Q1 Outlook: Mind the traps

We remain cautious overall as risks of the US election, trade with China, unpredictable geopolitical events and Brexit continue to smoulder.

Emiel van den Heiligenberg
Head of Asset Allocation

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

Since our last quarterly note, where we focused on the threats to the world economy, political and international events have meant that the global economic backdrop has become somewhat more positive and market positioning is less stretched than we had anticipated.

We have moved from cautious to neutral on risk on a medium-term view as the economic cycle has been extended and recession risks have decreased. Whilst we are still late in the economic cycle, it is fair to say that late-cycle dynamics have not worsened over the past few months. With reasonable growth, limited inflation and central banks committed to defending the downside, there is no immediate catalyst for a correction; we have therefore upgraded our view on equities from negative to neutral.

Whilst we believe that there is too much optimism around the so-called 'phase 1' trade deal between China and the US, and that it has already been priced in by the market, it is also difficult to see what would upset equity markets, assuming President Trump sees the S&P 500 Index as one of his success indicators. In addition, although there is not enough caution around the Democratic primary elections and the probability that a less market-friendly Democratic candidate could win, it appears too early for the primaries to play a decisive role at this stage. Below, Martin looks at how diversification is important not only across traditional, but also across alternative asset classes.

The result of the UK general election led to a relatively straightforward market reaction, reflecting the decisive Conservative victory. Although we were geared up for an all-nighter in the office, the clear result meant that in fact, we left the office shortly after the exit polls. As Hetal discusses below, market price movements were in line with our expectations for this scenario, with the exception of UK equities, which we believe remain undervalued and under-owned, leaving potential for a fair recovery over the coming years. Nevertheless, Brexit is not over, and trade agreements will become important in the second half of this year.

Everybody needs good neighbours

Despite recent developments in trade negotiations between the US and China, we believe that optimism here is generally too strong. Although a deal exists, it covers only a relatively small proportion of US imports (0.1% of GDP), and it should not be forgotten that President Donald Trump is unpredictable: he retreated from the Mexico trade deal only shortly after agreeing to it. The stand-off between the US and China affects a structural relationship and the longer the uncertainty remains, the greater the erosion of trust and impact upon global trade and supply lines.

Legal & General
INVESTMENT MANAGEMENT

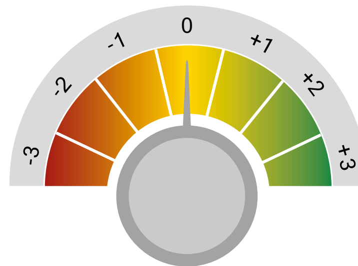
The recession indicators that we track still suggest the US economy is late in the economic cycle. In the run-up to the presidential election in November, which will follow the Trump impeachment proceedings, and amid fresh tensions in the Middle East, the pathway for the largest economy in the world is likely to be stalked by hazards.

China, meanwhile, is taking various measures to manage its slowdown, rather than resorting to a more aggressive credit expansion. But many developments belie a negative trend, including capital controls and controls on technology exports. China's relationship with its neighbours and particularly Hong Kong remains fractious; Magdalena discusses the broader backdrop of unrest in emerging markets and how this is likely to affect the global economy.

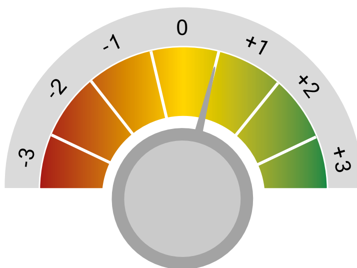
The doom of consensus

In our recent **CIO Outlook**, I wrote about fighting FOMO, the 'fear of missing out'. The 'Santa rally' and somewhat improved economic outlook snowballed into more bullish outlooks than we anticipated, but history has taught us that year-end consensus is very often incorrect. We continue to prepare rather than predict and by remaining cautious regarding crowding in asset classes, we aim to sidestep the traps created by investors herding into the latest trend.

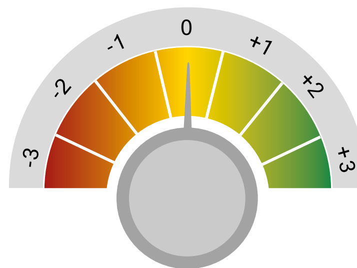
Summary of LGIM's asset allocation core view



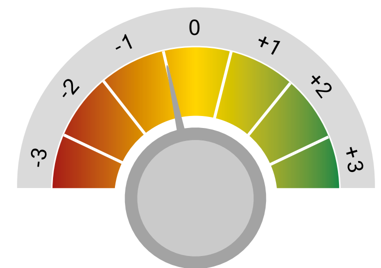
Neutral overall



Economic cycle
Economic cycle extended and recession risks have decreased



Valuations
Risk asset valuations are not excessive



Systematic risk
Material geopolitical risks balanced with an improving outlook on global debt levels

Economic cycle	Valuations	Systemic risk
Historically low unemployment	Equities mid range historically	Debt ratios high but stable
But inflation remains subdued	EM credit attractive versus other credit	Unconventional monetary policy
Central banks have eased policy	Risk assets cheap versus government bonds	Trade war uncertainty weighing on global economy

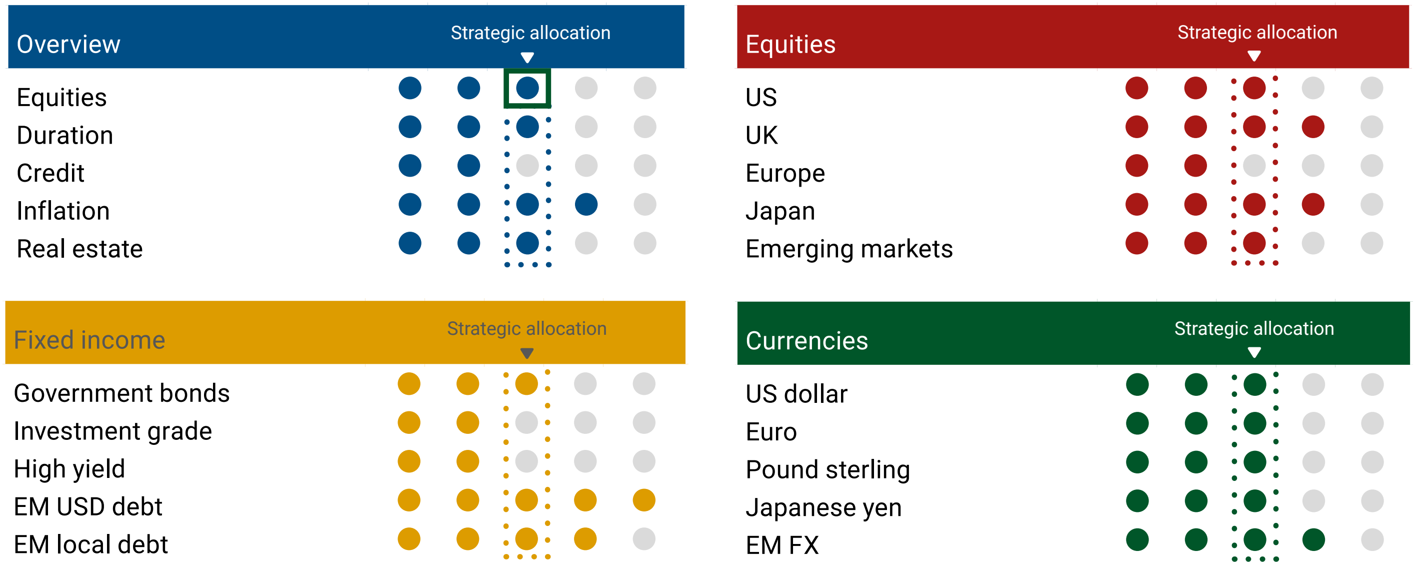
Source: LGIM. Our core view on risk assets, as illustrated by the big dial, may move in either direction going forwards; and our certainty over the expected direction of travel and timeframe for this next move has decreased in reflection of the uncertain geopolitical environment.

Our views at a glance:

A neutral view on equities – At a regional level we still favour Japan relative to the US, and also the UK which we believe to be undervalued and under-owned.

Remain positive on emerging-market debt – Spreads remain relatively attractive and default risks stay low.

Remain negative on credit – Credit spreads are tight and we believe liquidity would be thin in a bear market. The asset class tends to underperform at this part of the cycle and valuations remain unattractive.



Source: LGIM

This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of January 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. A box indicates a positive or negative change in view, a green box being positive and a red box being negative.

Hetal Mehta
Senior European Economist

UK election: a big win for the Conservatives, but what now?

Having endured two years of parliamentary gridlock, the UK now has a government with a significant majority. So what happens next?

Boris Johnson's election gamble has paid off for the Conservative Party, with the biggest win since 1987. In the shadows, the Labour Party suffered its worst result since 1935. A healthy majority of 80 seats for the government will, in the short term at least, lift the uncertainty stemming from the political gridlock that has paralysed policymaking over the past couple of years. The alternative outcome of a hung parliament would have brought a host of uncertainties, including the relationship with Europe, the potential for a Scottish referendum, nationalisation concerns, and corporate tax rates, to name but a few.

Furthermore, while Theresa May had to negotiate hard both at home and with the EU, Boris Johnson now only really has to deal with the latter. Passing a withdrawal agreement should now be relatively straightforward and this will unlock the implementation period, currently due to end in December 2020.

In light of this, we expect some bounce in sentiment and some stabilisation in business investment are likely to materialise, although a return to the levels of growth seen in 2013-2014 looks less probable.

Sense of déjà vu?

Beyond the next couple of months, focus will shift to what kind trade deal the UK government can negotiate and how long it will take. Currently, the deadline for requesting an extension to the transition period is set for July 2020. Already in the early days of the new government, there are plans to change the legislation to rule out such an extension. In this case, time would be very tight for a comprehensive deal to cover both goods and services. Typical trade deals take years of negotiation, let alone implementation.

Of course, governments can change their minds and when it comes to EU negotiations, 'deadline' has proven to be a loose term. The default situation in the absence of a deal or an extension is to leave the transition period without a deal; this would, on the government's own calculations, reduce the size of the economy significantly, including in the long term. We still see this as a key risk for the second half of 2020.

Policy outlook

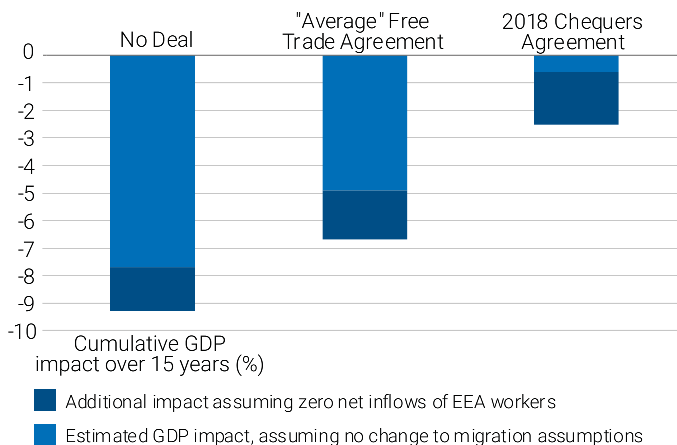
Brexit aside, the domestic policy stance looks set to be conservative with a small 'c'. The new fiscal rules of the government leave little room for a dramatic stimulus, particularly on the government investment side, but a small cushion, tilted towards more government investment, is available should the economy need it.

With regards to monetary policy, we expect inflation to remain below target, and economic growth to be close to trend; this is likely to keep the Bank of England in 'wait-and-see' mode. Prolonged uncertainty would suggest rate cuts are more likely than hikes.

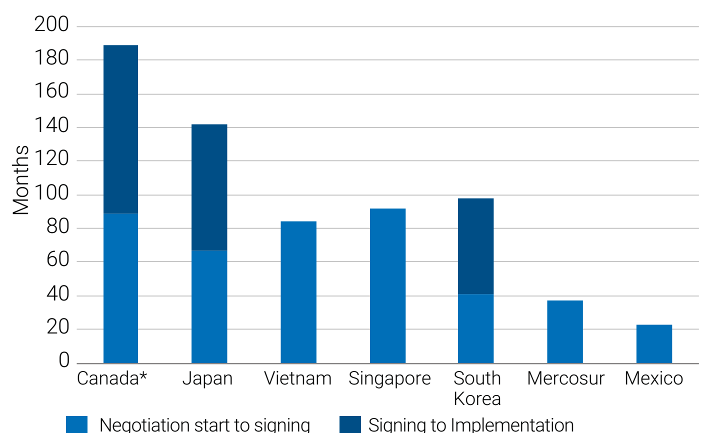
Investment implications

With a high degree of uncertainty hanging over the UK, many investors have preferred to sit on the sidelines and UK equities have underperformed. With the result of the election helping to lift some uncertainty and to reduce the 'extreme Left Wing risk', the UK could start returning to a state of relative normality, encouraging some flows to return.

Still potentially large adjustment costs for the UK



Agreeing a trade deal takes a lot of time



Source: Left-hand chart: "EU Exit, long-term economic analysis" HM Government, Nov 2018. Right-hand chart: European Commission, as at 12 Dec 2019. *Not fully ratified

Martin Dietz
Head of Diversified Strategies

Investing in the temperate zone

Finding opportunities between the traditional asset classes extremes.

Some market commentary often leaves readers with the impression that the investment universe is split into two polar opposite assets: equities offering growth exposure but with significant associated risk, and fixed income offering modest, but stable, returns. Discussion around "60/40" portfolios serves to feed that overly simplistic narrative.

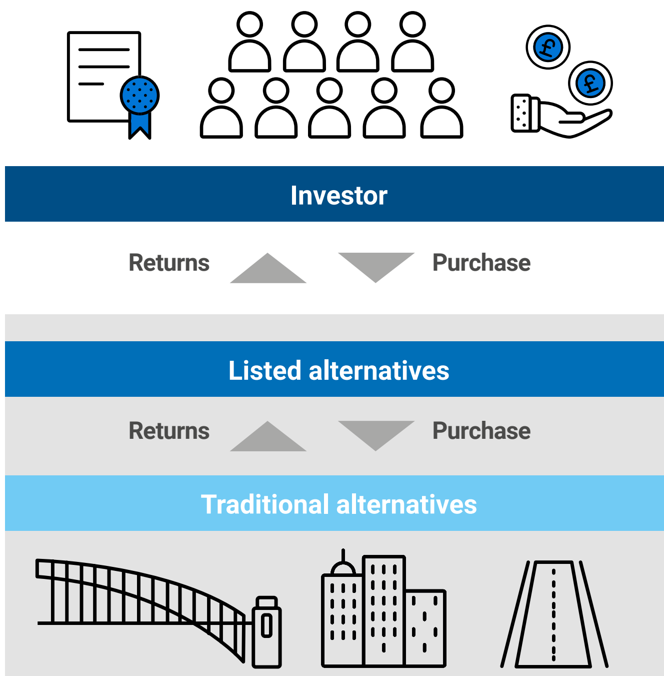
We would argue that **diversifying into alternative asset classes** is just as important as diversifying across traditional asset classes. Investor interest should therefore focus on the investment equivalent of the "temperate zone" when building a multi-asset portfolio.

Accessing some of these alternative assets can be relatively straightforward: exposure to various alternative credit markets, such as global high yield and emerging-market debt, is now available through index or actively managed funds. Others – notably direct real assets like property, infrastructure, and farmland or forestry – remain less accessible.

Over the long term, we believe that listed alternatives provide **similar risk-adjusted returns** to direct investments in the above-mentioned real assets. There is admittedly more volatility over the shorter term with listed alternatives – a function of their daily pricing and trading and their equity beta – but most investors should be able to look through this noise. Over longer time horizons, the share price of listed alternatives is driven mainly by the underlying assets, and these returns are passed through the listed alternative to the underlying investors.

The nature of these alternative assets means that they tend to be characterised by relatively stable cashflows, and are therefore influenced in the short term by anything which drives discount rates. The global central bank pivot towards looser monetary policy was a helpful fillip to returns in 2019. Although we are unlikely to see another lurch down in interest rates in 2020, the incentive for policymakers to prevent a spike in yields is equally clear. If yields remain contained by those offsetting forces, we would expect the strength (or weakness) of the underlying cashflows to be the key determinant of assets in the temperate zone.

Structuring alternatives to manage liquidity risk



- Liquidity is created by buying and selling the shares
- Share price goes up and down and can be more volatile than underlying assets

- Long-term valuation and return are driven by the underlying assets
- Share sales don't trigger asset sales

- Underlying assets are illiquid
- Hard to buy/sell and hard to value

Source: LGIM, January 2020 https://macromatters.lgim.com/categories/portfolio-thinking/why-aren-t-investors-eating-their-free-lunch/

Magdalena Polan
Senior economist

Making sense of EM protests

The multiple protests that materialised across a number of emerging market countries in 2019 raise three key questions. First, what is behind this dissatisfaction, and is there a common theme? Second, are protests a threat to the global economy? And third, what outcomes could they create?

Demonstrations have erupted from Chile to Lebanon, and Egypt to India. The wave of discontent has spilled from country to country, affecting especially Latin America, and brought back the memories of the Arab Spring that rocked the Middle East earlier this decade. It seems that the unifying reason behind most protests is dissatisfaction with individual governments: corruption, poor public services, increased tax burden, or allegations of meddling in the political process.

But there is also a wider theme of dignity of individuals and their perceived role in the local and global economy and society. Similar to the movement of discontent in the developed economies that has propelled populist parties – and led us to discuss the emergence of a 'new political paradigm' – it looks like voters in a number of emerging markets are also unhappy with the unequal distribution of benefits of growth and globalisation, the balance of power between corporations and individuals, and the economic outcomes of fairly stringent neoliberal economic reforms. Thus, even though the exact triggers that sparked protest in each country are different, they all seemed to be the 'last straws' that have broken the camel's back.

Despite affecting multiple countries, the protests do not seem to be, for now, a threat to the global economy. The countries most affected generate around 4.5% of global GDP (in purchasing power adjusted terms) so their impact on the global economy is limited in the short term, even if they lead to a slowdown at home. Emerging markets assets have largely shrugged off the protests. For example, the spread on emerging market US dollar debt has narrowed by nearly 150bp in 2019. Markets would be more concerned if the protests depressed growth in larger economies, such as Brazil, as these would also have deeper economic repercussions for their trade partners.

Finally, the question is still open on the long-term outcome of the protests. But if they lead to more equitable distribution of growth and deepening of the democratic process and control then, ultimately, they should be positive for the affected economies, even at the expense of short-term slowdown. Nevertheless, the range of potential outcomes is wide and depends on the starting point. For example, countries with low debt can afford the cost of structural reforms and better social protection, and should be able to see the fruit of the reform faster. In general, the old (and sometimes boring) rule of economists applies here too: fundamentals do matter, and remain an important differentiation tool in formulating our investment views.

Contact us

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