

# Q4 Outlook: Reasons to believe

As we enter the final months of 2020, we outline why we have become more inclined to buy dips in the equity markets.



## 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.

Over the past quarter, as we have assessed the evolving macro environment, quite a lot has changed in our thinking. Where we were once sceptics as to the potential for equities to rally further, we are now increasingly believers.

This is partly a function of the recent stumble in risk assets, which can be attributed to multiple factors. Among these are a worsening of the pandemic in Europe, leading to the reintroduction of containment measures, and a further hardening of the US political climate ahead of the election, following the passing of Supreme Court Justice Ruth Bader Ginsburg.

But there are also other, more structural reasons for why we have adopted a positive bias towards equities:

- High but declining unemployment suggests the global economy is early cycle, typically the most attractive phase to be long
- A vaccine for COVID-19 by 2021 is quite likely, in our view, while treatment is improving, lowering the risk of economic disruption due to the virus
- Equity sentiment is neutral-to-bearish, even though economic data are surprising to the upside



- Support for markets from policymakers is present, ample and tested
- Credit markets look more expensive than stocks

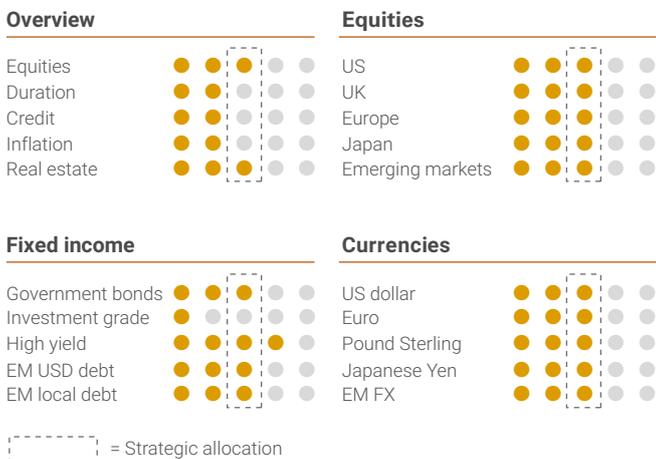
That said, we characterise this positioning as a positive bias within an overall neutral stance, rather than a more bullish stance on equities in particular and risk assets in general.

In this outlook, we touch on many of these issues in greater detail, analysing scenarios markets face in the US election, looking at the US Federal Reserve's (Fed) policy outlook and questioning the use of sovereign debt for hedging when yields are at rock bottom.

**Persistent worries**

We continue to be concerned by the prospect of economic scarring from the virus, which is only now starting to appear just as a second wave begins to emerge. Still, even as winter approaches, broad lockdowns do not appear likely due to the costs to output and the lower mortality risk.

Support measures from governments are also rolling off, as furlough schemes are wound up. And geopolitical risks continue to bubble away in the background; we believe these would increase if Donald Trump were to lag further in the polls. (Admittedly, the president’s tweets and rhetoric can be dismissed as electioneering, while China seems to be keeping a low profile at the moment in order not to provoke the US too much.)



Taken together, all this means we are awaiting the right time to increase our equity stance, on both a tactical and a medium-term view, in order to act on our newfound conviction. Or, put differently, we are now much more likely to ‘buy the dip’.

**Our views at a glance:**

**Equities** – Over the short term, we are looking to focus on laggards where we believe negative performance and sentiment to be overdone. We are neutral over the medium term, but inclined to buy dips.

**Duration** – We recently moved our short-term view from neutral to negative. We had been looking to reduce duration risk ahead of the US election, and did so following the strong performance of government bonds on news of President Trump’s COVID-19 diagnosis. On a medium-term view, we are also negative as we see risks to yields skewed to the upside.

**Credit** – On a short- and medium-term view, we are now negative on investment-grade credit due to the substantial spread tightening since March. We still feel there is more room for tightening in high yield, though, so remain positive over both time horizons.

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

**Summary of LGIM’s asset allocation core view**



**Economic cycle**

Coming out of recession is the 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 a vaccine by mid-2021
- Coming out of recession has historically been most positive phase of cycle
- We believe risk of a genuine relapse of the economy during second virus wave is lower

**Valuations**

- Relative valuations seem less attractive post market rally
- Credit spreads now below historical average
- Relative valuations more relevant than absolute valuations, in our view

**Systemic risk**

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

Source: LGIM. Views current as at September 2020.



**Lars Kreckel**  
Global Equity Strategist

## What investors can expect from the US election

Apart from the pandemic, the US presidential election looms as the biggest macro event of the rest of 2020.

Our baseline view continues to be that it will be a tight race to the end, irrespective of any October surprises. We have already seen several swings in polls and bookmakers' odds, but given the polarisation of the US electorate, with fewer undecided voters than four years ago, it seems unlikely that either candidate can build a large enough lead in the battleground states to feel confident on election night.

With the 2016 shock win by Donald Trump still in investors' minds, this means that markets are unlikely to price a specific outcome confidently ahead of the election, in our view. So all outcomes are likely to result in price movement.

This makes our general motto regarding political events of 'prepare, don't predict' even more important than normal. We concede that we have no edge over pollsters and bookies in predicting the election outcome. Hence, we focus our energy on thinking through the market implications of different scenarios. In the past, this has enabled us to react quickly to market moves during and after political events.

### Election permutations

Ahead of the vote on 3 November, we consider four scenarios:

1. **Blue Sweep**, where Democrats control Washington
2. **Biden 1.0**, where Biden moves into the White House but Congress remains divided
3. **Trump 2.0**, where the incumbent wins but Congress remains divided
4. **Red Sweep**, where Republicans control Washington as they did in 2017 and 2018

The following table outlines the subjective probabilities that we attach to each of these scenarios, alongside indications of the probable impact on US equities, government debt and the dollar.

**Figure 1: Scenario analysis for the presidential race**

	Probability	Equities	Treasuries (prices)	USD
<b>Red Sweep</b>	10%	● ●	●	●
<b>Trump 2.0</b>	30%	●	●	●
<b>Biden 1.0</b>	10%	●	●	●
<b>Blue Sweep</b>	50%	●	● ●	●

Source: LGIM, as at 24 September, 2020. There is no guarantee that any forecasts made will come to pass.

Both 'sweep' scenarios result in fiscal expansion, with another round of tax reform seeming likely in the Republican version. While we believe a Blue Sweep should result in significantly more fiscal spending in areas like the environment and healthcare, some of this would likely be offset by tax increases.

From an equity-market perspective, Democrats' planned corporate tax changes would weigh particularly heavily, as they could take up to 10% off S&P 500 profits. And both scenarios with mixed control of Washington would likely result in gridlock and limited policy changes.

The final wildcard, of course, is what happens if there is no clear winner on 4 November. The baseline should be that it will take some days to count the large number of mail-in ballots. It may take even longer than that for either candidate to concede, but markets may price a likely winner before that.



**Tim Drayson**  
Head of Economics

## The Fed's mea culpa

**Whisper it quietly, but the Fed has effectively admitted that it tightened too early in the last cycle.**

Chair Jerome Powell did so at Jackson Hole in August, while announcing the central bank's eagerly awaited long-term framework review, which had been under consideration for almost two years and whose conclusion was delayed by the pandemic.

The key change was a move to flexible average inflation targeting while maintaining the long-run goal of 2%. So following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time.

What this means was incorporated into new forward guidance in the September Federal Open Market Committee's statement around the timing of the first rate hike.

"The Committee expects it will be appropriate to maintain this target range until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2% and is on track to moderately exceed 2% for some time, wrote the policymakers.\*

Vice Chair Richard Clarida has subsequently confirmed that the 2% cited would be measured on a year-over-year basis and is a threshold to begin thinking about a rate hike, rather than a trigger for action.

\*Source: Federal Reserve, 16 September 2020.

### Credible recklessness

In practice, this does not change the near-term policy outlook, which in recent weeks has led to Powell repeatedly asking for help from stalled fiscal policy as the central bank is nearing its limit.

But once the economy recovers from the pandemic – and this might take a few years – there likely will be no pre-emptive tightening as unemployment reaches or exceeds estimates of maximum employment. The Fed will now wait for inflation to appear, rather than tightening in anticipation of inflation.

In our view, this is not a direct make-up strategy for previous inflation misses. The aim is to help anchor inflation expectations at around 2%. If inflation runs below 2% after a recession, but not above 2% when the economy is strong, this result would come to be expected and inflation expectations would fall below the 2% goal and pull realised inflation down.

So the degree of "moderate" inflation overshoot targeted will hinge on what is required to re-anchor inflation expectations – a forward-looking policy rather than a formula linked to past inflation misses.

There is no perfect framework and alongside clarifying the role of asset purchases in meeting its targets, the Fed still has two potential problems. The first is that there is doubt around whether the economy can generate the desired inflation before the next shock inevitably hits. This is keeping inflation expectations uncomfortably low.

The second problem is that for the new framework to work, the central bank has to be seen as 'credibly reckless'. By deliberately falling behind the curve, the Fed is risking a larger inflation overshoot if the economy eventually fully recovers.



**Joseph Firth**  
Investment Specialist

## Does sovereign debt have a future as a hedge?

We believe investors typically opt for a multi-asset solution of equities and bonds to benefit from the diversification that the latter have historically provided. While adding government debt to an equity portfolio may reduce the long-term expected return, the protection it can offer when equities fall should reduce overall volatility.

But with bond yields falling to record lows – many even in negative territory – following a multi-decade bull run in prices, what happens to that diversification? Can government bonds still yield a positive return when equities fall?

These questions were perhaps answered this year: going into 2020, the yields on 10-year US, German and Japanese government bonds were 1.8%, -0.2% and 0.0% respectively.<sup>1</sup> During the equity selloff in February and March, there was significantly more downside protection provided by the US, where the Fed had more room for monetary easing. In Germany and Japan, by contrast, bonds only offered a relatively small amount of insulation (see Figure 2).

So if multi-asset investors are no longer enjoying the same degree of diversification from government bonds, what strategies are potentially available to provide protection when stock markets slide?

One option is to allocate more to bonds where yields remain relatively high; for example, US 30-year bonds still yield 2.3% more than Germany.<sup>2</sup> Within the portfolios we manage, we have also allocated into markets such as Australia, New Zealand and South Korea, where yields have further to fall, in our view, thus helping to insulate portfolios in times of crisis.

### Portfolio FX

Another strategy is the use of currencies for risk-management purposes. We have seen during recent pullbacks in stocks that the performance of sterling has also been sharply negative, displaying a high correlation to equity markets. So for sterling-based investors, one approach could be to hold more foreign currency, particularly the US dollar and Japanese yen, which could typically act as safe havens during crises.

The positive returns of foreign currency exposure could, as a result, help to insulate overall performance in equity drawdowns. Indeed, for all investors – regardless of home currency – judicious exposure to foreign currencies could help portfolio diversification.

Finally, we can also add new asset classes into portfolios to increase diversification or focus on investment themes, such as climate change, where investors identify exposures and look to reduce risks through asset allocation and stock selection.

Within the Asset Allocation team, we have added exposure to artificial intelligence and forestry to gain different return streams from those offered by broad equities and government bonds, aiming to help reduce volatility.

In this 'lower-for-longer' environment, these approaches may become increasingly popular for multi-asset investors to avoid the nightmare scenario of equities falling sharply, yet bonds not providing a positive return with yields already on the floor.

**Figure 2: Total return of 10 year nominal bonds**



Past performance is not a guide to the future. Source: Bloomberg, as at 11 September 2020

1. Bloomberg, as at 31 December 2019

2. Bloomberg, as at 11 September 2020

## Contact us

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#### Key risks

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