

THE OLD NEW
CYCLE



Global Market Outlook – Q4 update





The old new cycle

Overheated technology stocks and U.S. election uncertainty are near-term headwinds, but positive COVID-19 vaccine developments, dovish central banks and an ongoing economic recovery should allow equity markets to push higher.



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Andrew Pease, Head of Global Investment Strategy



Introduction

2020 continues to surprise. A pandemic, the shutdown of the global economy, the deepest recession since the 1930s, a global equity market collapse and now, record highs for the U.S. equity market. The [upcoming U.S. election](#) is shaping up as a tight contest, with the potential for more surprises and market volatility.

We're in the early recovery phase of the cycle following the COVID-19 recession. This implies an extended period of low-inflation, low-interest-rate growth—an environment that usually favours equities over bonds. But after such a rapid rebound, an equity market pullback would not be surprising. Technology stock valuations are elevated, and the U.S. federal elections create uncertainty around tax changes, government regulations and the re-escalation of China/U.S. trade tensions.

Beyond this, the market looks set for a rotation away from technology/growth leadership toward cyclical/value stocks. This also implies a rotation toward non-U.S. stocks with Europe and emerging markets the main beneficiaries.

Our cycle, value and sentiment (CVS) investment decision-making process scores global equities as slightly expensive, sentiment as neutral and the cycle as supportive. This leaves us neutral on the near-term outlook, but moderately positive for the medium-term with slightly expensive valuations offset by the positive cycle outlook.

Economic cycle vs. market cycle

It's a *new* cycle for the economy, but some asset classes look decidedly late cycle in terms of valuation. Equity markets, particularly in the U.S., are exhibiting valuations typically seen after several years of strong returns, while credit market spreads look narrow for early in the cycle. In part, this reflects the speed of the market rebound. It is also a consequence of ultra-low, risk-free government bond yields and central bank asset purchases that have compressed risk premiums and boosted asset prices.

We expect that the early-cycle economy will trump later-cycle valuations for the next year or two. The turning point could occur when economies hit full capacity. This will be when unemployment has fallen as far as possible and inflation pressures start to rise. Central banks will signal that higher interest rates are on the way and bond yields will move higher.

The pandemic-driven decline in U.S. bond yields below 1% has allowed equity markets to trade at more expensive valuations in terms of price-to-earnings ratios. Rising bond yields will eventually place lofty equity market valuations under pressure.

Don't fight the Fed

The U.S. Federal Reserve's (the Fed's) [move to target average inflation](#) is a significant shift. We believe it should lengthen the expansion and delay the day of reckoning for equity markets from higher interest rates. The Fed will now allow an overshoot of its 2% target if inflation dips below the target for some time.

The Fed's preferred measure of inflation, the core personal consumption expenditure deflator, rose 1.3% in the 12-month period through 30 June. This measure of inflation has averaged 1.7% over the past five years and 1.6% over the past decade. This gives the Fed plenty of room to leave the Fed funds rate unchanged after inflation starts to pick up. Other central banks are undertaking similar reviews of their respective policy operations and we expect they are likely to reach similar conclusions.

The other important policy shift will be how quickly governments try to repay the debt arising from the support measures for the pandemic lockdown. Government debt levels for developed economies are likely to increase by around 15% of gross domestic product (GDP) on average.

There is speculation that [tax hikes](#) will be on the way once COVID-19 has passed. We're not convinced that governments will be in a hurry to implement fiscal austerity. It's not a winning electoral strategy and the current ultra-low borrowing cost makes high debt levels more sustainable. We believe the debt/GDP ratio can be stabilised provided the interest rate paid on debt is lower than the growth rate of trend nominal GDP¹—which is something that holds for almost every major economy as we move into the fourth quarter. The test for governments will come only after bond yields rise meaningfully and capital markets are driven by concerns about sustaining the higher debt levels. The bottom line in our view is that fiscal austerity and tighter monetary policy are still some years away.



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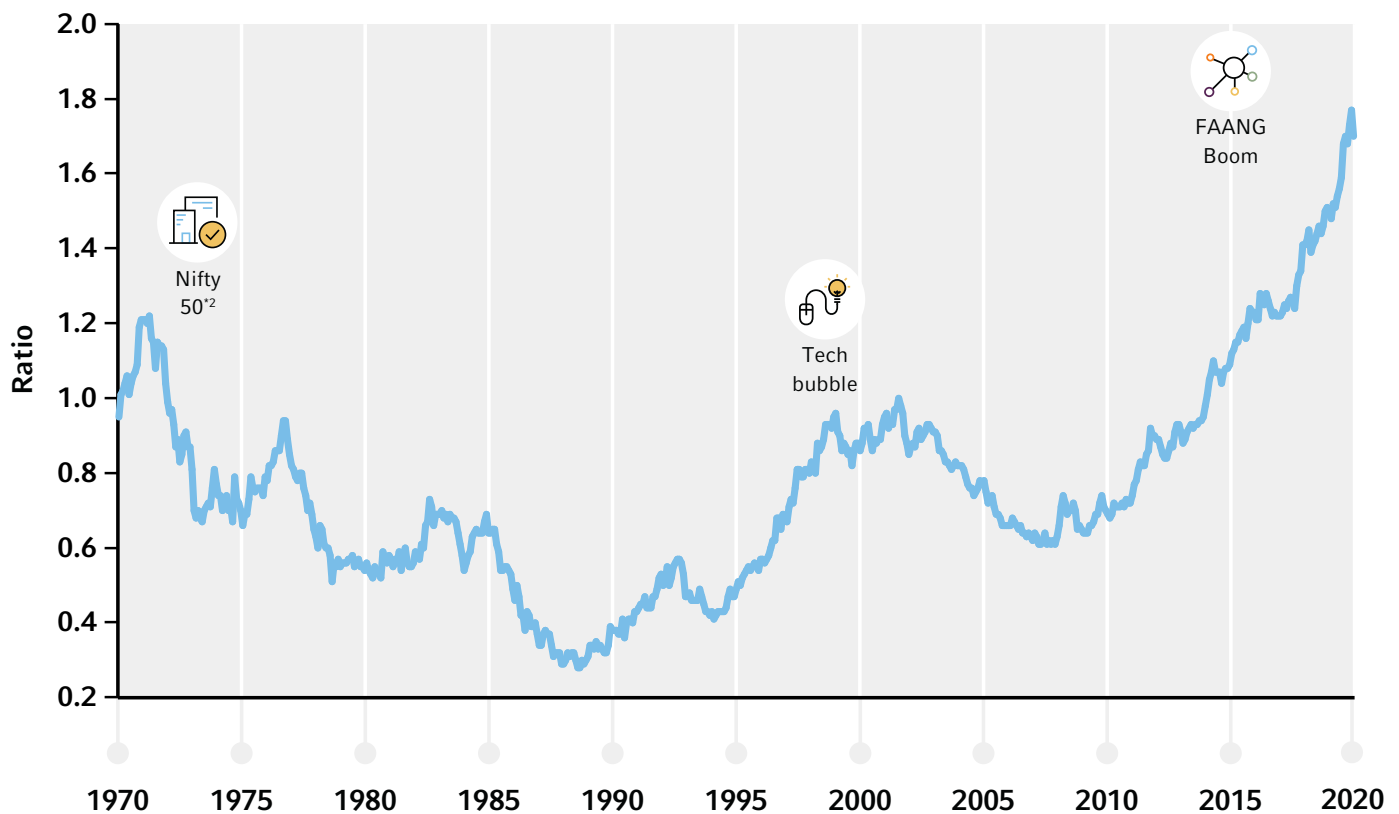
Andrew Pease, Head of Global Investment Strategy

¹ Nominal GDP is an assessment of economic production in an economy but includes the current prices of goods and services in its calculation. GDP is typically measured as the monetary value of goods and services produced.

Rotations ahead

Three major market trends could reach a turning point over the next few quarters: the outperformance of U.S. stocks versus non-U.S. stocks, the outperformance of growth stocks relative to value stocks and the decade-long upward trend in the U.S. dollar.

U.S. relative to Develop Markets ex-U.S.²



Sources: Refinitiv Datastream, MSCI. Last observation: September 17, 2020. Ratio based on the MSCI USA Index and MSCI World ex USA Index over the time period. Indexes are unmanaged and cannot be invested in directly. Index returns represent past performance and do not guarantee future results.

² The Nifty 50 is an informal designation for 50 popular large-cap stocks on the New York Stock Exchange in the 1960s and 1970s that were widely regarded as solid buy-and-hold growth stocks. These stocks are credited by historians with propelling the bull market of the early 1970s, while their subsequent crash and underperformance through the early 1980s are an example of what may occur following a period during which many investors, influenced by a positive market sentiment, ignore fundamental stock valuation metrics. Most have since recovered and are solid performers, although a few are now defunct or otherwise worthless.

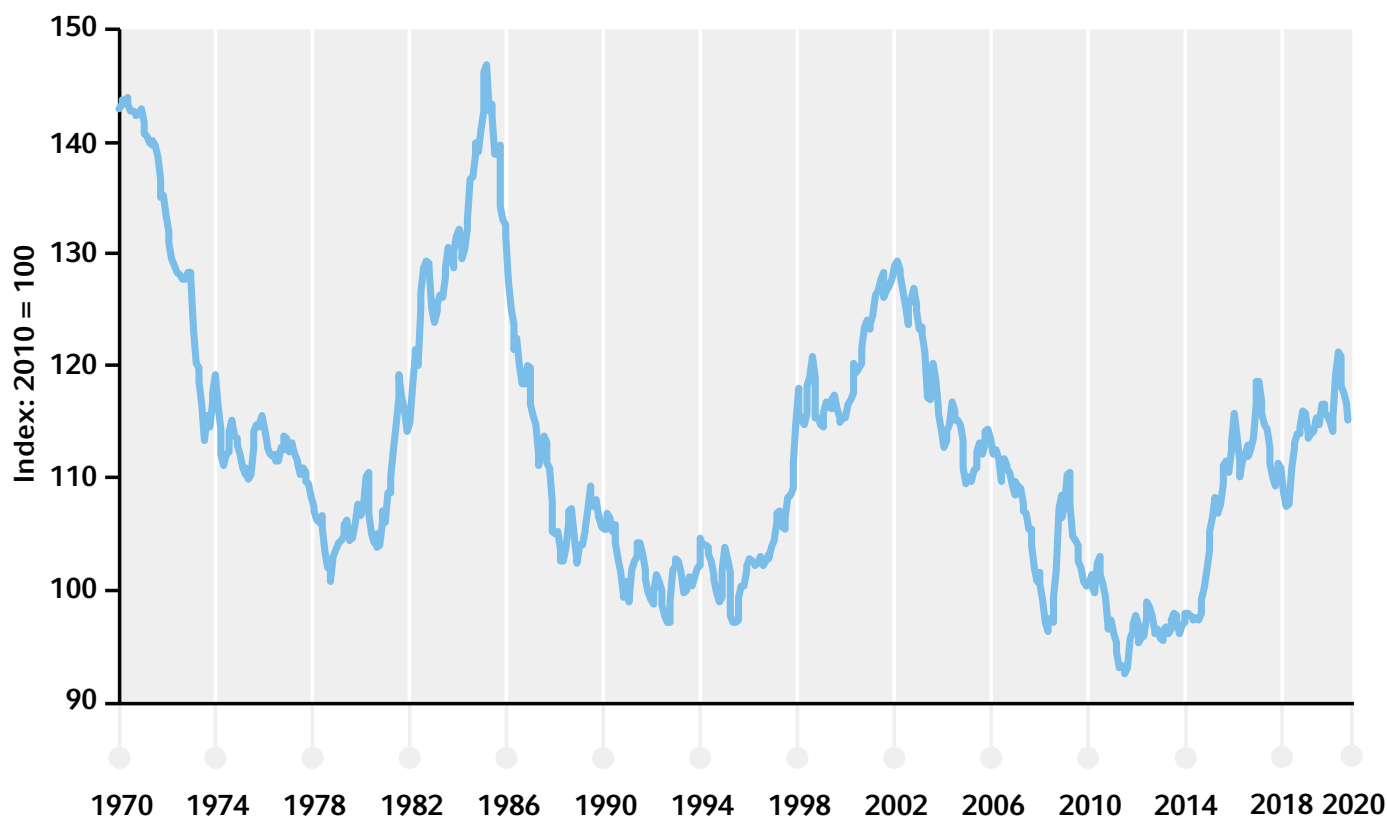
The tech stock market bubble was caused by excessive speculation in internet-related companies in the late 1990s, a period of massive growth in the use and adoption of the internet.

FAANG is an acronym referring to five large technology companies: Facebook, Amazon, Apple, Netflix and Alphabet (formerly known as Google). Together, the FAANGs make up about 15% of the S&P 500. This large influence over the index means that volatility in the stock price of the FAANG stocks can have a substantial effect on the performance of the S&P 500 in general.

The three trends are related and started around the time of the 2008 financial crisis. The U.S. market is overweight the technology and healthcare stocks that dominate the growth factor while the rest of the developed world is overweight the financial and cyclical stocks that populate the value factor. The U.S. dollar benefits from U.S. stock market inflows and the positive interest differential when the U.S. economy is performing well.

The U.S. dollar is showing signs of rolling over, in line with its counter-cyclical, safe-haven nature. It usually goes up in times of uncertainty and declines when uncertainty eases, as has been the case during the coronavirus panic and subsequent market recovery.

Real Trade Weighted Exchange Rate: United States



Source: Refinitiv Datastream, JPMorgan Chase & Co. Last observation: September 17, 2020. The Trade Weighted U.S. Dollar Index reflects the foreign exchange rate value of the U.S. dollar relative to other world currencies.

The surprise has been U.S. and growth stock outperformance during the rebound from the coronavirus bear market. Cyclical and value stocks—and by association, non-U.S. stock indices—usually perform well during the initial recovery phase from a recession and bear market. But not this time.

The reason has been the [strong performance of the technology stocks](#), the so-called FAANGs—Facebook, Apple, Amazon, Netflix and Google. These stocks, plus Microsoft, comprise 25% of the market capitalisation of the S&P 500® as of September 16, and they account for all the year-to-date gains in the index. Excluding these stocks, the S&P 500 would have declined by around 4% for the period.

Technology stocks received two benefits from the lockdowns. The first was from the decline in government bond yields.

Investors typically regard technology stocks as long duration as they are expected to grow their earnings over the longer term. The decline in bond yields made the present value of those future earnings more valuable. The second benefit was from the boost to current earnings from the lockdown as consumers went online for purchases, made more use of video call technologies and watched streaming services.

These tailwinds should soon become headwinds. Barring a second round of lockdowns, global bond yields have probably seen their lows and the near-term boost to technology stock earnings from lockdowns has peaked. This should allow the normal recovery dynamics to resume, with investors rotating toward [relatively cheaper value and non-U.S. stocks](#) that will benefit from the return to more normal economic activity.

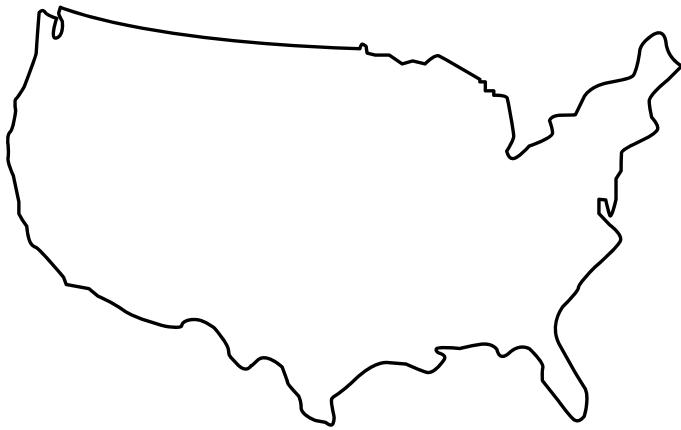
Risks: second wave, U.S. elections

The main risks are broadly unchanged from our previous quarterly report: a second wave of COVID-19 virus infections that causes renewed lockdowns and the [November U.S. federal elections](#).

- Infection rates are picking up and the advent of the northern winter could trigger a more meaningful second wave. Offsetting this, death rates have remained low in most countries despite the rise in infections, and vaccine development news has been promising.
- U.S. election odds are tightening. A contested election, with destabilising implications for markets, is becoming a risk.
- The re-election of U.S. President Donald Trump would likely benefit U.S. stocks (tax hikes averted, more protectionism) but a victory by Democratic presidential candidate Joe Biden would benefit non-U.S. shares (more harmonious foreign and trade relations).
- The negotiations in Congress over further U.S. fiscal support have become deadlocked. This would result in a hit to consumer income equal to around 4% of GDP if an agreement is not reached.

We expect that a second round of meaningful lockdowns will be avoided. Prospects for additional U.S. fiscal stimulus have dimmed and could need to wait until the next Congress is seated in January. There is enough uncertainty heading into the U.S. elections to generate some episodes of [market volatility](#).

Regional Snapshots



United States

Our outlook hasn't changed materially from last quarter. The business cycle troughed in April when 95% of Americans were under stay-at-home orders. The subsequent economic re-opening coupled with historic fiscal and monetary support drove a strong initial recovery. Consumer goods spending has already eclipsed its pre-pandemic peak and the services sector will get a shot in the arm early next year if one of the vaccine candidates receives U.S. Food & Drug Administration (FDA) approval in the fourth quarter. The Fed looks [unlikely to get in the way of this recovery](#) as the transition to average inflation targeting reinforces their commitment to stay lower for longer. Given there is still a large output gap to close, we don't expect inflation overshoots (and therefore Fed hikes) to become a serious risk until 2023. The November election is unlikely to derail the stock market. A Biden victory with Democrats sweeping both chambers of Congress would likely generate the most short-term volatility as investors would need to re-price their scenarios around tax policy. Any significant dislocations in markets around the election might offer a buying opportunity for nimble investors.



Eurozone

Economic indicators have rebounded through the September quarter following the easing of lockdowns. Infections have been rising, but hospitalisation and death rates remain low due to the shift in infections to younger age groups and more effective treatments. Local targeted restrictions seem more likely than a return to the nationwide shutdowns of March and April. The eurozone's direct fiscal policy response to the pandemic has been about half the size of that in the U.S. The fiscal response, however, has been boosted by state guarantees for corporate debt and the European Central Bank's support for bank lending through the TLTRO³ program. The most significant action has been the [European Recovery Plan](#), a €750 billion (6% of GDP) package of loans and grants that will be financed by the issuance of bonds jointly guaranteed by all 27 members of the European Union. Europe's recovery should continue over coming quarters. It is more exposed to global trade than the U.S. and will be a beneficiary of a rebound in Chinese demand.

The MSCI EMU Index has lagged the 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.

³ The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions. By offering banks long-term funding at attractive conditions they preserve favourable borrowing conditions for banks and stimulate bank lending to the real economy.



United Kingdom

Brexit uncertainty dominates the outlook. There is a year-end deadline for a European Union/UK trade deal, but negotiations are at a stalemate. The UK has the weaker position, which is why it is adopting an aggressive negotiating strategy. A hard Brexit on World Trade Organization terms is likely to have around three times the impact on the UK economy compared to Europe. Our assumption is that a deal will be reached on at least a *bare bones* free trade agreement, but the risk of a hard exit is uncomfortably high. The Bank of England has started to examine how a negative base rate could be implemented. Negative rates are unlikely, but the Bank of England is flagging negative rates as a contingency for a hard-Brexit scenario.

Brexit uncertainty has been reflected in the FTSE 100 Index, which as of 16 September has been the worst performer of the major developed stock indices this year. We like the value in the UK market on a longer-term basis.



Japan

The Japanese economy continues to lag the recovery of other major regions, with the services sector being particularly disappointing. Prime Minister Shinzo Abe's successor, Yoshihide Suga, should see the continuation of *Abenomics*, with a focus on policy accommodation to try to achieve 2% inflation. As cabinet secretary, Suga was instrumental in implementing elements of *Abenomics*. Suga has indicated that he will pursue further fiscal support before year-end in the form of payments to small and medium enterprises and households.

Even with the continuation of *Abenomics*, and the potential for further stimulus, we expect that Japan will remain a laggard in the recovery, due to constrained monetary policy and deflationary dynamics.



China

The Chinese economy has seen significant improvement since the COVID-19 crisis, with many indicators now pointing to growth over the year. The consumer and the services sector have started to catch up to the manufacturing sector. Fiscal policy is set to remain very supportive through the rest of the year and we expect that credit creation will be solid.

U.S./China tensions have escalated with U.S. restrictions on Chinese companies including Huawei and TikTok. Nevertheless, we think the *phase one* trade deal will remain intact through the U.S. election and have been encouraged by multiple reports of increased Chinese purchases of U.S. agricultural and energy goods.



Canada

Consumer spending data along with recent trends in housing and employment suggest the recovery has commenced. Fiscal and monetary policies are expected to remain stimulative for some time to come. The Bank of Canada has been clearly communicating its intention to maintain easy financial conditions to support a full recovery.

Canadian stocks have lagged the U.S. this year but have beaten most other markets. As of mid-September, the S&P/TSX Composite Index is down by around 2.5% from the start of the year. This puts it well ahead of Europe, the UK and its commodity counterpart, Australia. We expect it to outperform the U.S. in the next phase of the recovery, but the Canadian market may struggle to match some of the more beaten-down markets.



Australia and New Zealand

The economic recovery has been steady in both countries, but much of this has been easy *lifting* and some caution about the outlook is warranted given stretched household budgets and limited inbound tourism. This has been exacerbated by renewed lockdowns, with a six-week lockdown in Victoria and a three-week lockdown in Auckland.

Fiscal and monetary policy will remain very supportive. The Australian government is set to announce new measures in the October budget, and the New Zealand government announced additional measures in the May budget. We think the Reserve Bank of Australia will keep rates steady, but there remains a risk that the Reserve Bank of New Zealand will take its cash rate into negative territory.



Any significant dislocations in markets around the U.S. federal elections might offer a buying opportunity for nimble investors.

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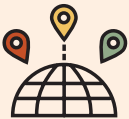
Asset class preferences

Our cycle, value and sentiment investment decision-making process has a moderately positive medium-term view on global equities. Value is slightly expensive, with the expensive U.S. market offset by fair value in the

rest of the world. Sentiment is neutral. The cycle is supportive of risk assets for the medium-term. The recovery from the recession means a long period of low-inflationary growth supported by monetary and fiscal stimulus.



We prefer **non-U.S. equities to U.S. equities**. The second stage of the post-coronavirus economic recovery should favour undervalued cyclical value stocks over expensive technology and growth stocks. Other major markets are overweight cyclical value stocks relative to the U.S.



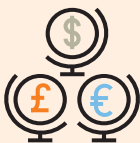
We like the value in **emerging markets (EM) equities**. China's early exit from the lockdown and stimulus measures should benefit EM more broadly.



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



Government bonds are expensive. Low inflation and dovish central banks should limit the rise in bond yields during the recovery from lockdowns. **U.S. inflation-linked bonds** offer good value with break-even inflation rates well below the Fed's targeted rate of inflation.

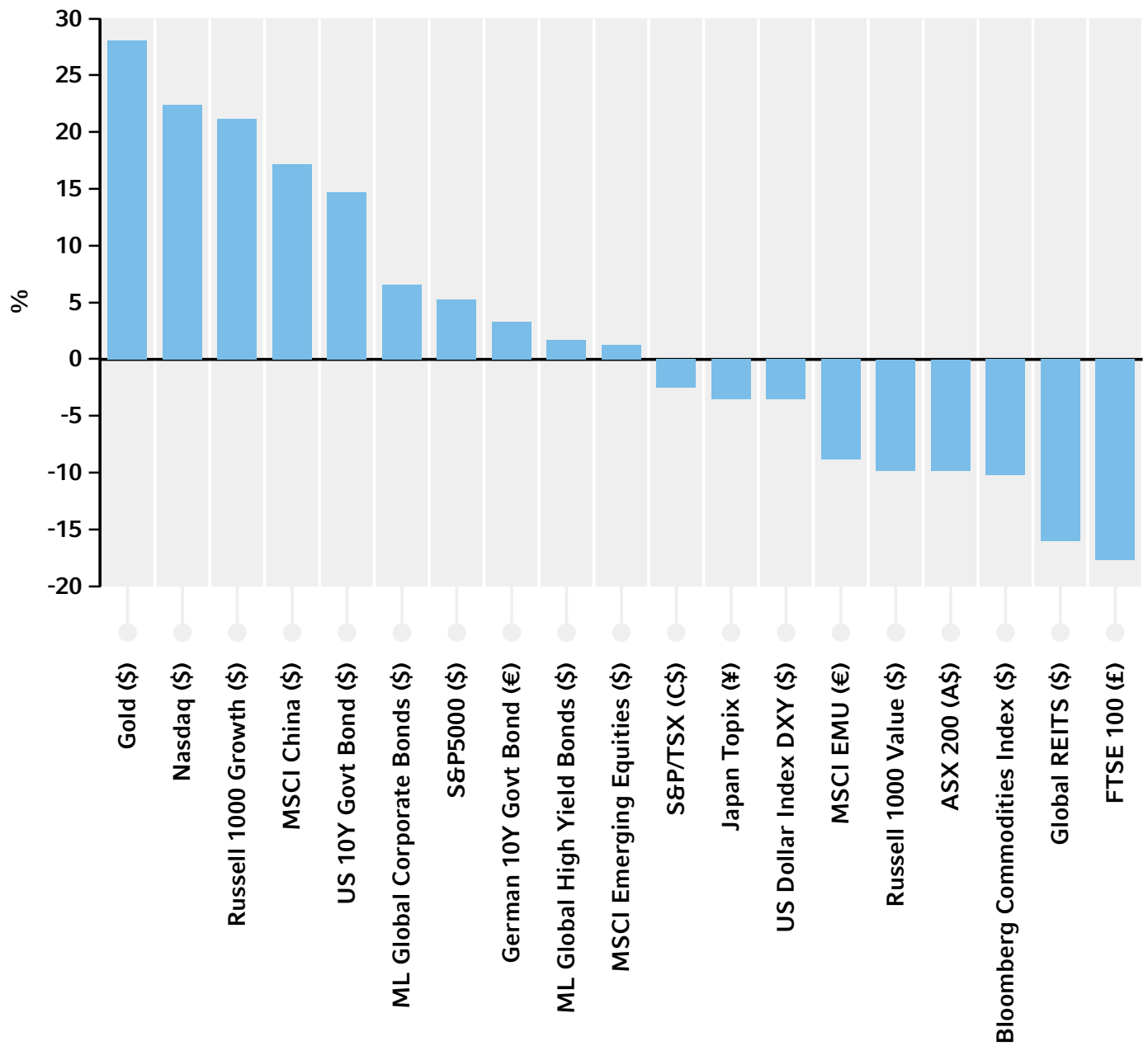


Real assets: Real estate investment trusts (REITs) sold off heavily in March, with investors concerned about the implications of social distancing and online shopping for shopping malls and office buildings. Sentiment appears overly bearish, while value is positive. These should be a pandemic recovery trade.



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*—the **Australian dollar**, **New Zealand dollar** and Canadian dollar. The **euro** and **British sterling** are undervalued. The euro should gain if a second virus wave is avoided and a recovery is sustained. Sterling, however, is likely to be volatile around Brexit negotiations uncertainty.

Asset performance since the beginning of 2020



Source: Refinitiv Datastream. Last observation: September 17, 2020.

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