

For investment professionals



CIO outlook:
Year of change

Foreword:

Risk and opportunity in 2020

Even though markets appear to underappreciate certain key risks, there are still reasons for investors to be cheerful

This is an extraordinary moment for investors. As at the beginning of December, many asset classes have notched up double-digit returns over 2019, with equities hovering close to record highs even as trillions of dollars of bonds offer negative yields.

And yet we cannot dwell too long on the factors that have taken us to this point, as 2020 is likely to be a year of change – from the holders of key posts at major central banks, to the EU leadership, to the US presidency.

At the same time, even though the outlook for the world economy has perked up a little, significant downside risks remain and geopolitical tensions will probably still command investor attention. After all, the trade hostilities and Brexit process are still bubbling away. It is nearly inevitable that the market and macro environment will shift materially, too.



In this outlook, teams from across LGIM examine the opportunities and risks with which investors are presented in this context. Here are some of our conclusions:

- Global growth may ultimately disappoint investors even as recession fears abate
- The many ways in which the US election could disrupt markets appear under-priced
- Watch the UK for clues to the trajectory of global monetary and fiscal policy
- In equities, growth has outperformed value for 10 years – a style rotation in 2020 could have a significant impact

There are also contributions from our Asset Allocation team, who explain why they have turned cautious on equities on both a tactical- and medium-term view, and our Solutions team, who outline steps investors can take to make their portfolios more robust.



Drawing all of this together, it is clear that the complexity and interconnected nature of global markets require a research effort across investment styles, regions and asset classes to separate the signals from the noise.

We believe the assessment of environmental, social and governance (ESG) risks and opportunities should also play a crucial part of this process. Indeed, looking ahead to next year, we expect that interest in all things ESG will only grow from investors, policymakers and regulators alike.

"It is clear that the complexity and interconnected nature of global markets require a research effort across investment styles, regions and asset classes"

Expect to hear more from LGIM on this front in 2020, as we continue to work with clients, peers and policymakers to bring further clarity to an area that can be both exciting and somewhat bewildering.

So even though markets appear to underappreciate certain key risks, there are still reasons for investors to be cheerful. With the right approach, we may yet enjoy more extraordinary moments in 2020.



Sonja Laud
Chief Investment Officer

Economics: Outlook brightens but risks remain

Geopolitical uncertainty has abated somewhat, reducing recession fears, but global growth may still ultimately disappoint



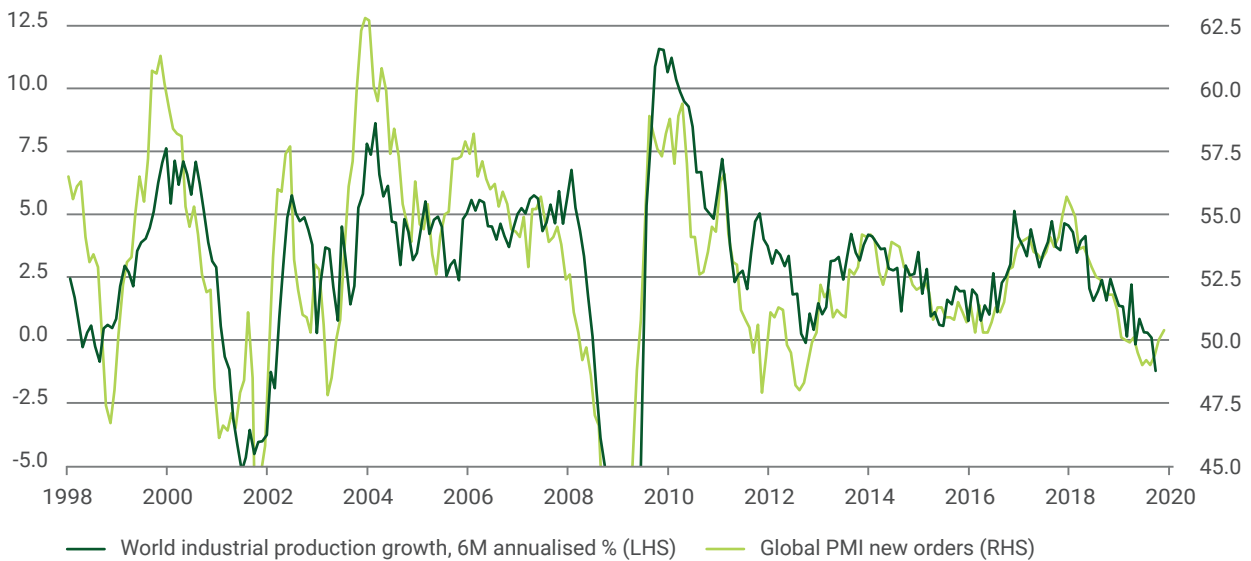
Since September, economic data have shown a tentative stabilisation from the slowing seen through most of 2019: employment growth has held up relatively well, as have global consumer confidence and retail sales.

With inventories becoming leaner, this could set the stage for some modest improvement in global manufacturing, which has stalled over the past year. At the same time, there have been a number of positive developments, which have reduced recession fears.

First, the US cancelled tariffs against China, scheduled for October. Second, the UK avoided a ‘crash out’ Brexit, with the Conservative party committing to passing the agreement reached with the EU should it gain a parliamentary majority.

Finally, policymakers have continued to support growth, most notably the US Federal Reserve (Fed) with a third consecutive rate cut at the end of October. This has helped to prevent a tightening of bank lending standards, which could have led to a self-reinforcing downturn.

Global PMI new orders vs world IP growth



Source: LGIM, Macrobond, as at 01 November 2019



That said, we see the downside risks as diminishing, rather than expecting a significant strengthening of growth – with the following factors still troubling us:

- Even with a trade war ceasefire, or mini-deal, it is unlikely that business investment will pick up meaningfully, given the potential for a sharp swing to the left in the US elections
- The recession indicators we track still suggest the US economy is late in the cycle
- Progress by the UK on leaving the EU would bring into sharper focus the even more challenging task of reaching an agreement on its future trading relationship
- China continues to manage its slowdown, rather than resort to a more aggressive credit expansion. This is probably a healthy medium-term development, but prevents a sharper rebound
- Europe is running out of policy options, with the European Central Bank (ECB) close to its limit and a reluctance to deploy fiscal policy among the countries with the space to do so

"We see the downside risks as diminishing, rather than expecting a significant strengthening of growth"

A modest growth outlook should mean inflation remains subdued and allow central banks to keep policy accommodative. But any deviation to either side from this baseline could have profound implications for asset prices.



Tim Drayson
Head of Economics

Economics:

Monetary mopes, fiscal hopes

If economies move from monetary policies to fiscal packages for stimulus, markets may start demanding more compensation for inflation risk

Central bankers are eyeing the prospect of the next downturn with some trepidation. The bags of monetary tricks from which they drew policy responses to the global financial crisis appear nearly empty. There are increasing doubts about ever-expanding balance sheets and growing concerns that negative interest rates may be counterproductive.

As a result, the policy debate is pivoting: there are growing calls for significant fiscal easing in reaction to current and future economic weakness. Voices which have long called for fiscal easing are getting louder; supporters of more austere control of the public purse strings are getting quieter.

The political winds are shifting, but so is the academic debate. Proponents of 'Modern Monetary Theory' (MMT) argue that countries with their own central banks and own currencies can never have a financing problem, so should not worry about over-spending unless inflation rears its ugly head. This just about hangs together as a theory, but it is not particularly modern and argues for more active fiscal, not monetary, policy.



In some of the smaller OECD countries, we are starting to see this in practice: Sweden has started to move away from negative interest rates as a policy tool; New Zealand is looking to launch a major infrastructure package. If these trends spill over into other economies, they will have far-reaching implications for the direction of inflation, interest rates and asset prices. In particular, they would raise questions about the sustainability of a global bond market in which 15-25% of the global universe has consistently traded with a yield below zero since 2016.

To BoE or not to BoE

At the epicentre of this debate is the UK, where both major political parties have pledged to re-write the fiscal rulebook. Both are committed to relaxing budgetary discipline, but there is clear blue (or red) water between their offerings. On one side of the aisle is a proposal for a relatively small increase in public spending on investment; on the other side is a proposal to push public spending to the highest levels since the 1970s. In both cases, the 'household economics' approach to government finances is dying.

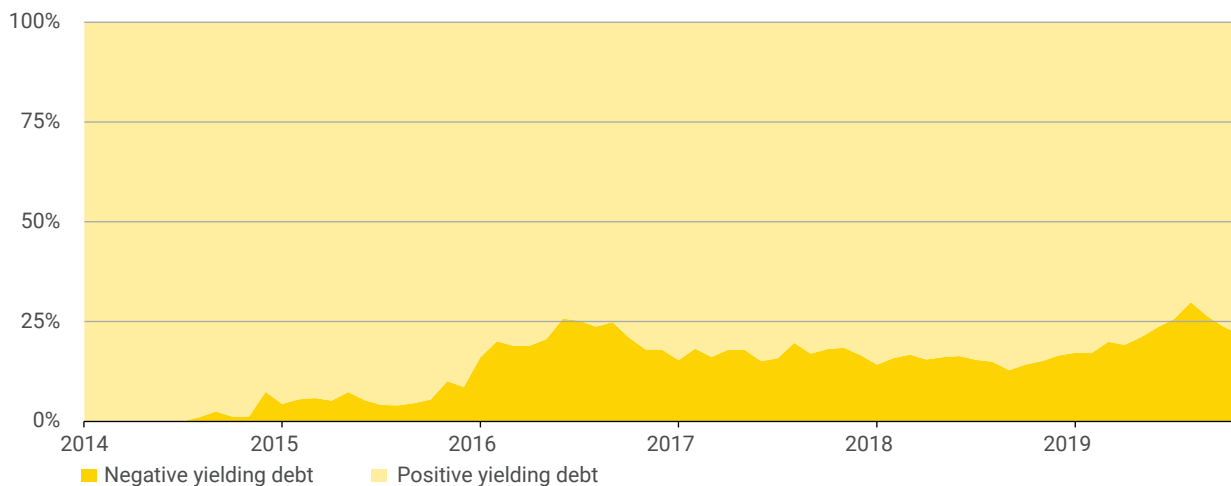
Regardless of the election outcome, we can safely say that more gilt supply is coming. The fundamental issue for asset pricing is whether that looser fiscal policy will meaningfully raise inflationary pressure. Fiscal policy can supply the impetus but, at the end of the day, inflation is "always and everywhere a monetary phenomenon".



The market will therefore watch plans for the Bank of England – and its next governor – very closely for signals about future mandate changes and signs of increasing politicisation. The markets would interpret

significantly looser fiscal policy facilitated by a captive central bank as a step towards MMT and require additional compensation for inflation risk.

Market value of positive and negative yielding debt as share of the Bloomberg Barclays Global Aggregate index



Source: Bloomberg. Data up to 30 November 2019



Alex Mack
Fund Manager



Christopher Jeffery
Strategist



Hetal Mehta
Senior European Economist

Political risk:

The US election and market complacency

Investors may be underestimating the many ways in which the presidential race could disrupt markets

The race to the White House in 2020 may be firmly on the radar of anyone with a Twitter account or who is the recipient of investment research. But there is scant sign of it in market pricing.

Yes, managed-care stocks in the US underperformed following a number of Democratic contenders' recent support for a Medicare-for-all policy. Elsewhere, from the broader equity market to rates and credit, it is difficult to establish that the chances of a dramatic shift in policy are being factored into valuations.

No foregone conclusion

We believe the election, set to be held on 3 November, is likely to impact – possibly to an extreme degree if there is a 'wave' election, in which the Democrats make major gains – US and global assets.

While Donald Trump may stand the best chance of beating a Democrat who seeks to disrupt the status quo, such as Bernie Sanders or Elizabeth Warren, versus a centrist like Joe Biden, this does not mean his re-election is a foregone conclusion.





Key policies

Without, of course, taking a view as to their merits, we believe the following policies advanced by progressive Democrats could prove the most disruptive to markets:

1. **Higher corporate taxes:** Expect a significant contraction in earnings in the event of a reversion to pre-tax-reform levels, or beyond
2. **Fracking ban:** This would affect the entire US energy industry, from exploration, to pipelines, to refiners and service companies
3. **Medicare for all:** This could result in the creation of something akin to the UK's National Health Service, severely damaging the managed care/health insurance sector in the US
4. **Lower pharmaceutical drug prices:** Under one proposal, the government could engage in direct price negotiations with pharma companies
5. **Break up the banks, increase regulation:** Deposit-taking banks could be separated from investment-banking activity, transforming the sector, amid a far more burdensome regulatory environment
6. **Clampdown on tech 'monopolies':** Amazon, Google, Facebook and other large tech companies could be prohibited from certain acquisitions and even broken up

"The election is likely to impact US and global assets – possibly to an extreme degree if the Democrats make major gains"

Many of these policies would require Congressional approval. But there is a chance that the Democrats could gain control of the Senate as well as the presidency – a possibility investors may be underappreciating.

And in the event that Trump is re-elected, political volatility may still remain elevated. His administration has been less obviously positive for markets of late, as attention has turned to trade and foreign policy. A second term for Trump might just be more of the same.



Jason Shoup
Head of Global Credit Strategy, LGIMA Fixed Income

Equities: **New year, new style?**

If the dominant equity style of the past decade goes out of fashion, the effect on markets could be dramatic

Equity investors are often described by their philosophy or style. The two most persistent styles are value, first espoused by Ben Graham and then Warren Buffett, and growth, championed by investors like Thomas Rowe Price and Philip Fisher.

Simply put, growth investors seek the companies that they forecast to have the best prospects for growing long into the future; they are not overly concerned if the initial valuation they pay is high. Value investors, in contrast, focus on how cheap a company is relative to its prospects; they will buy almost any company so long as the market appears to undervalue its prospects.

Looking through nearly a century's worth of data, we can see many rotations between the styles, with value having delivered better returns than growth overall. Most rotations have lasted only a few years, but since the financial crisis something very unusual has happened: value stocks have lagged behind the market for an unprecedented 10 years.



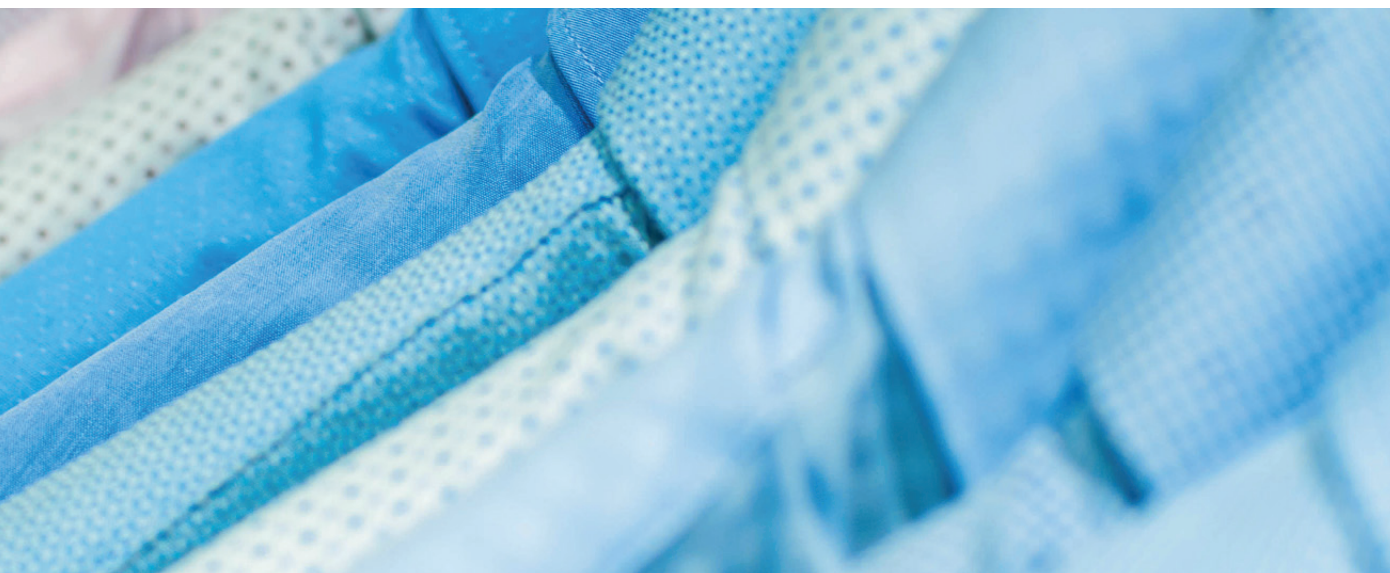
Which style will yield?

Part of the explanation for this lies with the unconventional monetary policies adopted by many developed countries, which have driven government bond yields to historic lows. Investors who would normally own those bonds for income have been forced to consider other assets to secure their target income, specifically equities. This money has flowed into companies with dependable and growing dividends, which has favoured quality and growth stocks. We believe this is a key reason why the style rotation has been so strong for so long.



10 years:

Value stocks have underperformed the market for an unprecedented length of time - a full decade



**The European value index has become cheaper relative to the European growth index
(12-month forward P/E ratio, MSCI Europe Value divided by MSCI Europe Growth)**



Source: Bloomberg, as at 21 November 2019

A related issue is that low yields for long-term bonds have changed how investors price equities. Growth stocks in aggregate are only achieving their historical rate of earnings growth compared with value stocks. However, the mechanics investors use to discount the future, based on these very low long-term rates, have led to significantly higher premiums for growth stocks than we have seen before. In essence, future corporate profits are being discounted less quickly because of these low rates, favouring growth companies with potentially better earnings prospects over value stocks with steadier present earnings but less exciting futures. The premium the market is paying for growth has now broken well out of its historical range.

There are arguments for and against bond yields remaining at these low levels for some time yet. But when investors have large amounts of money invested outside their customary areas, a reversion could lead to a significant rotation back in favour of their longer-standing style preferences.

The dotcom boom took approximately two years to mature around the turn of the millennium, and two years to reverse. The style reversal of a 10-year trend could be equally dramatic.



Andrew Koch
Senior Fund Manager

Asset allocation: **Fighting FOMO**

As US stocks flirt with record highs and risks to the world economy remain to the downside, our Asset Allocation team has turned cautious on global equities

The S&P 500 index set its all-time peak in the last quarter of 2019 amid signs that equity investors were in full 'Fear Of Missing Out' (FOMO) mode.

The fundamental drivers of this early Santa rally seemed obvious: the expectation of a trade deal between the US and China, and better-than-expected economic data.

In fact, investor optimism on what we consider rather thin fundamentals makes us nervous for the year to come.

As a result, we have reduced our equity stance to a slight negative position from neutral, on both a tactical and medium-term view.

Politics at a crunch point?

While some of the threats we fretted about in 2019 appear to have diminished – trade tensions and a possible hard Brexit, for example – they have certainly not disappeared. Others, not least those related to the US election, are growing in scale.

"Investor optimism on what we consider rather thin fundamentals makes us nervous."



The current perceived trade 'deal' might just represent a temporary peak in optimism ahead of the presidential election, in which China may come under rhetorical attack from both the incumbent and Democratic challengers. We also expect tensions to remain for years to come, as the US is locked in a *Thucydides trap*, where its leadership is challenged by the rising power of China.

On balance, we believe the risk of a sharp swing to the left in the US next year will make investors significantly more nervous, requiring a higher risk premium.

It's already late

Because the global economy appears to be firmly late-cycle, with risks tilted to the downside, the buy-the-dip strategy we have deployed over the past five-to-seven years might now prove less effective.

We believe the slowdown in China – a crucial driver of global growth – is largely due to domestic factors, rather than the trade war. As the country's room for policy manoeuvre is now narrower, risks to Chinese growth are firmly to the downside, too.

And while the Fed still appears willing to support markets in the event that credit conditions tighten, this stance is already priced in by investors, contrary to December 2018.

Solutions:
**Eight steps
to a more
robust
portfolio**

The application of our principles of portfolio construction can help clients win their investment battles

*“Obey the principles without being bound by them.”
– Bruce Lee*

When faced with the macro risks described elsewhere in this outlook, and the sheer volume of unknowable factors, constructing an investment strategy can sometimes feel like entering a battle.

Among other things, investors need to find a decent array of weapons, or investment opportunities; guard against attacks, or shield against unrewarded risks; and, as no plan survives contact with the enemy, adapt to changing market circumstances.

Clients come to LGIM’s Solutions team for help with solving their investment problems, with particular objectives in mind. To help them win their battles, we have established a set of eight steps:

1. Establish investment beliefs

We believe clarity and consistency of investment beliefs across a portfolio are important to ensure that all activity has a clear purpose and that conflicting decisions are not taken.

2. Clarify objectives and constraints

Return target, risk tolerance, liquidity requirements, asset class constraints, ESG criteria, and required performance in particular scenarios should all be considered, in our view.



3. Identify investment opportunities

Constant innovation is required to find the most attractive and efficiently expressed opportunities. Clearly identifiable economic, behavioural or structural reasons as to why a return should be generated are key.

4. Diversify rewarded risks

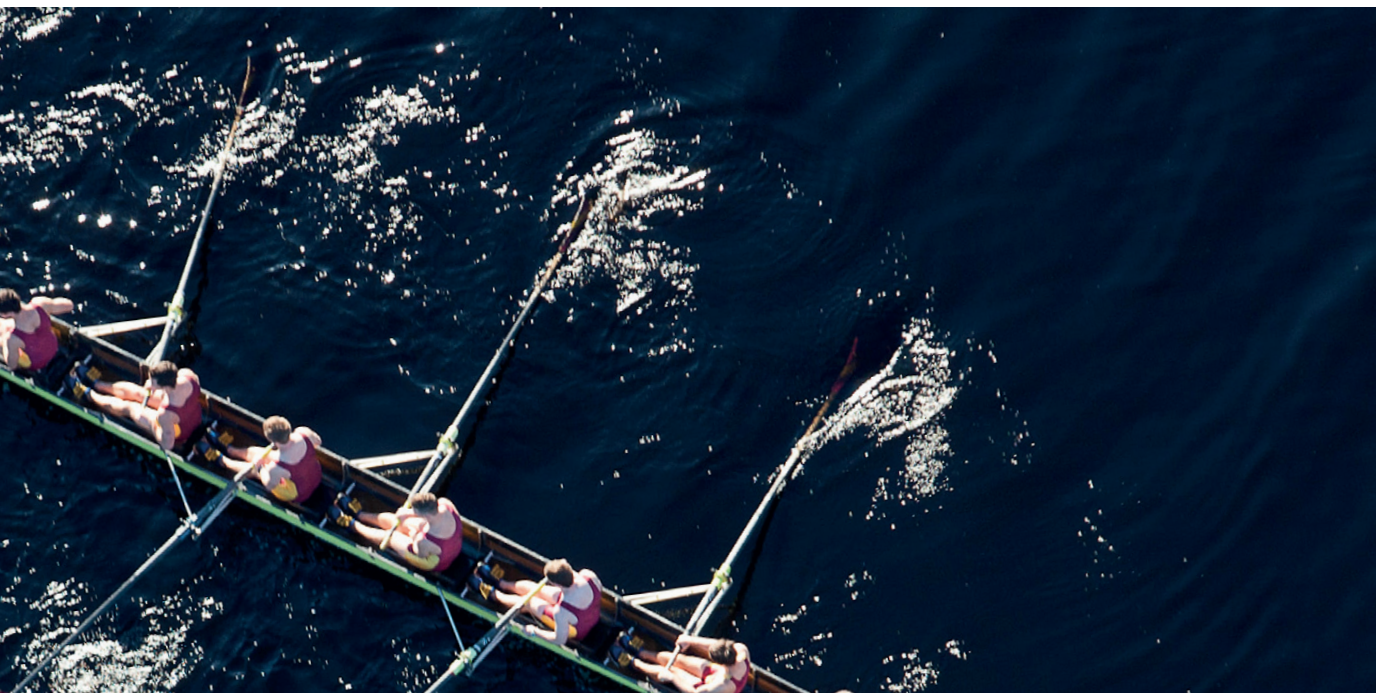
In order to maximise efficiency, we believe exposures should be diversified by risk factors, return drivers, asset class, currency, region and anticipated correlations, as well as taking into account conviction level for different opportunities.

5. Protect against unrewarded risks

Residual unrewarded, or poorly rewarded, risks to which a portfolio is exposed should be identified and hedged, managed or otherwise mitigated where possible, in our view.

6. Manage liquidity

Comparing the scope for both predictable and unpredictable requirements against expected and potential liquidity availability allows investors to stress-test portfolios.



7. Mitigate tail risks

Scenario thinking can help portfolios to cope with more extreme events, allowing for particular attention to be paid to those eventualities that are important for a given investor or for associated stakeholders.

8. Adapt to market conditions

A portfolio is never static; adjusting for the latest economic and market conditions, while seeking to capture new investment opportunities as they arise, should help to ensure it remains appropriate.

These steps are based on our principles of portfolio construction, which can help us to identify gaps in a strategy that may have been missed.

Client utility

Various models can assist throughout this process, particularly in sizing positions; however, care is needed – qualitative matters and common sense are just as important – and we are cognisant of model risk and assumption risk.

Our whole process is iterative, as decisions made at one stage will have knock-on implications for other stages. We view an overall portfolio, modelling it holistically as we seek to ensure it is well diversified, risks are controlled, and efficiency is improved.

We are currently in the process of applying these principles to an increasingly important problem for many Defined Benefit pension schemes: endgame portfolio construction. But we believe this framework is appropriate for all investor types, even though the specific issues may vary.

Expect to see more research from us in 2020 on how we can use these principles to help our clients win their investment battles.



Tim Dougall
Head of Investment Advisory



John Southall
Head of Solutions Research

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM sales representative



Important notice

Please remember the value of your investment and any income from it may fall as well as rise and is not guaranteed. You may get back less than you invest. Past performance is not a guide to future performance. Recommended investment period: medium to long term, ideally five years or more.

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