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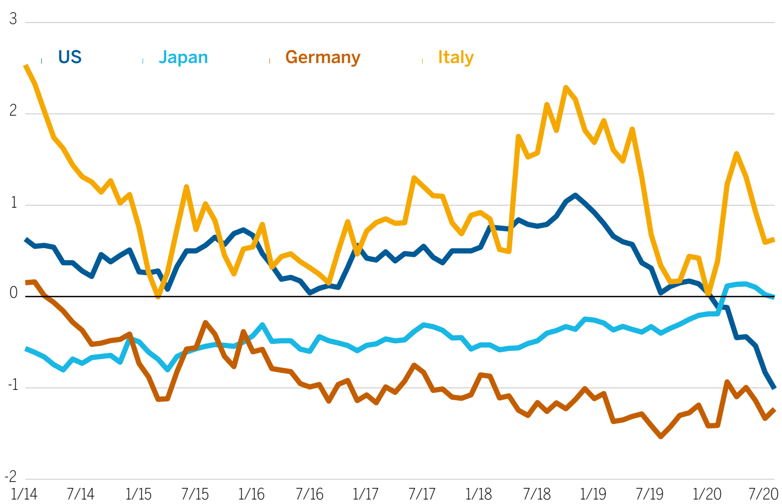
Politics, Policy, and the Pandemic

THE CONTRAST IS STUNNING: THE WORST ECONOMIC DOWNTURN SINCE THE GREAT DEPRESSION HAS BEEN FOLLOWED BY THE GREATEST EQUITY REBOUND IN HISTORY (DESPITE THE RECENT SELL-OFF). But we reject the theory that the market is in a bubble. The technology sector, whose rally has raised the most alarm, enjoys excellent fundamentals, and we think it could continue to exceed expectations in a low-growth world.

US election risk is also top of mind with investors, as the large number of mail-in ballots is likely to mean delayed results and legal challenges, and perhaps even civil unrest. The uncertainty will be a negative for global markets, but we expect election volatility to be temporary and are more focused on what comes next. Over our 12-month horizon, the main reasons to own risk assets[1] in our view are: progress on treatments and vaccines for COVID-19; continued fiscal and monetary support; the gradual reopening of economies; and positive demand technicals in a near-zero yield environment for developed markets (**FIGURE 1**). Our bullishness, however, is tempered by global economic indicators that remain well below pre-COVID levels, the potentially reduced fiscal and monetary oomph of future policy action, and COVID-19 uncertainty, (including a possible second wave, the path of vaccine trials and distribution, and the vaccine take-up rate).

FIGURE 1
"TINA" More Relevant at Near-Zero Yields
Ten-year real bond yields (%)



Source: Bloomberg | **Past performance does not guarantee future results.** | Chart data: January 2014–August 2020

We continue to prefer US equities given our expectation that global growth will recover slowly. The "TINA" effect (There Is No Alternative) is powerful given low fixed-income yields and the potential yield and earnings growth that US equities may provide.

[1] Risk assets (such as equities, commodities, high-yield bonds, real estate, and currencies) have a significant degree of price volatility.

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Key Points

- Potential treatments/vaccines for COVID-19, policy support, and gradually reopening economies make us more comfortable taking a pro-risk stance over our 12-month time frame.
- However, the market's rebound and the prospect of a slow economic recovery leave us only moderately bullish on risk assets.
- Within equities, we prefer the US and the growth and quality factors, though we think some higher-quality cyclical companies are attractive.
- We think rates will stay low and find some credit spreads attractive relative to government bonds.
- Downside risks include the US election, a second wave of COVID-19, a deeper and longer recession than anticipated, and worsening US-China relations. Upside risks include a faster-than-expected, safe/effective vaccine, another major dose of policy stimulus, and/or a sharp economic rebound.

Investor cash levels also remain high and could provide support for equities. We are neutral on European, Japanese, and emerging-market (EM) equities, as we think less attractive fundamentals are offset by cheaper valuations. We expect interest rates to stay low, given the Federal Reserve's (Fed) new policy framework, and find many areas of credit attractive given the demand for yield and the Fed's asset-purchase support. We believe the COVID-19 shock is deflationary and, consequently, think commodities could be a source of funds. The one exception is gold and other precious metals, which we think could be a complement to fixed income for diversification purposes in a period of near-zero yields.

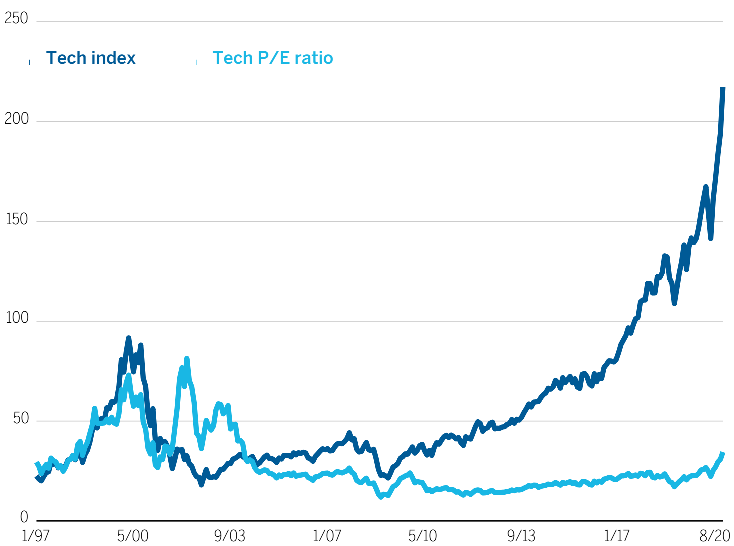
Equities: Leaning Toward Growth

We are moderately bullish on US equities given the less cyclical nature of the economy and the market's growth and technology exposure. In the post-COVID regime that we expect—low growth, low inflation, and low rates—growth areas such as technology could remain attractive thanks to their potential to increase earnings and cash flow despite rich valuations (**FIGURE 2**).

FIGURE 2

Advance in Tech Supported by Higher Earnings

S&P 500 IT Sector Index



Tech P/E ratio is the tech price/earnings ratio calculated as last market price divided by trailing 12M earnings per share. | Source: Bloomberg | Chart data: January 1997 – August 2020 | The S&P 500 Information Technology Index comprises those companies included in the S&P 500 Index that are classified as members of the GICS information technology sector. | **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment.

European and Japanese equities are cheap and their economies are recovering enough to potentially warrant some exposure, but equity valuations matter very little over a one-year horizon and both regions are highly exposed to the fragile global economy. To turn more bullish, we would want to see evidence that a widely distributable vaccine was on the way or that global leading economic indicators were turning more positive.

Europe has undertaken enough policy support to prevent material downside for the economy, though not enough to provide much upside. We are closely monitoring Brexit developments and prefer to steer clear of UK equities at this time. In Japan, we think new Premier Yoshihide Suga will continue the reflationary policies of his predecessor, but we fail to see a catalyst for the Japanese market to move much higher.

Our Multi-Asset Views

Asset class	View	Change
Developed market equities	**Moderately bullish**	—
US	Moderately bullish	—
Europe	Neutral	—
Japan	Neutral	—
Emerging-market equities	**Neutral**	—
10-year rates	**Neutral**	—
US	Neutral	—
Europe	Neutral	—
Japan	Neutral	—
Credit	**Moderately bullish**	—
Investment-grade	Neutral	—
High yield	Moderately bullish	—
Bank loans	Neutral	⬇
Emerging-market debt (external)	Moderately bearish	—
Securitized assets	Moderately bullish	⬆
Commodities	**Moderately bearish**	—

Change is from previous quarter. Views expressed have a 6–12 month horizon and are those of the authors. Views are as of September 2020, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

Emerging markets are a heterogeneous asset class, and country differentiation is key. Most of the countries and regions we currently find attractive are in Asia, and China tops the list. The country has made great progress in stopping the spread of COVID-19, and our macro team expects a steady if unspectacular economic recovery. Countries we see reasons to avoid include Brazil, Turkey, and South Africa.

Credit: Still a Good Case for Tighter Spreads

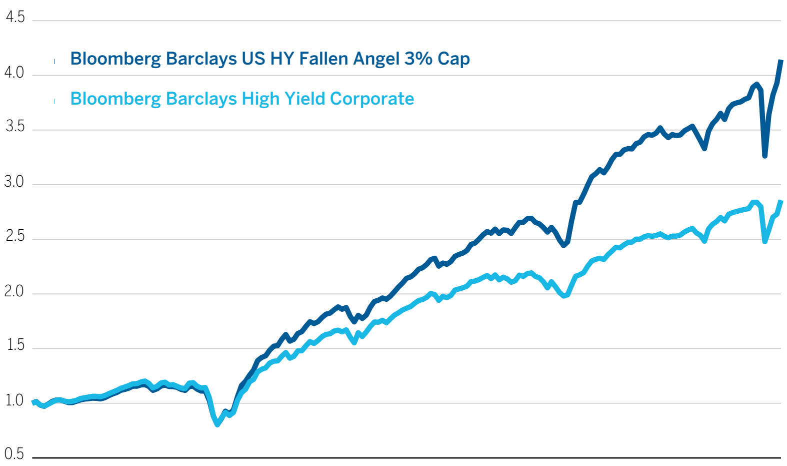
It was another good quarter for credit spreads,[2] which narrowed 20–100 basis points (bps),[3] and total returns were in the 1%–5% range with high yield among the best performers. The backdrop for continued spread tightening is positive in our view: 1) the economy is slowly improving; 2) the Fed will be on hold for years with its new average inflation targeting strategy; 3) demand for extra yield over government bonds is strong; and 4) valuations are at median levels versus history.

Within credit, we continue to favor high yield and think spreads could potentially tighten around 100 bps more over the coming 6–12 months. Defaults spiked in the April–July period but have already come down, and we expect a drawn-out default cycle with slightly elevated defaults relative to the long-term average of 4%. We prefer high yield to bank loans given the prospect of short-term yields staying at zero for several years. We also think "fallen angels" (bonds downgraded from investment-grade to high yield) will remain elevated into 2021 as some companies struggle with deteriorating credit metrics. Fallen angels have historically added to high-yield returns (**FIGURE 3**).

FIGURE 3

Fallen Angels Have Added Return to High Yield

Cumulative growth (assuming base value of $1 as of 1/31/05)



Performance metrics are based on monthly returns during the period from 1/31/05 to 7/31/20. | **Past performance does not guarantee future results.** | The Bloomberg Barclays US High Yield Fallen Angel 3% Capped Bond Index is a component of the US Corporate High Yield Index that is designed to track USD-denominated, high-yield, fixed-rate corporate bonds that have been downgraded from investment grade. | The Bloomberg Barclays US High Yield Corporate Bond Index is an unmanaged broad-based market-value weighted index that tracks the total-return performance of non-investment grade, fixed-rate publicly placed, dollar-denominated and nonconvertible debt registered with the Securities and Exchange Commission.

[2] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

[3] A basis point is a unit that is equal to 1/100th of 1%, and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

We see securitized assets as a way to express a positive view on residential housing, though we are cautious on commercial property such as malls and offices. With mortgage rates below 3%, unemployment declining, and millennials—now the largest age group in the US—creating a large source of demand, we see tailwinds for sectors such as workforce housing and credit-risk transfer. We are moderately bearish on emerging-market debt, especially USD-denominated sovereign debt. These economies have been hit by higher government spending and, given their export orientation, the global slowdown. We find corporate debt, with fewer sovereign-related problems, a more attractive option for EM debt exposure.

Risks

The biggest near-term risk is the US presidential election. Uncertainty surrounds the process and, we think the potential for post-election civil strife is quite high. Risk markets are also likely to initially react poorly to a blue-wave scenario in which Democrats win the White House and control both houses of Congress, paving the way for higher corporate taxes and more regulation (**FIGURE 4**).

FIGURE 4

Greater Potential for a Democratic Sweep

Swing state	Trump 2016 election margin (thousands)*	Current net polling (thousands)^	Current continuing unemployment claims (thousands)†
Arizona	91	-346	200
Florida	113	-672	410
Michigan	11	-706	439
North Carolina	173	-312	170
Pennsylvania	44	-898	583
Wisconsin	23	-332	139

* The Trump 2016 election margin is based on the 2016 presidential election and the margin represents the difference between votes received for Trump and Clinton. | ^ The current net polling is based on Trump's net approval rating as of 9/13/20; then the number of lost voters is extrapolated by using the approval rating and number of registered voters in each state. | † The current continuing unemployment claims are for the week ending 8/29/20. | Sources: New York Times, United States Census Bureau, United States Department of Labor

However, we are more focused on longer-term risks, including COVID-19 developments. Markets are optimistic that a safe, effective vaccine will be ready for distribution in 2021, so a disappointment on this front or a second wave of the virus in this fall or winter could derail the global recovery. In this scenario, we think more stimulus will be forthcoming.

Given our fairly balanced views, we also consider upside risk. We see three potential catalysts that could cause a definitive rotation into value-oriented sectors, which include non-US equities, deep cyclicals, commodities, EM equities, and EM currencies:

- **Vaccine** — If a safe, effective vaccine comes to market, distribution begins sooner than expected, and take-up is strong, growth expectations would likely rise.
- **US dollar weakening** — If global economic conditions stabilize and the US dollar weakens further, EM and cyclicals could outperform developed markets and defensives.
- **Valuations** — Despite the gaping valuation disparity between growth and value, we believe mean reversion requires a catalyst. Given starting valuation levels, should either of our first two scenarios come to fruition, we would expect a growth-to-value rotation to gain momentum.

About the authors

Nanette Abuhoff Jacobson consults with clients on strategic asset allocation issues and works with investment teams throughout Wellington to develop relevant investment solutions across asset classes.

Daniel Cook analyzes and interprets markets and translates this work into investment insights. He researches investment ideas for portfolio managers and consults with clients on tactical and strategic asset allocation.

Investment Implications

Looking beyond the election — An election-related spike in volatility seems likely in the near term, but we expect the course of COVID-19 and fiscal and monetary policy to ultimately have more sway over markets.

Leaning toward growth in equities — We prefer US equities, as we think they could retain their premium given the slow recovery we expect over the coming year. Given the upside risks described above, we have a neutral view on non-US equities and see the case for taking profits in technology (but staying long) and moving into higher-quality value-oriented companies that are more exposed to a cyclical upturn within retail, financials, and industrials. Within EM equities, we prefer China for growth exposure.

Seeing more spread-tightening potential in credit — Spreads have narrowed but are still around median levels as of this writing. Given the Fed's unprecedented support for credit, we think spreads will continue to grind tighter. We are less optimistic about EM debt given poorer fundamentals. Securitized assets are not the target of Fed credit programs, but the market offers exposure to the improving US residential housing market.

Diversifying with high-quality bonds — We think agency mortgage-backed securities and high-quality government bonds could potentially boost a portfolio's diversification and liquidity if the recession is deeper or longer than we expect. We think taxable investors should consider municipal bonds given attractive valuations.

Enhancing diversification with precious metals — Given rock-bottom fixed-income yields, we think precious metals can potentially play a role in boosting portfolio diversification and mitigating the effects of a stagflationary environment and geopolitical tensions.

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