

Q3 Outlook: Optimism versus reality

We believe there is a striking disconnect between market pricing and the real economy, especially with regard to expected company earnings.



Emiel van den Heiligenberg

Head of Asset Allocation

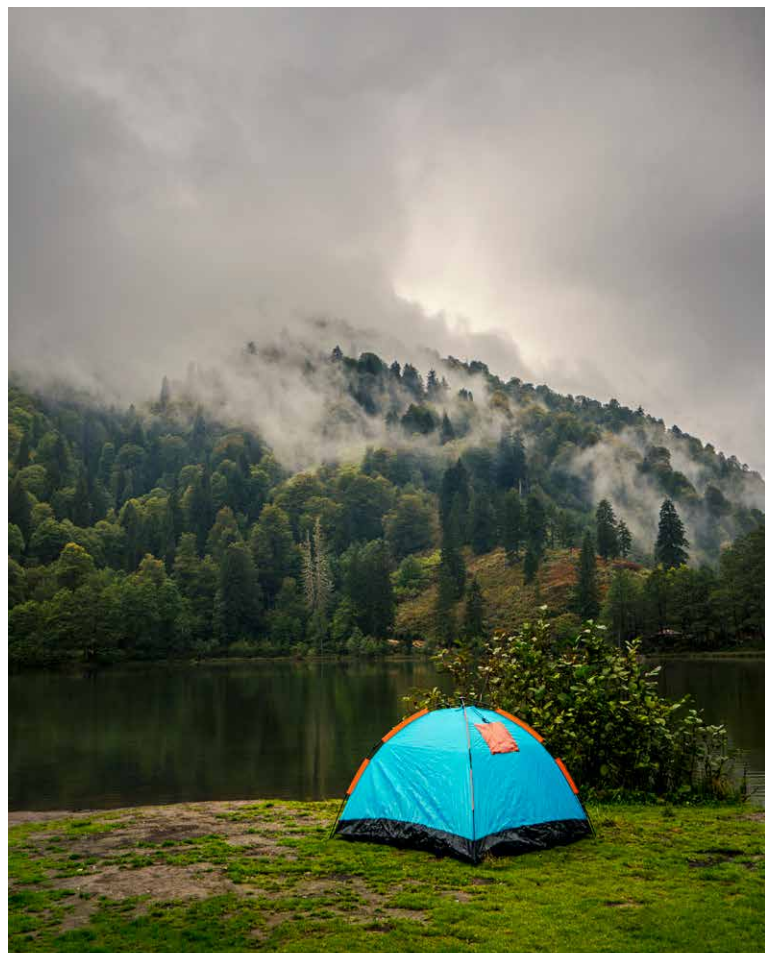
Emiel joined LGIM in August 2013 as Head of Asset Allocation, with responsibility for asset allocation, strategy and multi-asset macro research.

In the past three months, risk assets have pulled back from the brink of collapse, as policy makers hosed down markets with stimulus measures and investors turned from pessimists to optimists. We believe some of that optimism is misplaced.

As a result, our overall strategy remains broadly the same, with a cautious stance on global equities. In our view, markets are exuding over-confidence on the outlook for the economy, the path of COVID-19 and the development of a vaccine. Indeed, over the next six months, we expect to see mounting evidence of 'economic scarring', due to corporate defaults, layoffs and cuts to capital expenditure.

It is true that data compiled by our economics team suggest the great re-opening of economies appears to be proceeding somewhat faster than anticipated, with no clear sign yet of an increase in infections in those economies that have relaxed restrictions.

But regardless of whether you expect a V- or W-shaped recovery, the data are likely to improve for a while as the major economies begin to roll back containment measures. We think markets are underestimating the risk that growth weakens again, after the initial euphoria of exiting lockdowns, with many people remaining on government support.



So we believe there is a striking disconnect between market pricing and the real economy, especially with regard to expected company earnings.

When we plug our economists' scenarios into earnings models, we need to make quite aggressive positive assumptions to justify the current level of equities. We believe US earnings are likely to suffer a peak-to-trough fall of about 40%. Markets are clearly not pricing this in.

In a recovery, of course, investors will look through this decline. Yet even if we plot end-2021 earnings – so a fall and then a bounce – we think stocks still look expensive.

Long tech, short gilts

A fair amount of the optimism can be explained by the massive fiscal and monetary support deployed, not least extremely low interest rates. This is inflating asset prices, giving a sense of ‘all clear’ despite much of the stimulus being only temporary.

Even though we believe equity markets have rebounded too far and too fast from their March lows, we remain positive on tech stocks, as they are likely to constitute a winning post-pandemic sector, in a low-growth environment where technology becomes a strategic industry, in our view.

We also think equity laggards, which underperformed in the rally, have further to run. But we have taken some profits on our long-credit stance as spreads have contracted massively, returning the risk-reward ratio to more normal levels.

A new position we have introduced in portfolios of late is short gilts, reflecting our view that core rates are likely to rise more than forwards are pricing. This is because we believe:

- Fears over the advent of negative yields in the US and UK are overdone
- Supply from government issuance will outweigh central bank purchases
- Inflation expectations are likely to rise as policymakers experiment with ‘helicopter money’ and politicians grow addicted to fiscal stimulus

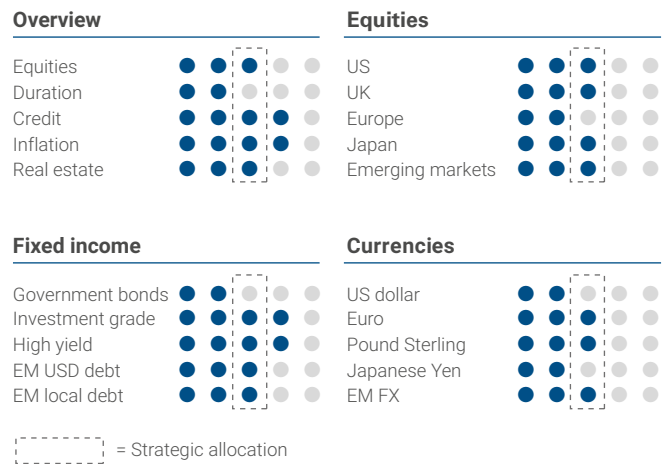
Elsewhere, we still like buying inflation-protection in the US, for similar reasons, and also favour gold as an alternative asset.

Our views at a glance:

Equities – While we remain tactically negative, we have pared this stance as the shape of the recovery remains unclear. Our medium-term view remains neutral in light of valuations, particularly relative to government bonds.

Duration – We are slightly negative in the short term. We expect central banks to keep yields low as they seek to prop up economies, although yields are likely to rise over the medium term as the world returns to ‘normality’, in our view.

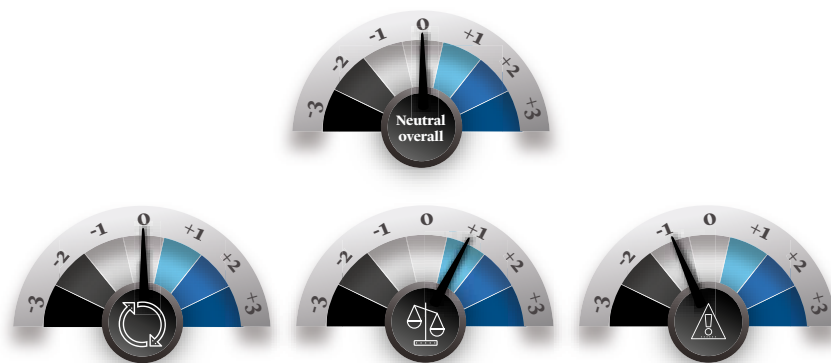
Credit – We have shifted our medium-term view on IG from positive back to neutral as spreads have contracted.



This schematic summarises the combined medium-term and tactical views of LGIM’s Asset Allocation team as of June 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.

Summary of LGIM’s asset allocation core view



Economic cycle
Nature of recovery dependent on economies opening up, virus suppression and success of vaccine deployment

Valuations
Relative valuations still very attractive, in our view

Systemic risk
Concerns around both political and credit risk

Economic cycle

- Cycle moving much faster than a normal recession
- Social distancing sectors have upside potential
- Cyclical outlook dependent on vaccine progress and economic scarring

Valuations

- US absolute valuations very expensive, ROW reasonable
- Relative valuations still very attractive, in our view
- Relative valuations more relevant than absolute

Systemic risk

- Troubled relationship between US and China
- Chinese housing market a concern
- Focus on downgrades and defaults in the US



Willem Klijnstra
Strategist

A spoonful of sterling...

The pound is sitting on a sizable year-to-date decline versus major rivals, presenting us with an opportunity to look again at the idiosyncratic factors that affect its performance – and the role of foreign-currency risk in multi-asset portfolios with sterling as a base currency.

Risk-on currency

Over the last few years, Brexit was often the usual suspect for any sterling weakness. It may have played such a role again earlier this year, but we believe the currency has mainly been driven by its more traditional risk factors.

We often say sterling acts as a risk-on currency, for a number of structural reasons. The UK is a large global financial centre and it runs a large structural gross foreign asset position. Losses on financial markets, as a consequence, typically do not bode well for the pound.

As a net asset owner, a bull market is better than a bear market, while the City thrives on more financial activity. Unfortunately, COVID-19 has dampened activity and triggered weakness in markets, broadly speaking.

H1 2020: A rough ride for the pound



Trade-weighted average value. Source: Bloomberg, Bank of England, as at 30 June 2020

Portfolio role

Although currency weakness is hardly a sign of strength, we believe it can be quite useful in the context of a global multi-asset portfolio.

When you buy a foreign asset, you receive the foreign currency exposure, too. Long-term expected returns on currencies are close to zero, as exchange rates are relative prices and the uncovered interest rate parity theory, which suggests that differences in interest rates will equal the relative change in FX rates over the same period, generally holds.

However, this does introduce extra short-term volatility. Within a portfolio context, some of that extra volatility can be helpful, as it diversifies other risks in the portfolio.

The degree of diversification depends on the base currency of the investor. For example, for a sterling-based investor holding US stocks, un-hedged through March, meant a loss on the stocks in US dollars terms – but a smaller loss when translated into sterling. For a dollar-based investor, it is actually the other way around, where the weakness in their UK stock holdings would be compounded by the loss in sterling.

So, some currencies can act as a shield for investors in risk-off periods, such as the greenback, while others boost the returns on foreign assets in good times, or make the situation worse in bad times, as we saw with sterling this year.

To hedge or not to hedge?

Drawing all of this together, some foreign currency exposure can be beneficial, but too much and it will start dominating portfolio outcomes.

What is ultimately required, in our view, is a balancing act that depends on the base currency. We hedge a substantial part of the foreign currency exposure in our global multi-asset portfolios via currency forwards and/or futures, but for the reasons outlined above, not all of it.



Hetal Mehta
Senior European Economist

The EU recovery fund: signal and substance

Market participants have grown accustomed in recent years to the EU dealing with crises in a fairly reactive manner, often hammering out solutions at summits that continue late into the night and are accompanied by large amounts of nail-biting.

So, in late May, investors were pleasantly surprised to see details from the European Commission on its decidedly proactive plan for a European recovery fund.

Building on an initial proposal from France and Germany, this envisages the EU borrowing €750bn in order to provide €500bn in grants to countries most affected by COVID-19, as well as another €250bn in loans.

In our view, the grants represent an important symbolic step closer to debt mutualisation among member states. First, leaders have recognised the need for fiscal transfers among member states. Second, it would be conducted through joint issuance, albeit backed by the EU-27 budget, showing a greater understanding that a priority is to minimise the cost of debt issuance and avoid burdening national balance sheets.

And while the additional €250 billion in loans may not be fiscal transfers, nor can they be excluded from a member state's debt/GDP ratio, they do offer further lower-cost support for 'peripheral' countries.

Grant designs

Through the disbursement of proceeds according to economic need rather than just impact from COVID-19, the plan takes account of the less favourable position of some southern states which are still suffering from the aftermath of the sovereign debt crisis.

It thus seems that high-debt countries will be the primary beneficiaries. In addition, the repayment terms appear more favourable than had been expected.

Still, the pace of implementation could be seen as slightly disappointing, with only €120-150bn scheduled to be raised in 2021 and the remainder to take place in subsequent years out to 2024. Moreover, at less than 6% of European GDP, the proposal is clearly not sufficient to absorb all of the virus-related costs.

Strong signals

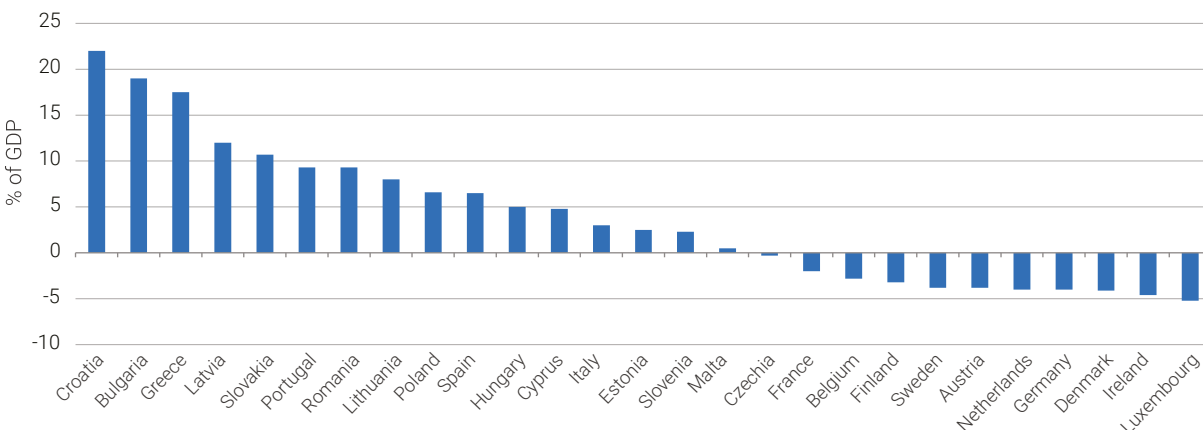
As important as the fund is, we should also bear in mind the broader objective of signalling European solidarity and establishing a framework for risk-sharing that could be revisited in future crises.

We also think it needs to be viewed in context of other support from the European Central Bank, the Support to mitigate Unemployment Risks in an Emergency (SURE) programme, European Investment Bank, and European Stability Mechanism.

Taken together, we believe there is more than enough here to allay market concerns – particularly over peripheral assets – in the near term.

Still, turning the recovery fund into reality is unlikely to be a smooth process, as all EU national governments will have to ratify it. Expect a few more nail-biters over the summer.

Proposed allocation from the European Commission for EU Recovery Fund, net gain (+) / loss (-)



Source: EC, as at May 2020



Lars Kreckel
Global Equity Strategist

Is it finally the time for value to shine?

Many investors, pondering the relative performance of investment factors in recent years, will probably have asked at some point: “Is it time to go long value?”

Value stocks, which trade at low prices relative to their fundamentals, have indeed underperformed by so much – and for so long – that they have long appeared to be due a bounce. But the correct answer would almost always have been simply “no”.

Now, though, the answer should be far less emphatic, in our view, as a key element that could trigger a rally in value is changing, even if only on a temporary basis. Indeed, this has prompted us to rephrase the original question: “If not now, when?”

Performance and popularity

Value stocks have been terrible relative performers pretty consistently since 2006; they currently trade at around 20-year lows versus the wider market. Value has now underperformed during the last two bear markets, the long bull market in between and has not outperformed in the sharp market rebound since late March.

Perhaps unsurprising given the poor performance, value stocks are located in a very unpopular part of the market, where little of the optimism that Emiel cites is priced in.

Relative valuations have fallen a long way: whether you look at price-to-earnings or price-to-book ratios, or dividend yields, most such metrics are at or near long-term extremes. At the same time, sentiment data mirror the valuation discount, with investor surveys consistently highlighting value near the bottom of the popularity rankings.

Value / growth (Europe)



MSCI Europe Value / MSCI Europe. Source: Bloomberg, LGIM as at 1 July, 2020
Past performance is not a guide to the future.

Structural headwinds

All of the above (and more) have been valid for a long time, even as value has continued to lag the broader market. What is new is that we believe the macro backdrop for value is likely to look more favourable in the months ahead than it has in many years.

High-frequency cycle data have already started to improve, with the countries emerging from lockdowns and the global economy recovering from recession, albeit only fitfully and to below their pre-crisis levels of activity.

Improving PMIs have tended to be good news for value. An arguably even more important and more durable factor is that we are likely to soon enter the part of the economic cycle that has typically delivered the best risk-adjusted returns for value: early cycle.

Mapping equity returns to the stages of economic cycles suggests that value has delivered its best risk-adjusted returns during the first part of expansions.

A word of caution, though. Even if the cyclical outlook for value improves, we expect the structural headwinds of a low-growth, low-inflation and low-bond yield environment over the medium term to remain. As a result, we see potential opportunities in value stocks as more tactical than structural.

Contact us

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