THE GREAT
REOPENING

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Global Market Outlook – Q3 update

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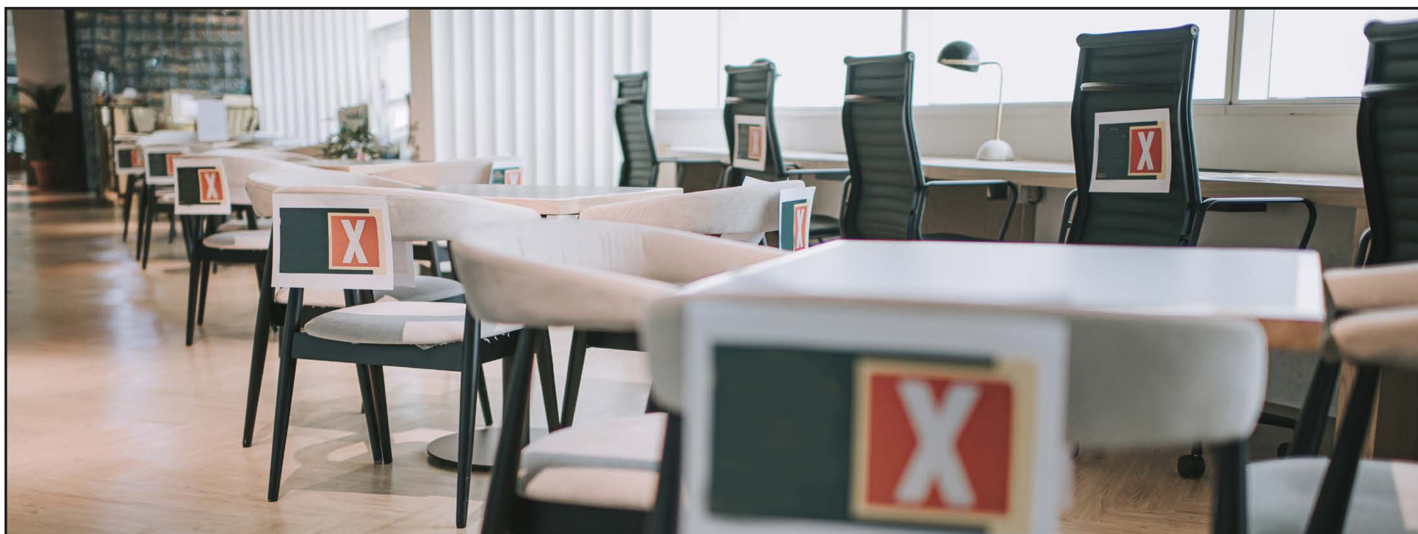


The great reopening

Markets have rallied on hopes for a recovery as lockdowns are eased. The rebound has been helped by oversold investor sentiment, but with sentiment back to neutral, so is the market outlook.

Record levels of fiscal stimulus, sustained low interest rates and ongoing low inflation create a supportive environment for risk-asset outperformance."

Andrew Pease, Head of Global Investment Strategy

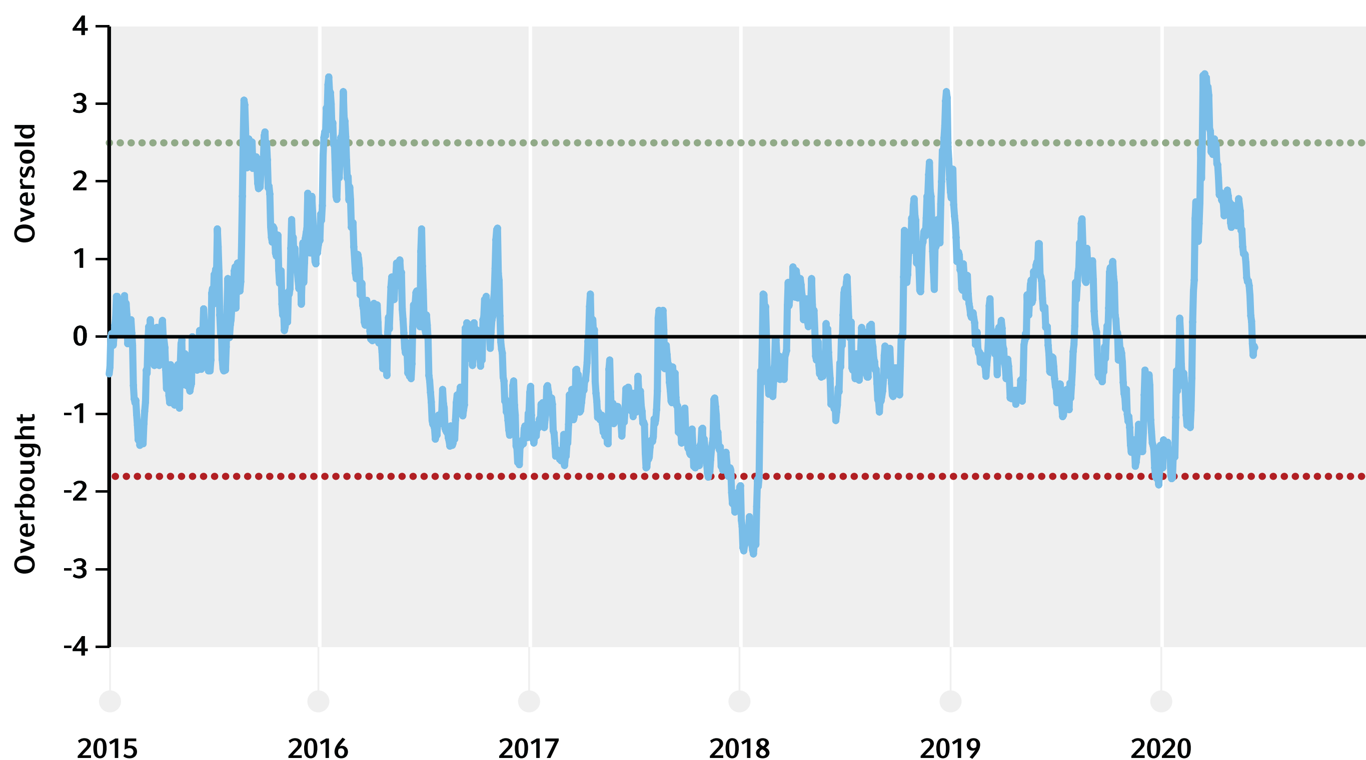
Introduction

Well, that was historic. The fastest 30% drawdown in the history of global equities in the first quarter followed by the largest 50-day advance in market history in the second quarter. The S&P 500® was back above 3,100 on June 3 and the Nasdaq hit a record high on June 10. Meanwhile, commentators have been lining up to claim that markets are detached from fundamentals.

We're not so certain that investors have it wrong. For sure, markets seem to be priced for an optimistic outcome of no meaningful second wave of infections as lockdowns are lifted. But record levels of fiscal stimulus, sustained low interest rates and ongoing low inflation create a supportive environment for risk-asset outperformance.

Our previous quarterly report in late March laid out a cautiously optimistic case for riskier assets, such as equities and credit, to outperform defensive assets like cash and bonds. This was based on our cycle, value and sentiment (CVS) investment decision-making process. Value had improved following the market crash, the cycle outlook was turning positive with central banks and governments in "whatever it takes" mode and, most importantly, our composite contrarian indicator of market sentiment was providing one of its most extreme buy signals. Oversold conditions imply that investors are cautious and worried about downside risks. These conditions provided a springboard for risk assets to rebound as the economic impact of the lockdowns turned out less bad than feared and as a possible second wave of infections failed to materialize by mid-June.

Composite contrarian indicator



Source: Russell Investments. Last observation: 12 June 2020. Contrarian indicators for investor sentiment give a numeric measure of how pessimistic or optimistic market actors at large are.

The market rebound means that value is no longer compelling for global equities or credit. On the other hand, the cycle outlook has improved as fiscal and monetary stimulus announcements continue and economies start to emerge from lockdown. The bottom of a major recession when stimulus is flowing is one of the few times it is possible to have a relatively confident view on the cycle. Sentiment, unsurprisingly, is no longer as supportive. Our composite contrarian indicator, as of mid-June, is providing a neutral signal. This means that the support from oversold conditions is waning and markets are at greater risk of pulling back on negative news.

Neutral value, neutral sentiment and a supportive cycle give us a more balanced view on the investment outlook. Looking near-term, markets are vulnerable to negative news after a 40% rebound and with sentiment on the verge of triggering our overbought signal. Over the medium-term, the supportive cycle outlook should allow equities to outperform bonds.

Main risks

The main risks come from a second wave of virus infections and the approaching U.S. federal elections in November.

- There is little evidence so far in mid-June of a meaningful second wave of virus infections following the easing of lockdowns across Asia and Europe. COVID-19, however, is highly contagious and has only been contained through the imposition of severe lockdowns. We should know in the next couple of months whether a second wave is underway. On the plus side, most countries are now better placed to manage a second wave in terms of healthcare capacity and treatment. Also, the news on vaccine development is promising, although 2021 is the most optimistic timeline.
- The U.S. federal elections are too close to call. They will become a bigger focus for markets if the Democrat nominee, Joe Biden, takes a decisive lead. Biden plans to at least partially reverse President Donald Trump's 2017 corporate tax cuts. This could deliver a hit to earnings per share in 2021. One of the key watchpoints will be the election outcome of the Republican-led U.S. Senate. Democrat control of the White House, Senate and House of Representatives would make a corporate tax hike more likely. It would also create the risk of more corporate regulation.
- The other election risk is a re-escalation of the U.S./China trade war. A recovery in the stock market and the economy provide President Trump with his best chance of re-election. We expect he will not endanger this by re-starting trade hostilities. This calculus could change if Trump's poll ratings show him in a losing position a couple of months from the election. He may conclude that nationalism and China-bashing increase his chance for victory.

Longer-term COVID-19 implications

Here are five likely longer-term impacts of the pandemic.

1. **Low interest rates for longer.** The global economy has taken a huge hit from the pandemic and interest rates are zero or lower at all the major central banks. There is a lot of economic spare capacity which will keep inflation low for the next couple of years at least. This means central banks will keep rates low, which will keep bond yields low. Furthermore, after experiencing zero rates, central banks are likely to keep rates low once inflation rises. They will be reluctant to tighten too quickly.
2. **Less globalization.** Globalization was already in reverse before COVID-19. The 2008 financial crisis undermined the trust of western voters in the free market capitalist model. The backlash continued with Brexit, the rise of Trump and the U.S./China trade war. The virus is accelerating the anti-globalization trend. Global supply chains are being unwound and the pandemic has created fears about food security and pressure for domestic production of medical supplies.
3. **More government debt and a bigger share of government in the economy.** The lockdowns are leading to the largest rise in government debt levels since World War II and higher levels of government support for industries. Eventually, the political debate will turn to how to pay for the lockdown support measures and how to address the inequalities that have been worsened by the pandemic. Well-paid white-collar workers have been able to isolate at home while lower paid workers have been laid off or had to work in less-safe conditions.
4. **Higher inflation, eventually.** Inflation shouldn't be a problem for the next couple of years due to economic spare capacity caused by the recession. Longer-term, inflation could rise by more than expected. Globalization was deflationary and its reversal will be inflationary. On the supply side, it would be inflationary from higher input costs, less cheap foreign labor and rising tariffs and protectionism. On the demand side, central banks likely would take a lax approach to rising inflation and governments would see higher inflation as a way of reducing debt burdens.

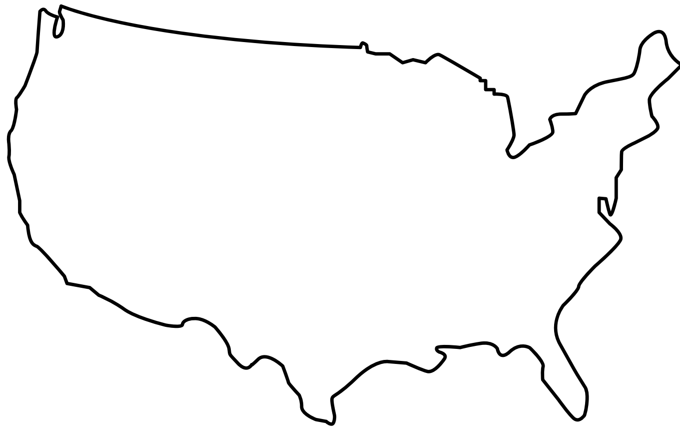
Ongoing low interest rates favour higher yielding assets such as stocks, property and infrastructure over government bonds and cash.

Andrew Peasew

5. **Pressure on profit margins.** Slower trend economic growth, less efficient capital allocation, just-in-case instead of just-in-time inventory management, higher taxes and higher labor costs will place profit margins under pressure. One potential offset is that the increased use of technology encouraged by the lockdowns will generate cost savings and productivity improvements.

These trends should favor domestic stocks over those exposed to global revenues and supply chains. Mid- and small-cap stocks should do better than large-cap stocks, in a reversal of the trend of the last decade. Developed markets should benefit relative to emerging markets as there will be less technology transfer and less export-led growth. The unwinding of globalization is a headwind for emerging markets. Ongoing low interest rates favor higher yielding assets such as stocks, property and infrastructure over government bonds and cash.

Regional Snapshots



United States

The U.S. economy experienced a historic slowdown through April with, at one point, 95 percent of Americans under stay-at-home orders. The fiscal and monetary response, however, has been equally extraordinary. The U.S. Federal Reserve cut interest rates to zero, announced unlimited quantitative easing, and committed to buy investment grade and high yield corporate bonds. The fiscal stimulus packages include forgivable loans to small businesses and unemployment benefits equal to wage income for the median worker who loses their job. This is the most significant fiscal thrust since World War II, and more stimulus appears to be on the way. We are positive on the economic outlook.

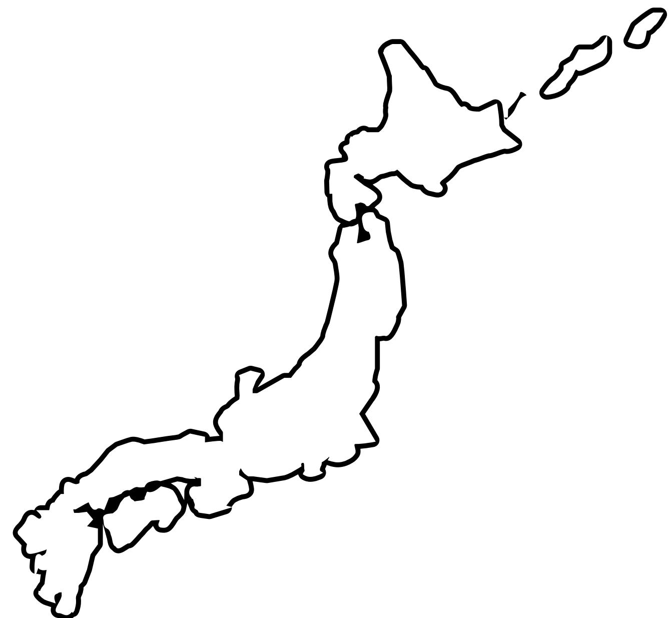
Unprecedented stimulus and the potential for a few years of non-inflationary growth suggest investors may earn a larger than normal equity risk premium going forward. The U.S. still has relatively high infection rates, so a second wave is an obvious downside risk to monitor. A further deterioration in U.S./China relations would also be a concern. Conversely, news of an effective vaccine, with results expected in June or July, could drive markets significantly higher well in advance of doses becoming widely available. The risks to markets from here are two-sided, not purely to the downside as many commentators are suggesting.

Eurozone

European economies are emerging from lockdown and, so far, there has been no evidence of a significant second wave of infections. The economic cost, however, has been large with the Organization for Economic Co-operation and Development (OECD) forecasting a Eurozone gross domestic product (GDP) decline of 9.1% in 2020 followed by a 6.5% rebound in 2021.

Europe's disadvantage heading into the COVID-19 crisis was its lack of policy ammunition. The European Central Bank (ECB) policy rate was already negative, there were strict rules around increasing fiscal deficits, and high-debt countries like Italy were at risk of a re-run of the 2012 debt crisis. The policy response has surprised to the upside. The ECB has increased its asset-purchase program by more than 12% of GDP. Rules on fiscal deficits have been temporarily relaxed, resulting in fiscal stimulus of around 3.5% of GDP across the region. The work subsidy schemes implemented in most countries have kept the Euro area's unemployment rate near record lows. The most far-reaching policy response is the proposal by Germany and France for a €750 billion (6% of GDP) recovery fund that would be financed by the first-ever issuance of bonds jointly guaranteed by all 27 members of the European Union. This is still to be agreed upon but represents an historic step forward in European unity and stability.

The MSCI EMU Index rebounded by 33.3% from its March lows through June 10 but lagged the 43.2% rebound in the S&P 500. Europe's exposure to financials and cyclically sensitive sectors such as industrials, materials and energy give it the potential to outperform in the second phase of the recovery, when economic activity picks up and yield curves steepen.



United Kingdom

The U.K. has been hit hard by the COVID-19 crisis. It has suffered high infection and death rates, which are delaying the easing of lockdowns. The OECD is forecasting an 11.5% GDP decline in 2020 followed by a 9% rebound in 2021.

Economic uncertainty is compounded by the Brexit negotiations. There is a year-end deadline for a European Union/U.K. trade deal, but negotiations seem to be at a stalemate. Our assumption is that a deal will be reached, but the risk of a no-deal exit, with negative consequences for trade and the economy, cannot be ignored.

This has been reflected in the FTSE 100 Index, which has been the worst performer of the major developed stock indices. We like the value in the U.K. market on a longer-term basis. It offers a dividend yield at mid-year of 4.5% with a trailing P/E ratio of 14.5 times.[1] Brexit uncertainty and the slow decline in virus cases could continue to hold the U.K. market back.

Japan

The Japanese economy was struggling before the COVID-19-led downturn. Fiscal policy has become supportive, with the Japanese government recently approving a second stimulus package worth close to 117 trillion yen ($1 trillion U.S. dollars). The Bank of Japan has expanded its toolkit and is providing commercial banks with the funds to make loans. The boost to the economy from the postponed Olympics has been delayed to 2021.

Japan's structural weaknesses in terms of weak monetary policy and persistent deflation mean it will likely remain an economic laggard relative to other developed economies.

[1] Trailing price-to-earnings (P/E) is a relative valuation multiple that is based on the last 12 months of actual earnings. It is calculated by taking the current stock price and dividing it by the trailing earnings per share (EPS) for the past 12 months.

China

After being the first country to enter the COVID-19 crisis, China has emerged from the shutdown. The recovery in China has continued through the second quarter of 2020, with the services sector starting to catch up to the manufacturing sector. Construction activity has seen significant improvement in the last month, and there remains a large pipeline of infrastructure projects to be started.

The Chinese government has announced further stimulus measures, including coupons to households to encourage spending, and the People's Bank of China is making monetary policy more accommodative. However, the stimulus does not match 2015/16 or the financial crisis of 2007-08, and the government appears worried about excessive debt levels. While geopolitical risks are rising, we think the rhetoric between the U.S. and China is at this stage unlikely to see the Phase One trade deal dissolved in the short term. China seems well positioned for a strong rebound through the second half of 2020 and into 2021 as stimulus kicks in and the global economy recovers.

Canada

The Canadian economy is expected to contract by around 9% in 2020 based on industry consensus estimates. The path forward looks more optimistic. The phased reopening of the economy, recovery in the price of oil, and historic fiscal and monetary stimulus are laying the foundation for the upturn. A risk to the outlook is consumption. The Canadian consumer had underpinned the most recent expansion. Rising home values elevated household net worth but also indebtedness. Coupled with a high level of unemployment at mid-year, the cracks may be forming in this foundation.

High frequency data such as credit card transactions suggest April marked the cycle trough. Although a full jobs recovery will take time, 290,000 jobs were added in May. While this recaptures just 10% of the jobs lost in the prior months, it suggests a gradual recovery is unfolding.

Australia

Australia and New Zealand have been successful in containing the coronavirus through a combination of stringent border control and lockdowns. The focus now turns to the economic recovery, where some caution is warranted.

High household debt levels and slow growth in wages mean a cautious consumer will be a headwind to the recovery in Australia. A similar situation is likely in New Zealand, where household debt is also elevated. The downturn in tourism will also be a challenge for both economies in the shorter term.

Asset class preferences

The recovery from the recession means a long period of low-inflationary growth supported by monetary and fiscal stimulus.

Andrew Pease

Our cycle, value and sentiment investment decision-making process has a moderately positive medium-term view on global equities. Value is neutral, with the expensive U.S. offset by reasonable value in the rest of the world. Sentiment is also neutral as of mid-June after being strongly oversold in late March. We see the cycle as supportive of risk assets for the medium-term. The recovery from the recession in our view means a long period of low-inflationary growth supported by monetary and fiscal stimulus.

Sentiment is no longer overbought, and supportive following the market rebound. Our near-term view on equities is more cautious with the risks around a second wave of infections and U.S. politics heading into the federal elections in November.

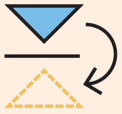
Asset performance since the coronavirus-drivenmarket bottom

From the S&P 500® Index through on 23 March 2020 through 10 June 2020

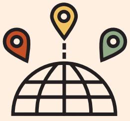
60%
50%
40%
30%
20%
10%
0%
-10%

Brent Crude Oil ($)
Russell 1000® Growth Index ($)
Nasdaq ($)
S&P Global Infrastructure ($)
S&P 500 ($)
MSCI World ($)
Russell 1000® Value Index ($)
Global REITS ($)
MSCI Emerging Equities ($)
MSCI EMU ($)
Japan Topix (¥)
FTSE 100 (£)
MSCI China ($)
Merrill Lynch Global High Yield Bonds ($)
Merrill Lynch Global Corporate Bonds ($)
Gold ($)
Bloomberg Commodities Index ($)
U.S. 10Y Govt Bond ($)
German 10Y Govt Bond (€)
U.S. Dollar Index DXY ($)

Source: Refinitiv Datastream, last observation 10 June 2020.

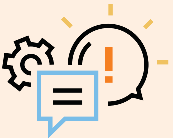


We prefer **non-U.S. equities to U.S. equities.** This is partly driven by expensive relative valuation. It also reflects that the second stage of the post-coronavirus economic recovery will see corporate profits recover. This should favor cyclical and value stocks over defensive and growth stocks. The rest of the world is overweight these stocks relative to the U.S.



We like the value in **emerging markets (EM) equities**. China's early exit from the lockdown and stimulus measures should benefit EM more broadly

High yield and **investment grade credit** were very attractive in late March when spreads were wide. Spreads have since narrowed and as of mid-June only adequately compensate for the likely rise in default rates following the recession. We have a neutral view.



Government bonds are universally expensive. Low inflation and dovish central banks should limit the rise in bond yields during the recovery from lockdowns.

Real assets: Real Estate Investment Trusts (REITs) sold off heavily in March, with investors concerned about the implications of social distancing and online shopping for shopping malls and office buildings. Sentiment appears overly bearish, while value is very positive. By contrast, Global Listed Infrastructure (GLI) is expensive, which leads us to prefer REITs to GLI.

The **U.S. dollar** should weaken into the global economic recovery given its counter-cyclical behavior. The dollar typically gains during global downturns and declines in the recovery phase. The main beneficiaries should be the economically sensitive "commodity currencies", such as the **Australian, New Zealand and Canadian dollars.** The **euro** and **British sterling** are undervalued at mid-year 2020. The euro should gain if a second wave of the virus is avoided and a recovery is sustained. Sterling, however, is likely to be volatile around uncertain Brexit negotiations.

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IMPORTANT INFORMATION

The views in this Global Market Outlook report are subject to change at any time based upon market or other conditions and are current as of June 22, 2020. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Keep in mind that, like all investing, multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

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Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

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