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Investing in uncertain times

Our views on today's market volatility and how we use these to position the Multi-Index portfolios

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As many countries around the world begin lifting their COVID-19 lockdowns, global financial markets are assessing the likely impact of easing these measures and how it may affect an economic recovery. Whilst recent conversations have been dominated by Coronavirus, developments concerning Brexit and US/China trade talks continue, adding to the uncertainty.

The Asset Allocation team has received many questions from our advisory intermediary clients on navigating these challenging markets. In May we hosted a series of Fireside Chat calls, putting these questions to Justin Onuekwusi, Head of Retail Multi-Asset Funds and Hetal Mehta, Senior European Economist. We share some of the top questions and our answers below.

We understand investors' concerns during these volatile times. However, we want to stress the importance of having a long-term view and have also highlighted our top five reasons to be optimistic about investing today, which we hope will provide some reassurance.

What are your thoughts on the current coronavirus developments and the likely economic impact?

Most developed market countries in the world have passed the peak in coronavirus-related daily deaths so it does seem the severe lockdowns seen in most countries have had the desired effect on reducing the spread of the virus. Policy discussions are moving on from the impact of the lockdowns (which we know has caused many countries to run at 70-80% of normal economic activity) to the impact of lifting them.

Our economists have set out two potential main recovery scenarios: one will lead to a sharp rebound with very little economic activity curtailed by the end of 2021, and the other – which is currently our base case - outlines a more muted recovery by the end of the year and into 2021.

We are tracking many things in order to understand how the economy is evolving. Gross domestic product (GDP) is lagging at the best of times, but right now it is very backward looking. So we are being more innovative with data and are looking at higher frequency tracking numbers. For example, we are using the Citymapper mobility index and the Google mobility data set to track how people are starting to move and then map that onto the level of economic activity. We are also using PMI data, cinema bookings, and restaurant reservations to build a picture of the economy and see where pick up comes from.

These indicators are currently showing that economic activity is picking up in some countries that have lifted their lockdowns early, such as Germany, France and Austria. Based on this, we believe things may start to look better by the end of Q2, and potentially we're set for a decent bounce back in Q3. However for now, the outlook for Q4 remains unclear.

How are individual countries faring? Who is making the most and least progress?

We've mentioned above that Germany, France and Austria have lifted their lockdowns early and are seeing signs of more economic activity which is positive.

In Europe, we are concerned with how vulnerable Italy may be due to this crisis. The sheer stock of debt makes it vulnerable to economic shocks. Despite seeing a 12-15% hit to economic growth, Italy has put in place fiscal support of around 4% of GDP[1].

We are also keeping an eye on how the US handles the spread of the virus. While many other countries have seen sharp falls in their daily death rates, the US has moved sideward for a few weeks and there is a risk that we start seeing restrictions lifted earlier in the virus cycle which could lead to a second wave.

1. IMF, May 2020

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What other key economic developments or issues are you are keeping top of mind?

Before coronavirus, US/China trade talks and Brexit were the two most important topics for us and they continue to give us pause for thought.

Coronavirus has not helped ease US/China tensions, especially as China's early handling of the virus may have lost them credibility among some, and President Trump may look for someone to blame for the virus's spread as elections draw near. We do not believe these tensions will go away and this will negatively impact any trade talks; we think there is a low probability for any meaningful trade discussions this year.

Brexit remains a significant issue and recent negotiations have not given us much confidence that a comprehensive trade deal is forthcoming anytime soon. There is still much to be discussed and agreed with the deadline to request for an extension fast approaching at the end of June. We believe the UK will have to ask for an extension especially as discussions for many key sticking points – including the Northern Ireland backstop and regulations of services – are very much on going. Although the risk of the UK ending the transition period without a deal in place should not be underestimated.

Governments have introduced significant fiscal stimulus recently. Do you think they will increase taxes to recover funds?

If we look back to the Great Depression in the 1930s, one thing that was clear was policymakers were too quick to tighten fiscal policy in the aftermath, which meant growth took longer to pick up. And while we would have liked to have thought a lesson was learnt, in 2008, we saw many countries respond to the global financial crisis with austerity. We believe after this crisis many countries will implement a more cautious approach in recovering money, especially in countries with more populist politics that try to avoid funding spending through increased taxation. It is hard to imagine that governments will be so short-sighted to claw back money too quickly this time around as in our view it would be very detrimental to recovery.

Taking into account your research and insights on the current volatility, how do you put those into play in the Multi-Index portfolios?

We believe it is important to prepare and not predict. We as portfolio managers are not trying to predict when the bounce back will happen and when markets will recover, but we are preparing the portfolios for both the above recovery scenarios and managing the risk in our portfolios accordingly with a longer-term view.

For example, between 19 February 2020 and 8 March 2020, we saw a traditional, albeit quick bear market – and a few days into this bear market we went negative on risk from a medium-term perspective, which helped cushion some of the falls. We moved back to a neutral stance when markets started behaving rationally after the widespread sell-off in mid-March, and are looking at how and when to buy back into equities.

Another example of how we prepare portfolios for a longer-term horizon is with our exposure to real estate investment trusts (REITs) and infrastructure. These asset classes didn't give the protection we would have wanted or expected on the downside. Typically REITs offer more downside protection than equities, as tenants would cut other costs before not paying rent and being evicted, but in a lockdown scenario many tenants are not trading therefore cannot possibly afford their rent, especially in retail as footfall has been low. Similarly in infrastructure, airports, toll roads and railroads tend to function even in downturns as they typically offer reliable and stable cashflows; however lockdowns and travel restrictions prevented these relatively defensive asset classes from performing as expected. However we remained invested as we believe in their potential and since 23 March 2020, we have seen significant bounce back in both asset classes, with REITs being the best performing in our universe in April.

We understand investors' concerns amid the current uncertainty, but we want to stress the importance of having a long time horizon over timing the market. Typically in a bear market, US equities measured by the S&P 500 index fall by 20%. However, over the course of the following five years, the returns have tended to rally from the very bottom by an average of 100% . So if you are willing to take a long-term view and are able to look beyond short-term volatility, you may potentially see stronger returns.

What opportunities are you currently seeing?

While global high yield has already shown some signs of recovery, we believe there are still some opportunities within this space. We have only seen high yield spreads at these levels a few times and this has typically led to double digit returns over the next few years. We are spreading our risk outside the gilt market by buying into other developed market government bonds in Australia, Korea and New Zealand.

We have created a basket of equity 'laggards' where we believe the downsides are limited, but upside potential is large. These include European autos, US energy, value stocks and small caps and these could be a big driver of returns in the future. These all share attractive valuations, negative sentiment and a sensitivity to improving macro that has so far not been reflected in prices. We see potential for catch up with only little downside risk in case equity markets start finding the lows again.

We like technology, but we are looking to diversify our exposure by moving into areas including artificial intelligence. We still have concerns over the concentration risk in the US, given that the top five US stocks make up 20% of US equities and we are not willing to risk client money through accidental stock concentration.

How are you managing currency exposure?

We believe currency is the second biggest risk driver in our portfolios, just behind equities. For us, the biggest currency risk is sterling versus the rest of the world as any Brexit developments will have serious consequences for the currency, and it will also be main transition mechanism of potential

Brexit negotiations. So, we are trying to manage that sterling risk over time. In our view, we could make 10 great asset allocation decisions, but one wrong currency move could potentially wipe them out, so we are vigilant and will monitor this going forwards.

Can you provide five simple reasons to be optimistic and potentially stay invested?

1. There is progress towards a coronavirus recovery: the R rate is going down, lockdowns are being lifted in some countries, many vaccines are being trialled – there is clearly many key developments happening.
2. We believe there are still many appealing opportunities and some investments are looking cheap – including high yield, value stocks, and artificial intelligence.
3. Governments and central banks have shown willing to do whatever it takes to prevent disorderly or non-functioning markets.
4. We believe it is clear that there will not be a credit crunch-type crisis in the short term which was a real concern for investors just a few months ago.
5. Markets tend to discount the bottom around five months before it happens. So despite the negative news and potential future volatility, we believe staying invested with a medium-term view is the best way to meet end client outcomes'.

Key risks

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested. There is no guarantee that any forecasts made will come to pass.

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Views expressed are of Legal & General Investment Management Limited as at 22 May 2020.

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