Global Investment Strategy

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MUFG ASSET MANAGEMENT

Mitsubishi UFJ Asset Management (UK) Ltd. (Registered in England No 1842259)
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Investment Summary

The Covid-19 virus has not gone away, without a vaccine it remains a question of lives vs jobs.

- Shutdowns work to stem the virus, but decimate the economy.
- The lives vs jobs trade-off is neither easy nor cheap for Governments, fiscal spending continues to rise.
- A "second wave" in Europe is leading to new national lockdowns as regional efforts have not worked.
- The fundamental economic architecture remains in place, promising a return to normal at some point.
- But we should remember 'normal' was low productivity, low real interest rates and zero bound problems.

Inflationary expectations have weakened alongside weak activity and job losses.

- Inflation expectations have remained well anchored.
- The Fed now have an average inflation target: lower short rates for longer, but ultimately higher long rates.
- Loose fiscal policy alongside loose monetary policy raises inflationary possibilities longer term.

An end to loose money is not in sight.

- The short end of the interest rate curve remains at low levels and negative for several major countries.
- Ten year yields remain below inflation targets for the next ten years, hardly suggesting a boom.
- This is a damning view of the future, no growth, as well as concern that central banks are now powerless.

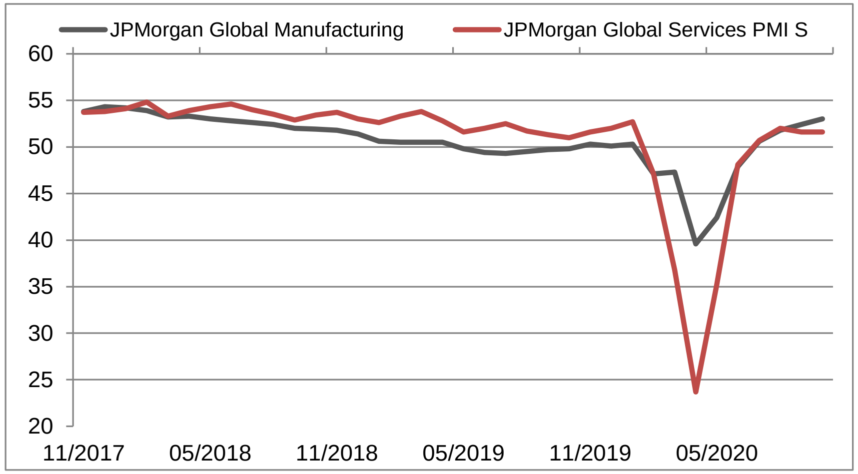
Equity markets assume earnings will recover strongly.

- Corporate earnings for the next 12 months are unknown, while for now profit downgrades continue.
- Sector trends are unchanged; Tech and Media in the ascendancy, Banks and Oil companies with no future.

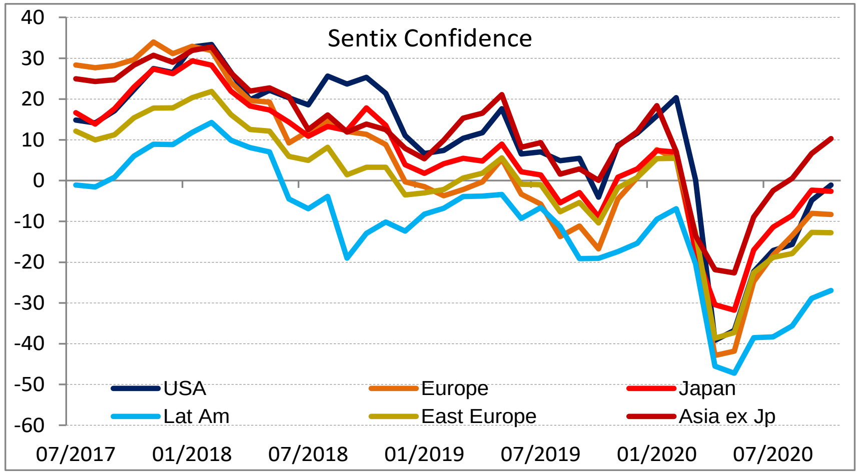
Growth and Inflation

Source: JP Morgan, Sentix, OECD, Bloomberg,

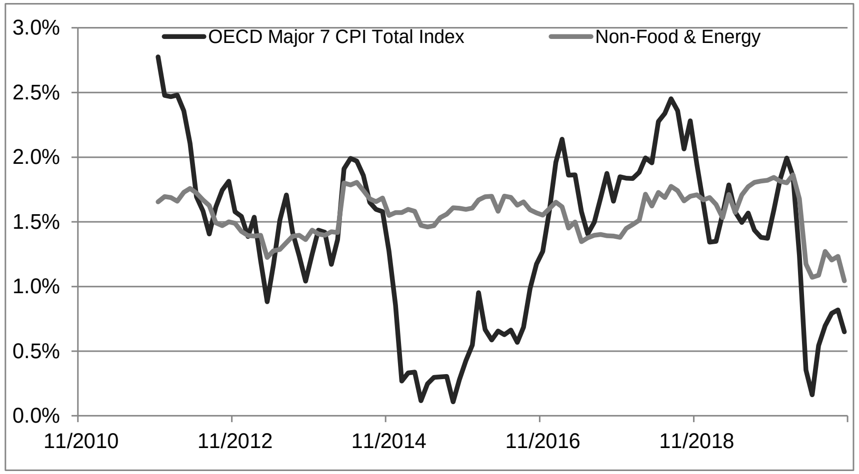
JP Morgan Global PMIs



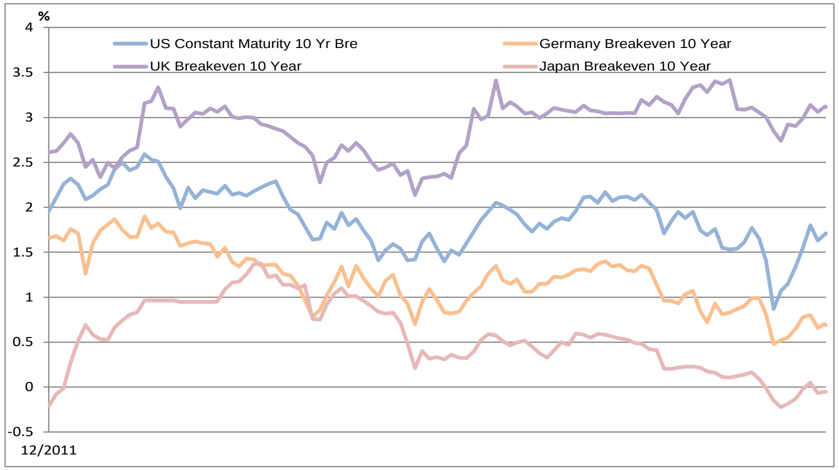
SENTIX Business Expectations Survey



OECD G7 Inflation



Implied Inflation from Index Linked Bonds



Commentary

What are markets telling us?

At this moment in time it probably does not matter what market levels are as they only reflect the here and now.

In particular equity markets have no information to go on, share prices are meant to reflect future earnings.

If so then a profits boom is forecast, but there is little hard evidence on main street to support this.

At the same time dividends are being cut in a bid to retain cash, rather than any view of the future.

At this point no one knows when life returns to normal, and for once it may well be a “New Normal”.

Bond markets have stabilised: yields are at recession levels, with weak non-inflationary growth for many years.

Real interest rates are negative for years to come.

Forward curves have shifted higher suggesting a small shift away from never ending loose money.

Or it may reflect some expectation that inflation risks have risen.

Loose money, increased fiscal spending, change in inflation target, all suggest higher prices in the future.

What are we thinking?

Markets are hoping that the Covid-19 virus has peaked, and are trying to imagine what the future looks like.

As the Western world heads into winter a big test of virus control is coming, and so far it does not look good.

Governments will be wary about closing down economies again as the cost is prohibitive.

Central Banks have no ammunition left and negative rates are impacting the financial system.

Low real interest rates make bonds very poor value, while equities need to look cheap to spur buying.

Fixed Income

Fixed Income Strategy (1)

DURATION

We are neutral duration and only very modestly overweight to yielders.

Central banks were already struggling to meet inflation targets, the goal has moved further away.

There are now longer term worries about fiscal positions and central banks loosening targets.

The US Presidential Election will be important, potential changes to: fiscal action, corporate tax, trade policy.

Country spreads have narrowed and inflation targets shifted so we are less forceful in favouring yielders.

SPREAD PRODUCT

Spread product is attractive, but choose carefully.

The economic outlook, slow growth and supportive policy, favours spread product.

Despite this we have reduced our overweight for reasons given below:

Spreads have come in from 330 over to 130, only 10bp above the Pre-Covid range;

Corporate leverage has increased, so far for precautionary reasons but that could change.

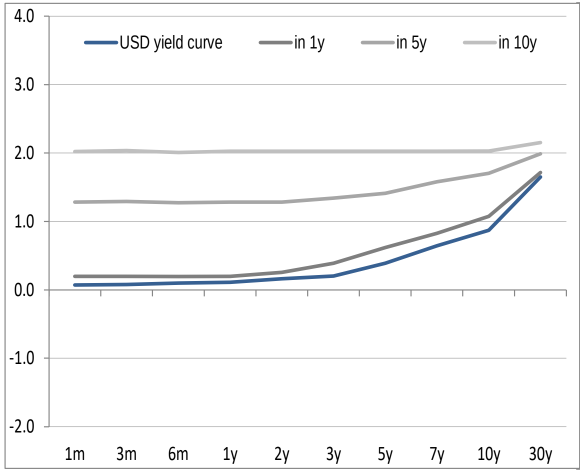
Governments are in weaker positions: debt levels are higher, monetary policy limited in efficacy.

We don’t see another economic shock, but if there is one there is less ability to withstand it.

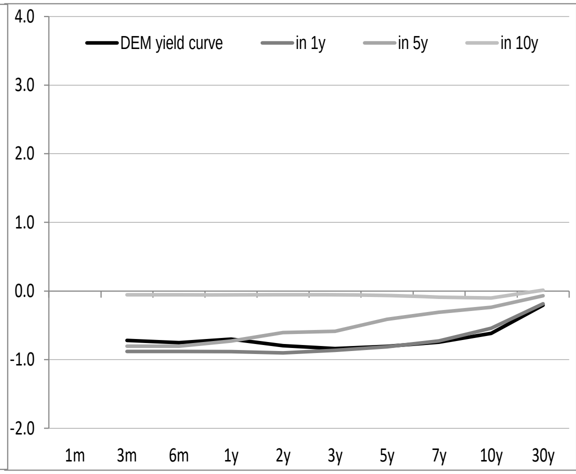
Forward Yield Curves

Source: Bloomberg,

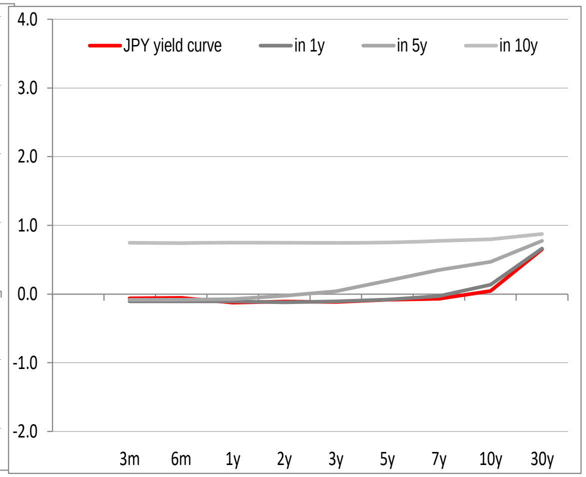
USA



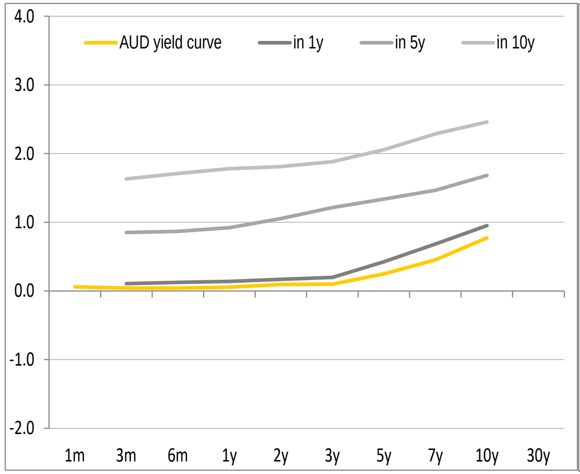
GERMANY



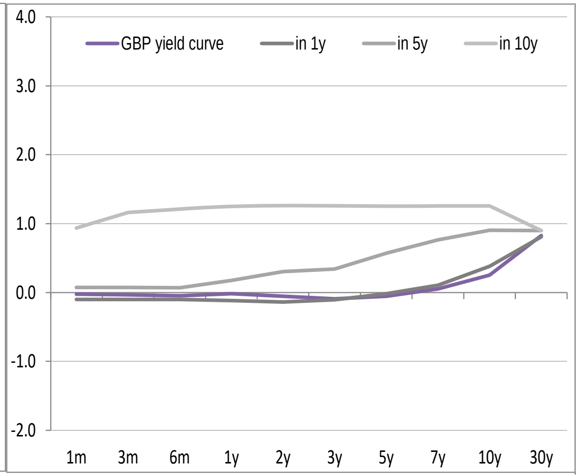
JAPAN



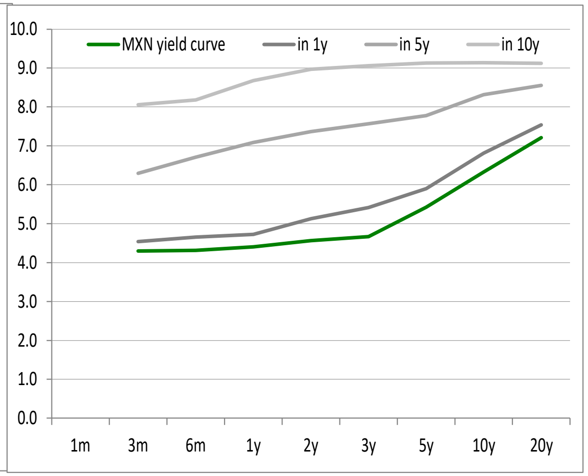
AUSTRALIA



UK



MEXICO



Fixed Income Strategy (2)

COUNTRY ALLOCATION

We prefer markets where yields are higher, but less so.

We mildly prefer the higher yielding markets (USD long end, CAD shorter end).

If growth disappoints yielding countries still have a bit of room to act.

Central banks will not anticipate and will keep rates low until targets are reached.

The world before Covid suggests that will be a long time coming.

Changes to inflation targets make nominal yield convergence less obvious.

The fiscal and monetary actions are raising some concerns longer term, worry about those later.

Negative yields are no longer rare.

Banking sectors are struggling in the negative yield environment creating a vicious circle.

Japan oddly now looks normal rather than an outlier.

German yields are poor value. If yield downside is negligible why risk suffering the upside?

CURRENCY

We have limited currency positions.

The USD has cheapened but is fundamentally a more robust economy.

The Euro is cheap on fundamentals, but rates are not rising and risks around the EU persist.

Much depends on the shape of the recovery: we just don't know.

Equity

Equity Strategy (1)

GLOBAL

The global profit cycle should be important to investors.

The 12 month forward global EPS drifts higher while current earnings fall – suggesting an earnings boom.

This suggestion of rising growth is not supported by economic fundamentals, even if they are improving.

The market rise continues to be based on hope of a return to “normal” rather than solid fundamentals.

With little room for disappointment we would wait for a sell-off before buying equities.

Valuations are extended and still not the focus.

P/Es are related to future earnings growth which currently remains uncertain.

The current historic P/E of 28x is expensive as announced earnings continue to fall.

Future earnings are not being revised down, which is keeping the forward P/E at 20x.

Dividends are under pressure and the current yield is low when one would expect it to be high.

Indeed the last time yields were this low was 2007, just before the financial crisis.

Profit momentum favours no one at present.

Current earnings continue to fall, future earnings remain unchanged, suggesting strong profit growth ahead.

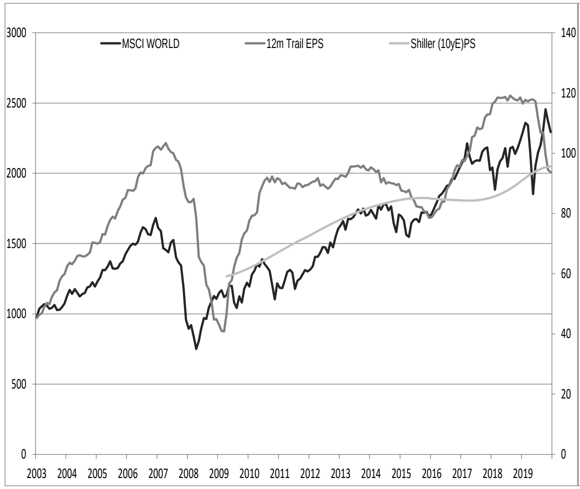
But this is fool’s gold as at some point future earnings will be revised down, once economic uncertainty abates.

Markets that discount weak profits i.e. Asia are becoming better positioned for upside potential.

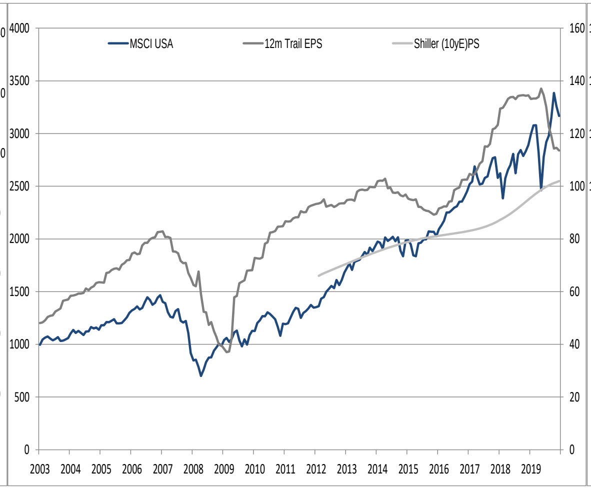
MSCI Equity Indices and Earnings (right hand axis)

Source: MSCI, Bloomberg,

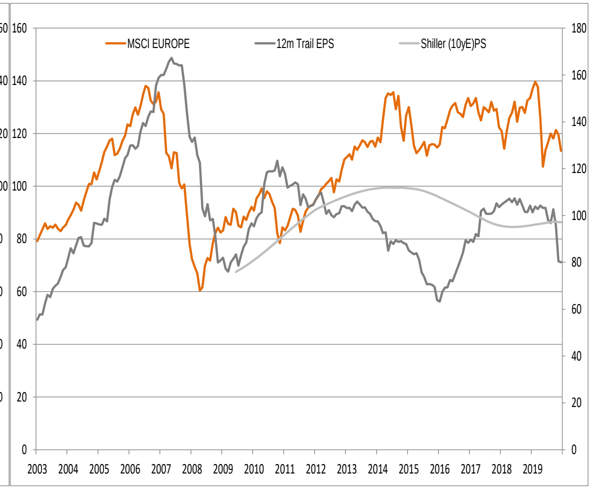
WORLD



USA



EUROPE



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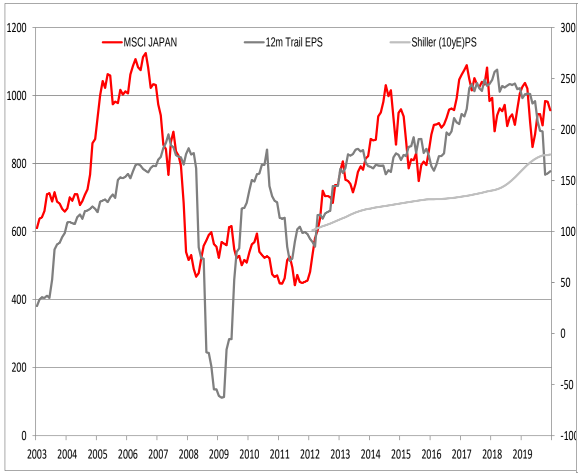
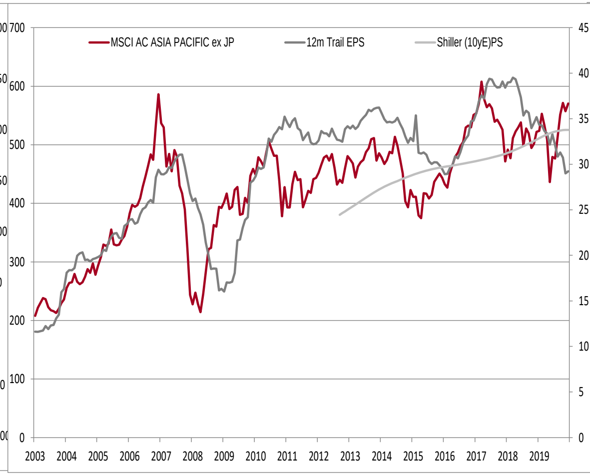
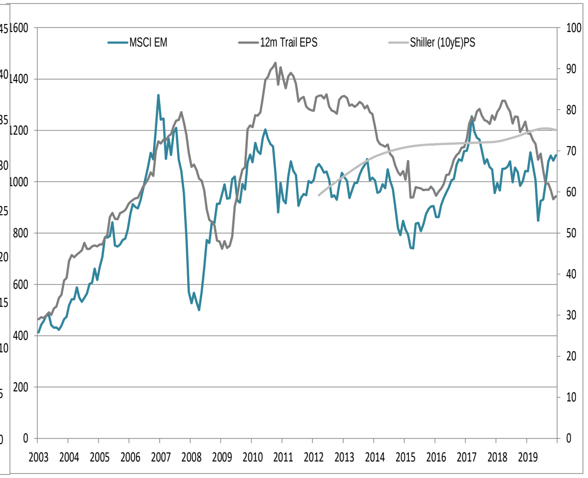


ASIA ex JAPAN



GLOBAL EMERGING



Equity Strategy (2)

SECTORS

Limited information from sector trends as earnings remain uncertain.

Technology and Consumer Discretionary moved further ahead of the pack.

Energy and Bank stocks remain friendless hitting new lows relative to the market.

Other sectors are trendless at present.

Cyclicals have support from better business confidence but economy-wide lockdowns in Europe will not help.

Uncertain dividends have left yield paying sectors without their normal support.

FACTORS

Earnings uncertainty rising due to “second wave”.

Value remains a key topic of discussion due to its long term underperformance.

The “second wave” has raised uncertainty as to when “normality” resumes but it is ultimately only postponing.

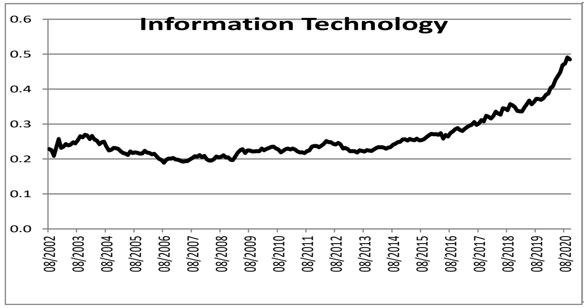
Profit and dividend announcements have an impact, and valuations are ignored.

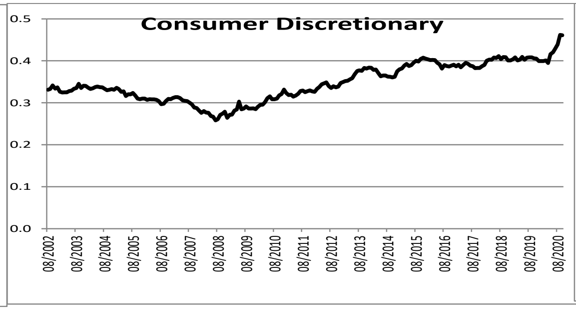
Size is equally no guide to the future, with mixed signals, but we would still tilt to Small Cap.

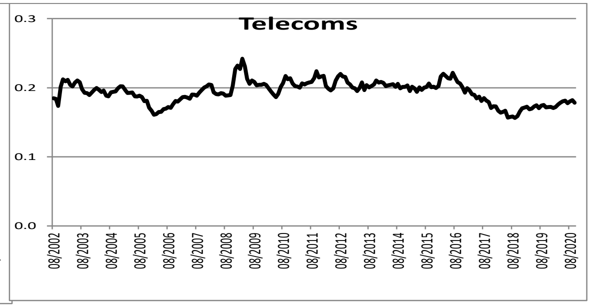
MSCI Equity Sectors Relative Performance (in USD)

Source: MSCI, Bloomberg,

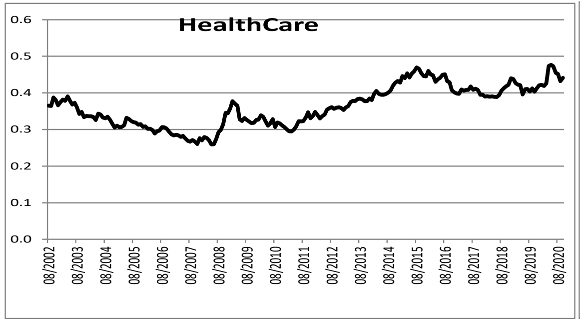
WINNERS

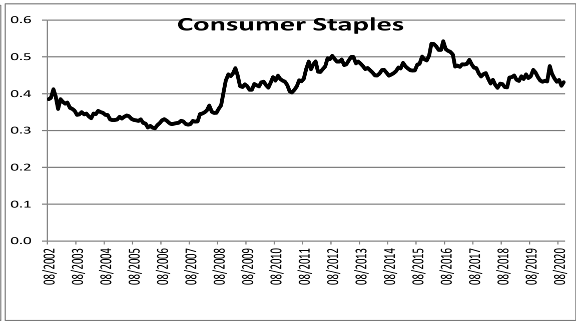


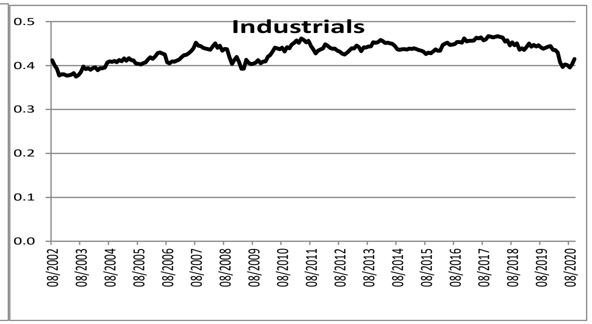




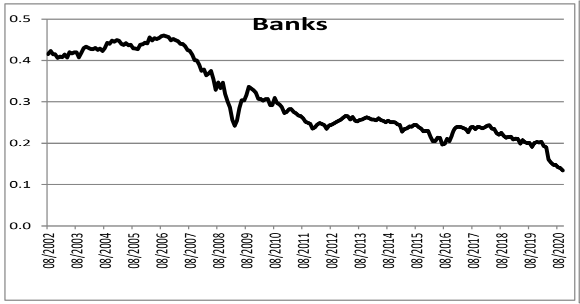
MAKING THEIR MINDS UP

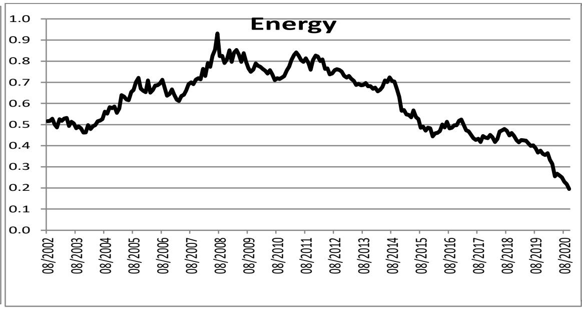


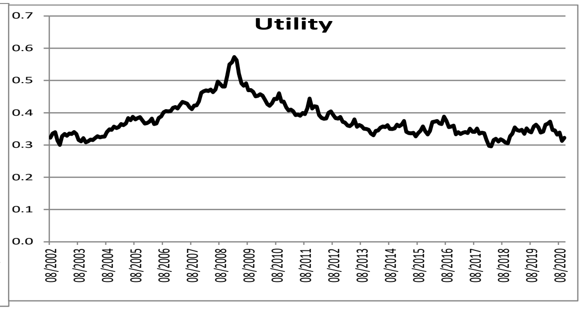




LOSERS



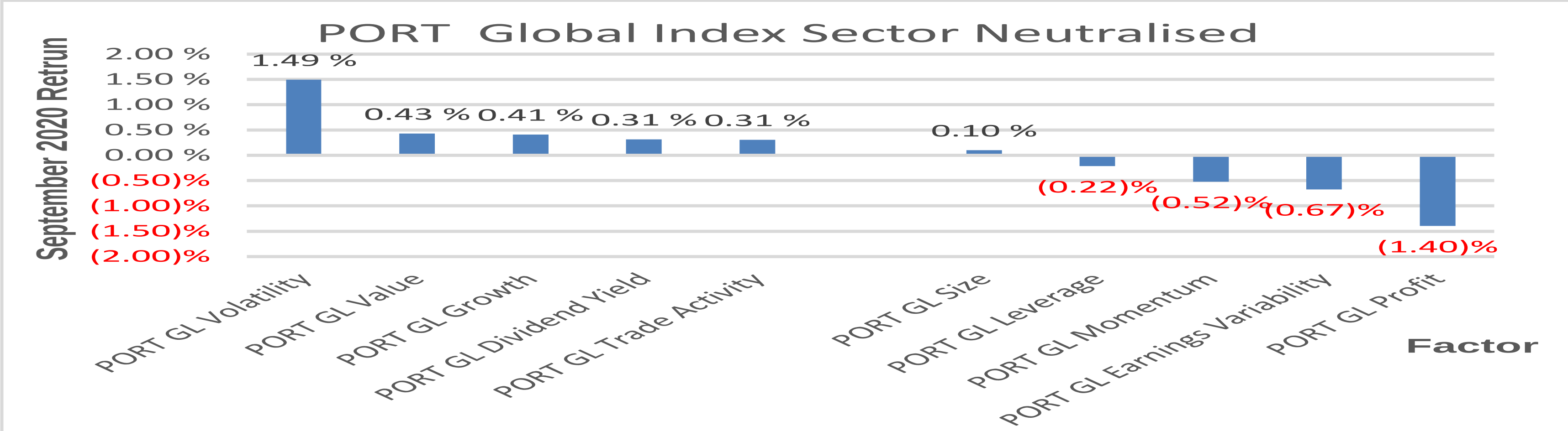




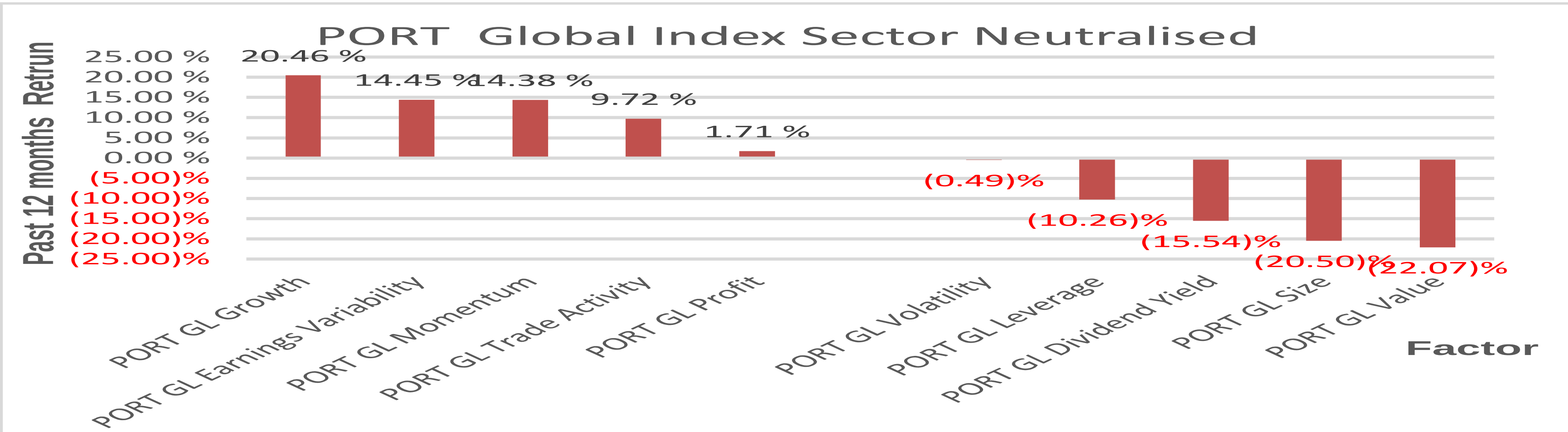
PORT Factor Analysis

Source: Bloomberg,

1 MONTH



PAST 12 MONTHs



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