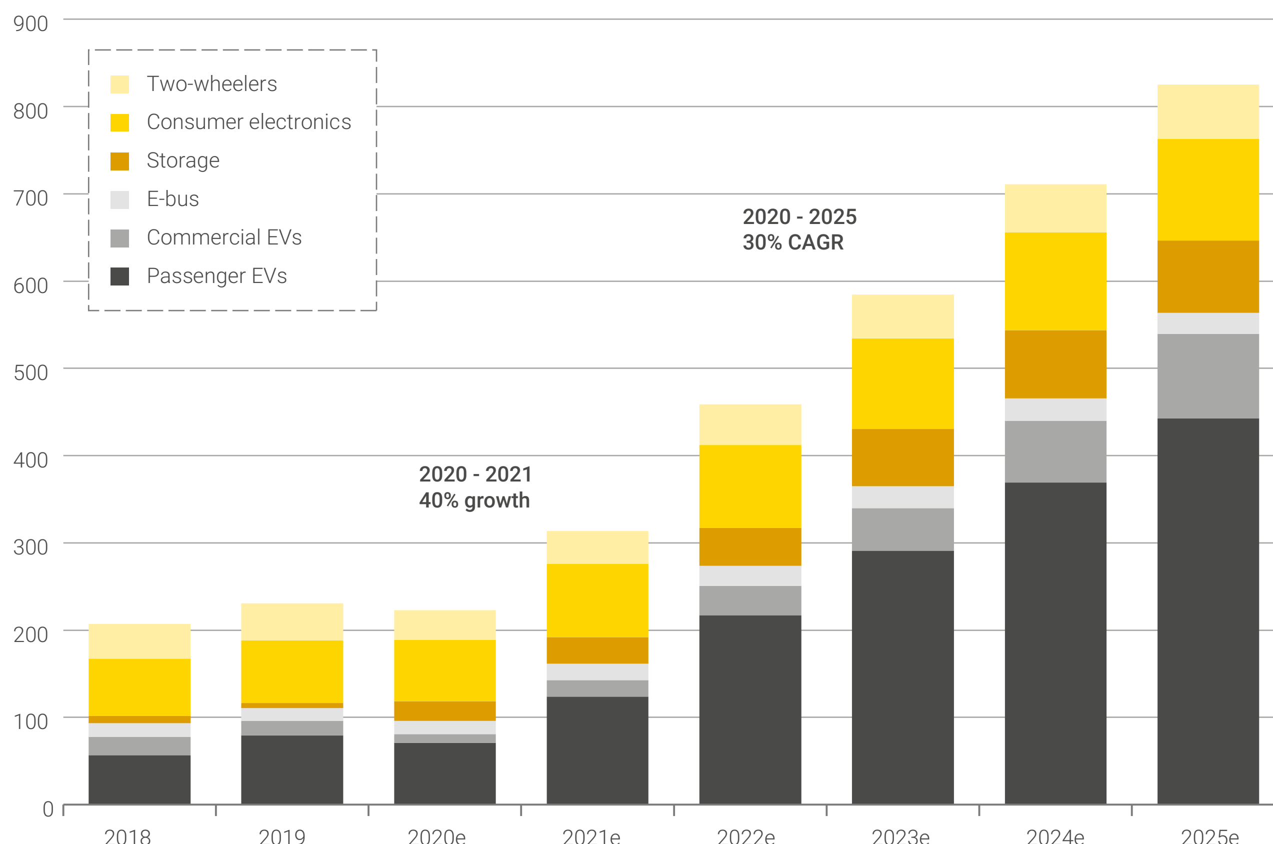
But two events late in 2020 really electrified the industry: Tesla's* admission to the S&P 500, and the UK's plan to ban the sale of new cars fuelled solely by petrol or diesel from 2030.

Epitomised by the rise of Tesla, a company that we believe should be recognised as much for its battery innovation as its car design, these welcome steps illustrate how investors can focus on batteries principally as an element of the electric-vehicle revolution.

That market, however, is only part of the role batteries will play in helping the world move to a less carbon-intensive economy. We believe they will also be vital in harnessing the potential of renewable energy.

*For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

Electric vehicle battery demand *(GWh)* is forecast to surge after COVID-19



Source: Bloomberg New Energy Finance, as at June 2020. There is no guarantee that any forecasts made will come to pass.

Charging at windmills

Fossil fuels have accounted for most of the world's mix of power generation since the 1970s, but according to BloombergNEF, renewables are now poised to take the lead. Wind and solar technologies alone are expected to provide 48% of all our electricity by 2050.

This progress is both exciting and essential, but the utility of clean energy will be limited without better and more extensive battery storage. Improved energy storage can help overcome the short-term intermittency – due to daylight hours or fluctuating weather – of renewable sources. Without an upgraded storage infrastructure, much of the electricity that could potentially be generated by renewables will be lost, and coal and gas-fired power stations will remain necessary to cover supply shortfalls.

Encouragingly, 2021 should be a marquee year for storage capacity. The world's largest new battery installation was completed near San Diego in August, and we expect that record to be broken again next year. For example, the new San Diego plant has a capacity of 250 megawatts (each megawatt can serve an estimated 750 homes). Another new project just south of San Francisco will provide 400 megawatts of storage when completed in 2021.

Maintaining this trajectory of progress, underpinned by the advances made in battery technology, will be critical in achieving the energy transition necessary to avert the climate emergency.

Aanand Venkatramanan
Head of ETF Investment Strategies

Letter from Hong Kong:

Meanwhile, in China...

China's financial sector is clearly growing more dynamic, opening up significant opportunities for international investors, in our view.

While global investors have understandably focused on the US election, virus waves and a potential vaccine, seismic events have also been occurring in the world's second largest economy with similarly significant implications.

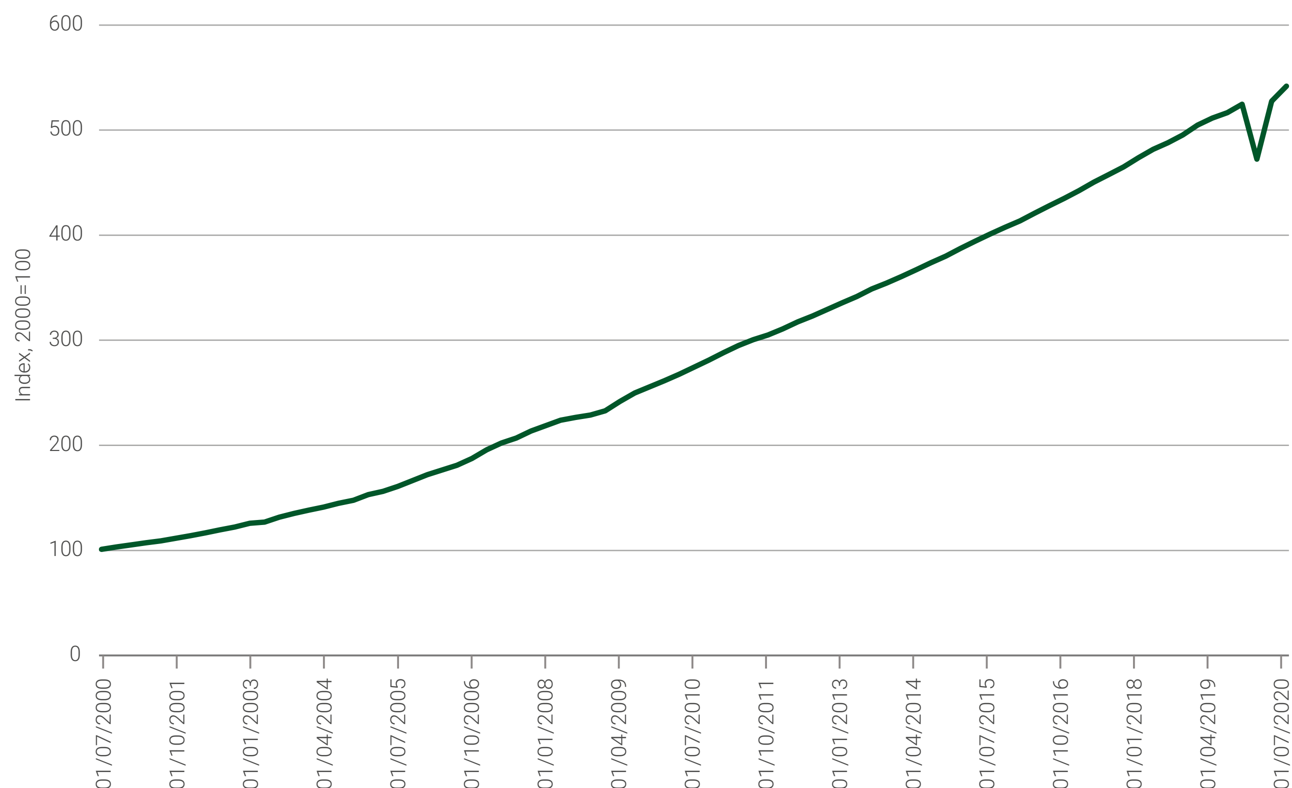
First, it's easy to underplay just how successful the country has been at controlling the virus and returning to pre-pandemic economic output. The benefits of an efficient track-and-trace system are obvious. And by getting back on its feet quickly, China has avoided much of the sustained unemployment and defaults that will scar Western economies for years to come.

The cost is government control of private data. But for now, economic practicalities dominate such concerns and, in our view, China is well placed to be a relative winner from this crisis.

The technology sector has been another pandemic winner, but the second key event in China has been the regulatory focus on its domestic players. Clearly, the country has some extremely successful technology companies, with Alibaba* recently announcing that Singles Day sales totalled 498.2 billion yuan, an increase of 26% versus last year.

But Alibaba's founder Jack Ma publicly criticised Chinese regulators for holding back technological innovation, with an investigation and suspension of Ant Group's* impending IPO quickly following, ultimately causing the roughly $35 billion capital raise to be postponed. This doesn't look like an isolated incident, with China announcing a set of draft rules against the broader monopolistic behaviour of its technology sector. A motivation for such intervention is to protect consumers and nip fintech systemic risks in the bud.

Chinese GDP bounces back



Source: Macrobond, as at July 2020. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Constrained expansion

Does this spell the end for the Chinese technology boom? Certainly not if you believe the latest plenum of China's Communist Party, which declared that self-reliance in science and technology is a strategic pillar of national development.

Perhaps the unconstrained expansion is over. But even constrained growth is attractive in a country expanding much faster than Western economies, so many investors could see recent market volatility as potentially an opportunity to add exposure.

The final key event is actually more of an ongoing trend, arguably even more important than the first two. This is the opening up of domestic Chinese financial markets; the internationalisation of the renminbi; and the introduction of risk into previously 'bullet-proof' investments, such as dominant property developers and bonds issued by state-controlled entities.

The direction is clearly towards a more dynamic financial sector, with significant opportunities for international investors. Here, the result of the US election will be influential, as the new administration will have to decide how much to push against China's globalisation and how much to embrace it.

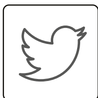
Once a COVID-19 vaccine has been successfully deployed, perhaps we can also remember 2020 for this hugely important development, which will be the topic of future Letters from Hong Kong.

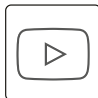
Ben Bennett
Head of Investment Strategy and Research

*For illustrative purposes only. Reference to a particular security is on a historic basis and does not mean that the security is currently held or will be held within an LGIM portfolio. The above information does not constitute a recommendation to buy or sell any security.

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative





Important information

Past performance is not a guide to future performance. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Legal & General Investment Management Limited ("LGIM"), a company incorporated in England & Wales (Registered No. 2091894). Registered office: One Coleman Street, London EC2R 5AA. Authorised and regulated by the Financial Conduct Authority.

Ultimate holding company - Legal & General Group plc.

© 2020 Legal & General Investment Management Ltd. All rights reserved. No part of this document may be reproduced in whole or in part without the prior written consent of Legal & General Investment Management Ltd. Legal & General Investment Management Ltd, One Coleman Street, London, EC2R 5AA. Registered in England No. 2091894.

The term "LGIM" or "we" in this document refers to Legal & General Investment Management (Holdings) Limited and its subsidiaries. Legal & General Investment Management Asia Limited ("LGIM Asia Ltd") is a subsidiary of Legal & General Investment Management (Holdings) Limited.

The information contained herein reflects the views of LGIM and its subsidiaries and sources it believes are reliable as of the date of this publication. LGIM and its subsidiaries makes no representations or warranties concerning the accuracy of any data. The contents of this document may not be reproduced or further distributed to any person or entity, whether in whole or in part, for any purpose. There is no guarantee that any projection, forecast or opinion in this material will be realized. The views expressed herein may change at any time after the date of this publication. This document is for informational purposes only and does not constitute investment advice. LGIM and its subsidiaries do not provide tax, legal or accounting advice. It does not take an investor's personal investment objectives or financial situation into account; investors should discuss their individual circumstances with appropriate professionals before making any decisions. This information should not be construed as sales or marketing material or an offer or solicitation for the purchase or sale of any financial instrument, product or service sponsored by LGIM and its subsidiaries. LGIM accepts no responsibility for the content of any website to which a hypertext link from this document exists. The links are provided 'as is' with no warranty, express or implied.

This document is issued in Hong Kong by LGIM Asia Ltd, a licensed entity regulated by the Hong Kong Securities and Futures Commission ("SFC") to conduct Type 1 (Dealing in Securities), Type 2 (Dealing in Futures Contracts) and Type 9 (Asset Management) regulated activities in Hong Kong. This document has not been reviewed by the SFC.

Legal & General Investment Management Asia Limited, Unit 5111-12, Level 51, The Center, 99 Queen's Road Central, Central, Hong Kong. www.lgim.com

CC998112020 _ASIA

Legal & General
INVESTMENT MANAGEMENT