LOMBARD ODIER
INVESTMENT MANAGERS

Global Perspective

Global Outlook: catch 2020

For professional investor use only • Asset Management

November 2019

Salman Ahmed
Chief Investment Strategist

Didier Rabattu
Head of Equities

Christopher Kaminker
Head of Sustainable Investment Research and Strategy

Yannik Zufferey
Chief Investment Officer, Fixed Income

Maxime Perrin
Client Portfolio Manager, Convertible bonds

Dhiraj Bajaj
Portfolio Manager and Head of Asian credit

Aurèle Storno
Lead Portfolio Manager, Multi-asset

Key global macroeconomic views

- We see a potential catch-22 situation[1] arising in 2020 as policy, economic and political dilemmas loop between each other, and create a more complicated investment landscape for investors to assess.
- We believe climate change will be front and centre of the agenda for policymakers, and see further developments when it comes to dealing with extreme climate change events from major central banks.
- Our base case assumes a shallow trajectory of global growth in 2020. We do not see a V-shaped recovery in global capex/business investment, despite the likely confirmation of a phase 1 trade deal between the US and China. We see the risk of recession and a hard landing as moderate (less than 20%) over the coming 12 months, and note that the likelihood of such risks has fallen lately.
- Major issues between the US and China remain unaddressed, and the US presidential elections and the impeachment inquiry are incentivising the Trump administration to finalise a deal, in our view. This should help cancel the proposed tariffs but we find it hard to see how tariffs could revert back to pre-trade war levels anytime soon.
- The US presidential race is likely to tighten as we traverse through 2020 – thus shaping up to be a major risk for US assets, especially if Elizabeth Warren becomes the Democratic front-runner.
- A Brexit deal is likely to pass as the Conservatives appear poised to win the UK elections. However, another cliff edge may approach in a year.
- We expect real rates to remain low and the search for yield to strengthen as a major structural theme because meaningful fiscal easing remains elusive, especially in Europe. We expect additional monetary policy easing from the European Central Bank, whilst the Federal Reserve may have to cut again in H2. We also expect further accommodation from China as growth remains under pressure against the backdrop of financial stability concerns.

Key investment views

- Sustainable financing will continue to bridge the gap to decarbonisation, but a vast increase in investment levels and policy ambition is still required.
- In equities, cyclical companies at the bottom of their investment cycles are likely to present opportunities. We see sustainability as a growth opportunity in a low growth world.
- Adopting a constructive stance on credit, we favour crossover issuers, as well as moving down the capital structure of high quality companies.
- Balanced, global convertible bond strategies stand to benefit from an expected return of equity volatility and risk assets in 2020, in our view.
- We are extremely positive on the search for yield in USD-denominated corporate bonds, especially in emerging market, hard currency credits.
- For multi-asset portfolios, we favour risk-based rebalancing, seek structurally higher diversification and actively manage drawdowns.

[1] A catch-22 situation is a dilemma where the only solution is denied by a circumstance inherent in the problem.

Foreword

Nathalia Barazal, Head of Convertibles & Fixed Income

What are the main themes likely to drive the investment landscape in the coming year and beyond? In our outlook for 2020, we consider the central macroeconomic and sustainability steers that we expect to shape the investment backdrop, as well as considering the opportunities and risks identified by our specialists.

Over the long-term, we maintain our core conviction that sustainability will be a very important driver of investment returns. Indeed, the transition to a sustainable economic model is already firmly under way, and we expect the transition to accelerate going forward.

From a more cyclical macroeconomic perspective, we see a potential catch-22 situation arising as policy, economic and political dilemmas loop between each other. This could create a more complicated investment landscape for investors to navigate in 2020.

Our base case assumes a shallow trajectory of global growth next year. We do not see a V-shaped recovery in global business investment (capex), despite the likely confirmation of a phase 1 trade deal between the US and China. We also think that risks of a global recession look moderate (less than 20%) over the coming 12 months given outsized policy support and note that the likelihood of such risks have fallen lately.

In addition, political risk emanating from US elections will be a key theme. The US presidential race is likely to tighten as 2020 unfolds, thereby shaping up to be a major risk for US assets, especially if Elizabeth Warren becomes the Democratic front-runner. In the UK, a Brexit deal is likely to pass in January, but given the design of the new deal another cliff edge scenario could approach in a year, in our view.

The backdrop of continued low growth and inflation creates an environment where we expect real rates to remain low and the European Central Bank delivers further easing. We foresee the search for yield strengthening further as a major structural theme as meaningful fiscal easing remains elusive and the forces of Japanisation continue to grip Europe.

In 2020, we also expect climate change to be front and centre of the agenda for policymakers and we are likely to see more direct central bank involvement in order to deal with the extreme climate-driven events unfolding.

Overall, the landscape of sustainable finance is likely to continue bridging the gap to a decarbonized world. Sustainable finance has already grown more diverse in terms of issuers and geographies, and more complex in terms of instruments. Going forward, we see exponential growth in total assets invested according to responsible investment strategies, but highlight that a vast increase in investment levels is still required. Investors could indeed find that sustainability becomes a key driver of growth in a low-growth world. As such, we believe that the sustainability revolution will come with the speed of the digital revolution and the scale of the industrial revolution.

The revolution is now – and we are embracing it.

Global macroeconomic outlook

Salman Ahmed PhD, Chief Investment Strategist
Jamie Salt, Analyst

Introduction

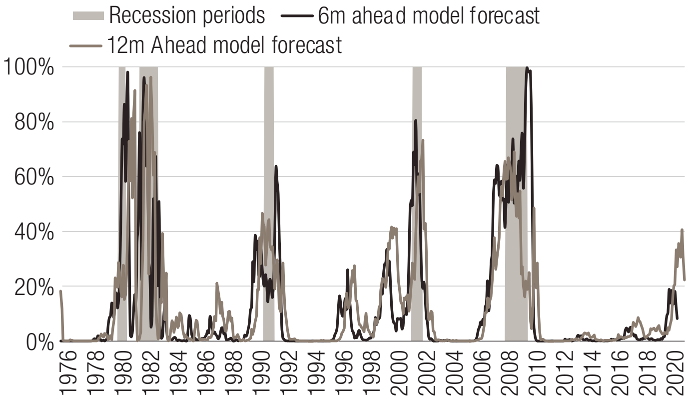
We see a potential catch-22 situation arising in 2020 as policy, economic and political dilemmas loop between each other, and create a more complicated investment landscape for investors to assess.

In this two-part report, we lay out our top-down themes for 2020 and provide outlook perspectives from our individual investment teams, focusing on the key opportunities and risks they see in their respective asset classes. Our sustainability research team has also shared their views on the key trends they see as likely to strengthen further in 2020.

Last year, we headlined our outlook as "No Recession Yet Tricky." At least on the basis of global economic growth dynamics seen so far in 2019, this scenario has held true, despite a fair share of "tricky" along the way. We have global central banks led by the Federal Reserve and the European Central Bank (ECB) to thank for making sure that the world economy avoided a recession. Real rates plummeted, globally, on the back of their easing actions, providing a strong source of monetary stimulus as worsening trade war uncertainty ravaged global business confidence and global trade activity.

In a different business cycle, 2019 would be a recession year, but as we have seen key economic relationships (such as the link between inflation and unemployment) have changed materially since the global financial crisis, and the sustained de-linking of the consumer and business sector seen in 2019 is another change now added to the list.

FIG. 1 US RECESSION PROBABILITY MODEL FORECAST



Source: LOIM Calculations. Past performance is not a guarantee of future results.
See: https://am.lombardodier.com/en/contents/news/global-perspectives/2018/november2/managing-a-no-recession-yet-tric.html

Slow global growth

Our base case for global growth in 2020 sees no major bounce in the pace of world economic activity. For instance, the International Monetary Fund (IMF) sees growth remaining around 1.6% in 2020 in advanced economies (unchanged from 2019), whilst anticipating a bounce back in emerging market (EM) growth to 4.5%, up from 3.9% in 2019. Recent market dynamics (with higher yields and equities) imply that a major reflation scenario can play out in 2020.

However, we believe that four base factors need to shift meaningfully for such an sustained reflationary outcome to occur:

1. **Trade truce gives way to a V-shaped recovery in capex:** Recent news flow indicates rapid development towards what is being called a phase 1 deal between China and the US. Compared to a few months ago, the outlook for a trade deal has improved as both sides appear to be working towards a narrow-scope accord. At the very best, we think that once a deal is confirmed (the exact timing remains uncertain), it will help stabilize the free fall in trade volumes and capex that intensified this year - for instance, global capex growth has fallen from a growth rate of more than 8% in Q1 2018 to near zero in late 2019.

   However, major issues of conflict between the two sides going beyond trade remain unaddressed, and with US presidential elections coming into focus, incentives for both sides are likely to be more short-term than was the case a year ago. We do expect a narrow deal to be in place in the coming weeks and the proposed December hike in tariffs to be avoided as domestic impeachment enquiries and upcoming presidential elections keep the Trump administration occupied. From China's side, reduction of uncertainty will clearly be welcomed given the sustained negative pressure on economic growth.

   At the same time, we fail to see how tariffs will be rolled back to pre-trade war settings on the back of current discussions. Tariffs have proven to be a strong leverage tool for the US, which we believe will continue to be deployed to keep pressure on China irrespective of who wins the next US presidential election.

   All in all, we think that a likelihood of a V-shaped recovery in capex is quite low despite the formalisation of a phase 1 deal in coming days and weeks.

2. **China delivers massive credit stimulus:** China's policy mix since the onset of the trade war in May 2018 has been to use fiscal policy to support domestic demand. Unlike in 2015-2016, the credit channel has not been used aggressively at all – a policy setting we think will continue in 2020. The latest release of credit numbers confirms this dynamic, with both bank and non-bank credit growth coming in notably below consensus. In addition, financial stability concerns have remained important so far this year given the take-over of Boasheng bank in May.

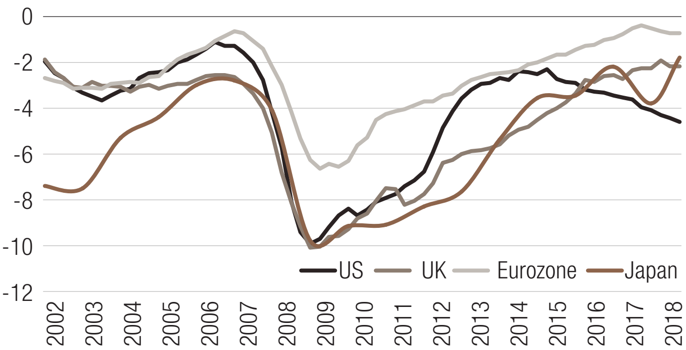
   On the monetary policy side, with CPI inflation rising sharply on the back of the surge in pork prices, the People's Bank of China (PBoC) has shown reluctance to ease monetary policy meaningfully so far, which we believe will have to change in 2020. Indeed, deepening deflation, visible in PPI numbers, implies that growth continues to slow and will need ongoing support, despite the reduction in uncertainty from a likely phase 1 trade agreement. That said, we do not see a hard landing in China next year, despite further moderation in growth to below 6%, together with symptoms of over-leveraging remaining visible via the ongoing default cycle and further consolidation in the banking sector.

3. **Europe deploys meaningful fiscal easing:** We expect around 0.3ppt of fiscal easing in the Eurozone next year - just enough to keep growth afloat but still far short of what is required.

Despite talk of Germany changing its fiscal stance, we note key policy makers have implied fiscal easing is unlikely as they reiterated the need for balanced budgets and strong labour markets. Such a stance contrasts with potential easing scope of 2% of GDP estimated by some economists.

We believe a deeper recession and deterioration in labor markets will be needed for fiscal policy to be used in a more meaningful way, even if various ECB members have highlighted a strong fiscal multiplier effect when monetary policy is constrained. In conjunction, we believe the ECB will need to remain very accommodative in its policy stance, with potentially one more cut to the deposit rate under President Christine Lagarde. We expect an expansion of the pace of quantitative easing (QE), with active discussions on changing the current parameters in H2 2020 as the inflation target appears unlikely to be achieved. We expect a change in policy style at the ECB under Lagarde as some of the maverick tendencies of former President Mario Draghi are likely to be absent, leading to a potentially slower change in policy than was previously the case.

FIG. 2 FISCAL DEFICITS (% OF GDP)



Source: Bloomberg, Thomson Reuters.

More structurally, as we discussed in a recent piece, there are strong signs of "Japanisation" gripping the Eurozone. Without a fiscal policy response, it is unlikely to see real rates rising permanently in the single currency union, in our view. If anything, rises in rates driven by positioning will challenge a recovery in growth as structural forces weigh the region down.

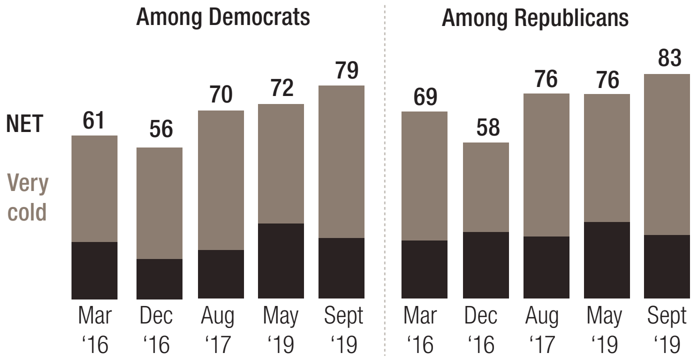
4. **Fed cuts rates again:** With the FOMC on hold after 3 cuts in 2019 that aimed to reverse part of the overtightening delivered by the Fed in 2018, we believe further easing would be needed to generate stronger growth momentum in the US next year. We believe that the Fed will remain sensitive to any visible signs of a renewed slowdown, but we think that the bar for restarting the cutting cycle has been raised, due to the political environment and possible finalization of a trade deal between the US and China.

   Of the four factors needed for a strong reflation scenario to play out, we believe another Fed rate cutting cycle is perhaps the most likely one to consider. Currently, the ongoing strength of the labor market and mitigation of external growth risks imply that the Fed is likely to remain on hold for the next 6 months, with a sustained trend in data shifting the stance (once it happens). We don't expect any rate hikes in 2020, and may see easing resume in H2 if US growth and inflation soften again.

Trump versus Democrats

The US presidential election remains the key, market-defining event of 2020. Although investor surveys highlight a very high likelihood of a Trump victory, we think that the final result is likely to be a closer call as polarization in the US continues to increase (see Figure 3). We think the economy, evidence from the impeachment inquiry and voter turn-out will be critical in determining the final outcome.

FIG. 3 % OF PARTISANS WHO GIVE MEMBERS A COLD RATING ON A 'FEELING THERMOMETER'



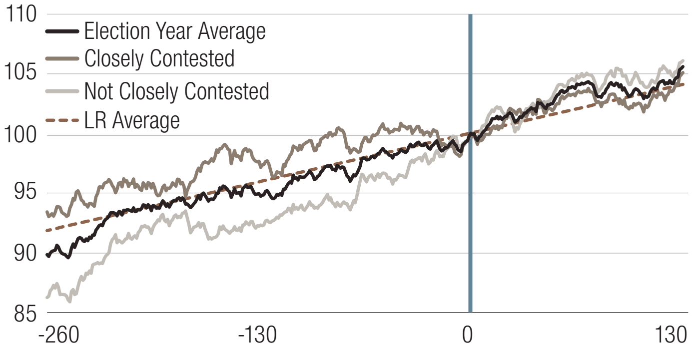
Source: PEW Research centre, Survey of US adults conducted September 3rd–15th 2019.
Note: Partisans do not include leaners. On a feeling thermometer from 0 (coldest) to 100 (warmest), cold ratings are 0-49, very cold 0-24.

The move towards the hard left is visible in the Democratic primary race, with both Bernie Sanders and Elizabeth Warren polling around 40% of support. Although former Vice President Joe Biden remains the front runner according to polls, the weak fund raising and "energy" of the campaign are becoming serious issues.

Historical analysis shows that when US presidential elections are closely contested (i.e. the popular vote difference is below average), the market path leading to election day tends to be more volatile (see Figure 4). Going into November 2020, we see a more than a 50% chance that, at one stage, Warren will become the front-runner (once Sanders' support shifts to her), which can generate a risk-off shock to the market. We remain concerned about a perception of shift in healthcare policy and the impact on the managed care sector, and also highlight downside risks to energy, big tech and financials as the race tightens in coming months.

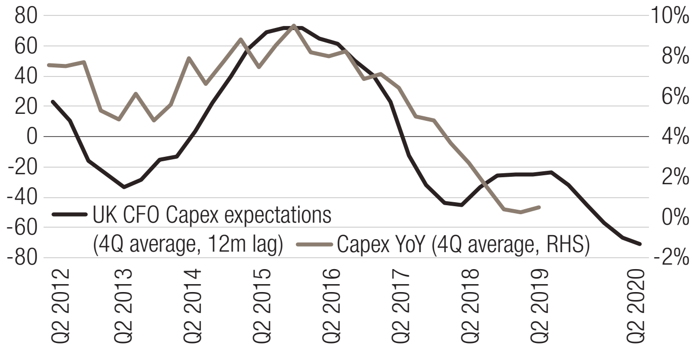
Potential drag from US presidential election noise is one of the main reasons we are cautious on US equities versus the rest of the world over the coming 12 months.

FIG. 4 AVERAGE PERFORMANCE OF S&P 500 APPROACHING ELECTION DAY (INDEX = 100 ON ELECTION DAY [T=0])



Source: Bloomberg, Morgan Stanley Research. Note: based on presidential elections since 1960, excluding 2008, where market performance was an outlier. "Closely contested" defined as where resulting popular vote margin is below average.

FIG. 5 UK CAPITAL EXPENDITURE AND CFO 12M AHEAD CAPITAL EXPENDITURE EXPECTATIONS



Source: ONS, Deloitte, Thomson Reuters Datastream, LOIM Calculations.

Brexit elections

Although Brexit's end appeared in sight briefly in October as Prime Minister Johnson's divorce bill passed an approval vote in parliament, parliament engineered a further extension of the deadline to January and opened the door to a December general election (scheduled for the 12th December). As a result, any probability of a given Brexit outcome is now conditional on the election result, complicating the outlook.

At the time of writing, the base case points to a Conservative majority, be that outright or via coalition. Most recently, the decision by Nigel Farage's Brexit party to not contest Conservative seats has increased this likelihood. Such an outcome represents the most market-friendly scenario in the short term as it would almost certainly see the bill passed by the 31 January deadline. However, question marks remain over any possible amendments to the bill. The most important potential amendment concerning UK asset performance relates to the hard break at the end of 2020, which threatens another no-deal cliff edge scenario in a year if insufficient progress is made in transition negotiations. The Conservatives have rejected the possibility of an amendment to push back this deadline (which helped secure Nigel Farage's support), and any future extension would have to be agreed by the end of the summer.

A surge in Labour popularity heading into the election cannot be completely discounted. In the 2017 election, Jeremy Corbyn's campaigning expertise saw Labour wipe out the Conservative's 20-point poll lead. This time around, their lead sits at around 10 points (as of 14th November). Broad Labour gains, and perhaps even a Labour-led coalition with the SNP, would likely be very unfavorable to UK assets, through both the policy channel, as well as extended Brexit uncertainty, which is already dampening investment spending (Figure 5).

We maintain our stance that a no-deal outcome is highly unlikely, and Conservatives are likely to win the upcoming elections, leading to the approval of the latest iteration of the deal. However, another potential cliff edge at the end of 2020 means that depressed investment spending may struggle to recover, which may necessitate monetary policy easing.

Green central banking

At the recently-concluded IMF/World Bank meetings, climate change and what role central banks can play was a major theme. A speech by Fed governor Lael Brainard eloquently outlined the broad parameters of the role of central banks when it comes to dealing with and mitigating the impact of climate change.

We believe central bank involvement could occur through three interconnected channels:

1. Assessing the severity and frequency of extreme climate change events and their impact on macro variables in order to calibrate monetary policy reaction and evaluation of financial stability risks.
2. Addressing financial stability issues arising from the transition to a lower carbon economy.
3. Supporting through signaling and incentives the 'greening' of the financial system. Potential tools include promoting lending to the green industry and perhaps even a green QE. Although these act powerfully as signals, the actual impact on carbon reduction would likely be much lower than regulatory-driven changes (such as increasing the price of carbon emissions) which governments can and should enact.

Wildcard risks

When it comes to wildcard risks for 2020, extreme climate change events (the intensity of which continues to grow) and their impact on the economy, policy and markets remain important considerations.

On the traditional economic front, a synchronised increase in global inflation remains a wildcard risk, while overt policy moves remain another factor to consider (i.e. the Dudley Doctrine and/or deployment of some form of Modern Monetary Theory (MMT), especially in the Eurozone). In a recent opinion piece, former NY Fed governor William Dudley made the point that the Fed shouldn't accommodate a negative shock coming from the trade war and should let the administration face the political consequences of the resulting shock. Although this view drew sharp criticism for weakening the independence of the Fed, it remains a wildcard risk that could bed into the thinking of the current FOMC, and therefore may manifest itself in 2020. On the political side, an unexpected impeachment of President Trump and ensuing blowback is another wildcard risk. Impeachment would require support of 67 Senators which appears highly unlikely, given the Republican-controlled Senate. Another bout of political tensions in Italy, given the fragile nature of the coalition, is also another risk worth monitoring.

In addition, the wide-ranging public protests impacting various countries bear close attention, especially after severe public protests led to the ouster of the Bolivian president in recent days. Escalating protests in Hong Kong remain a wildcard risk for the global economy, especially if they endanger the island's financial system and jeopordise China's access to dollars.

On a more structural level, rising illiberalism in India under President Narendra Modi's second term is also an important shift. It could have deep negative consequences for the country's cohesion (where the economy is already reeling from a credit shock) and will require close monitoring in 2020 as the administration moves away from a pure economic, prosperity driven policy path.

Conclusion

All in all, we see the trend of slow global growth continuing in 2020 and do not foresee a V-shaped recovery in global capex despite the potential finalisation of a trade deal between the US and China. We expect real rates to remain low globally (thus supporting the search for yield) and see downside risk to US assets as the presidential race tightens. We see little chance of meaningful fiscal easing in Europe. Finally, we expect more tangible policy responses to extreme climate change events as central banks get a handle on the nature of this risk and its implications for key macro variables.

The next section of this report will consider how our experts view the key trends likely to shape 2020 in: sustainability, equities, corporate credit, convertibles, emerging market credit and multi-asset.

Sustainable finance: bridging the gap to decarbonisation

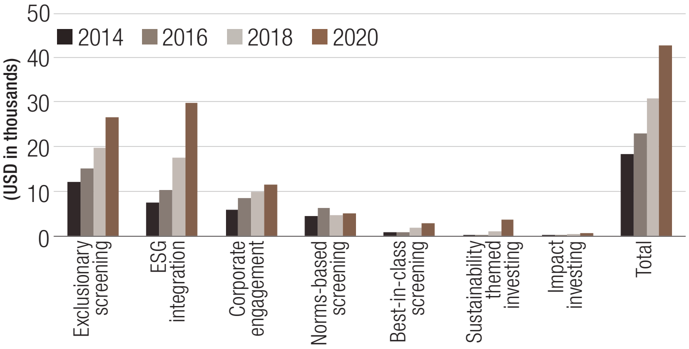
Christopher Kaminker, PhD, Head of Sustainable Investment Research and Strategy
Thomas Hohne-Sparborth, PhD, Sustainability Analyst

In 2019, the sustainable finance landscape continued to grow more diverse in terms of issuers and geographies, and more complex in terms of instruments. Last year, total assets under professional management invested according to responsible investment strategies exceeded USD 30 trillion for the first time.[i] Issuance of sustainable debt in 2019 looks set to to fall just short of USD 400 billion, with green bonds expected to account for around two-thirds of this or 250-265 billion (well above most market estimates from the beginning of the year).[ii]

These trends are now accelerating. In July, nine Dutch pension funds managing EUR 800 billion in assets committed to reduce their carbon footprint, necessitating a more active management approach.[iii] By 2020, we see total assets invested according to responsible investment strategies exceeding USD 40 trillion.[iv] Sustainability and impact-focused investing can account for four to five trillion of this total, nearly tripling from 2018. Based on our analysis of the prospects for sustainable debt issuance, we see the potential for issuance to reach USD 560-620 billion in 2020 and USD 720-810 billion in 2021.[v] We expect that green bonds could account for USD 320-360 billion of this total in 2020 and USD 400-450 billion in 2021.

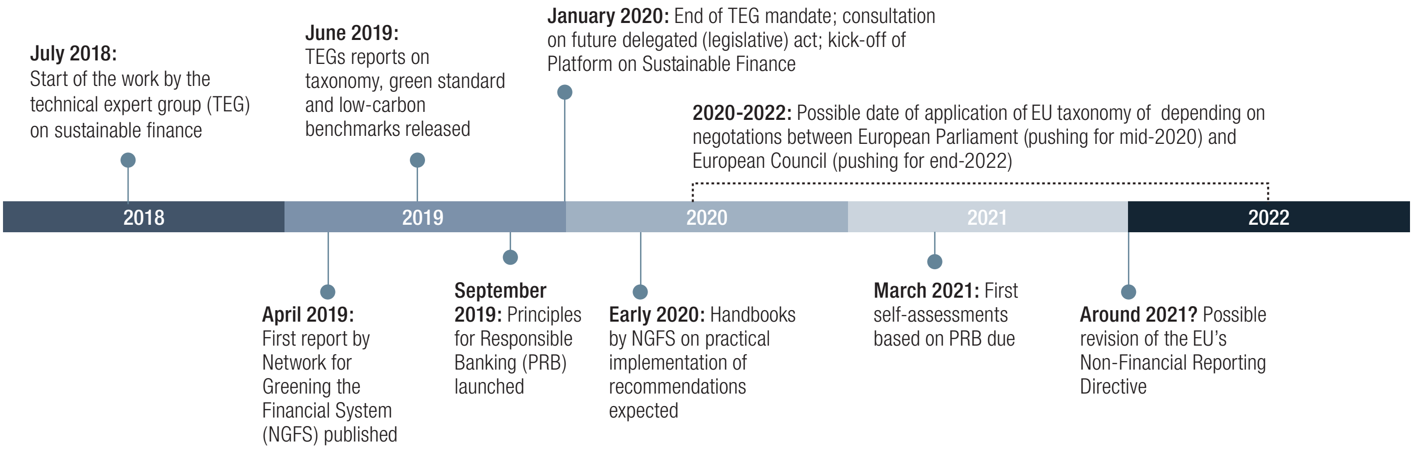
As the sustainable finance industry grows, regulators and voluntary initiatives are looking to bring welcome standards and transparency to the sector. The EU Commission's action plan on sustainable finance is a case in point, comprising the establishment of a taxonomy to classify sustainable activities, an EU standard for green bonds, benchmarks related to decarbonisation, and disclosure requirements on ESG integration.[vii]

FIG. 6 VOLUME OF ASSETS UNDER PROFESSIONAL MANAGEMENT INVESTED ACCORDING TO RESPONSIBLE INVESTMENT STRATEGIES, 2014-2020F (USD BILLION)



Source: Data from Global Sustainable Investment Review for 2014-2018;[vi] LOIM forecasts for 2020; note that as many forms of sustainable investment combine several of the strategies listed, the sum of the individual strategies exceeds the total figures shown

FIG. 7 TIMELINE OF ONGOING REGULATORY INITIATIVES

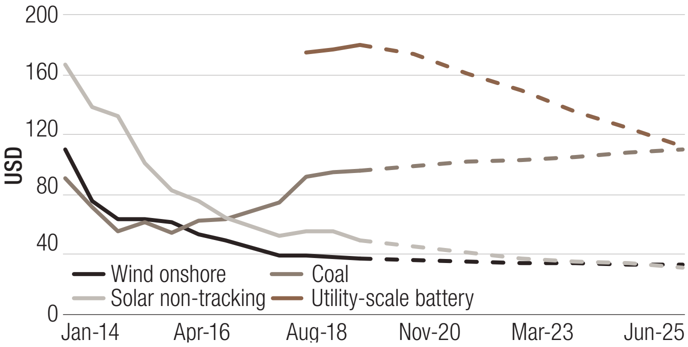


Source: LOIM analysis.

i Global Sustainable Investment Alliance (2019). 2018 Global Sustainable Investment Review. And previous editions. Accessed at http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
ii LOIM forecasts, dated 9 November 2019. Note that the percentage of debt issued towards the end of the year has steadily increased from 2014 to 2019, as a result of which full year figures are forecast to be substantially higher than year-to-date figures.
iii Financial Times (2019). Dutch pension funds set to pivot from passive to active management. Accessed at https://www.ft.com/content/942dd387-d676-4206-888b-021d96f9b065
iv LOIM forecasts.
v LOIM forecasts, dated 9 November 2019. Note that the percentage of debt issued towards the end of the year has steadily increased from 2014 to 2019, as a result of which full year figures are forecast to be substantially higher than year-to-date figures.
vi Global Sustainable Investment Alliance (2019). 2018 Global Sustainable Investment Review. And previous editions. Accessed at http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf
vii European Commission (undated). Green finance. Accessed at https://ec.europa.eu/info/business-economy-euro/banking-and-finance/green-finance_en

Market trends are supporting these regulatory and policy trends. Costs of wind and solar power continue to fall and The International Renewable Energy Agency (IRENA) forecasts that by 2020, auction prices of solar and wind power will fall below the operating cost of 700 GW and 900 GW, corresponding to 35%-45% of the coal industry's current capacity.[viii] Nonetheless, up-front capital costs can be significant, creating a role for the finance industry in bridging the gap between near term funding requirements and future returns.

FIG. 8 TRENDS IN LEVELISED COST OF ELECTRICITY IN THE US (USD/MWH, 2018 REAL TERMS)



Source: LOIM analysis based on Bloomberg NEF.[ix]

We believe a vast increase in investment levels is still required. Current policies place us on a pathway towards a 3-5°C increase this century. IRENA estimates that to meet the goals of the Paris Climate Agreement, additional funding in the range of USD 27 trillion (over and beyond present commitments) will be required to support energy, mobility and related transitions. The finance industry will be ready to support that increase in scale, but it is a pipeline of investable projects that is the missing part of the equation today. Policy ambition will have to significantly increase to create the magnitude of projects commensurate with the challenge, beyond what market forces and corporate action can deliver.

viii IRENA (2019). Renewable power generation costs in 2018. Accessed at auction prices of solar and wind power will fall

ix BloombergNEF (2019). Levelized cost of electricity. Accessed at https://www.bnef.com/core/lcoe?tab=Forecast LCOE

x LOIM analysis based on International Institute for Applied Systems Analysis (2018). SSP Database (Shared Economic Pathways) – Version 2.0. Accessed at https://tntcat.iiasa.ac.at/SspDb/dsd?Action=htmlpage&page=10

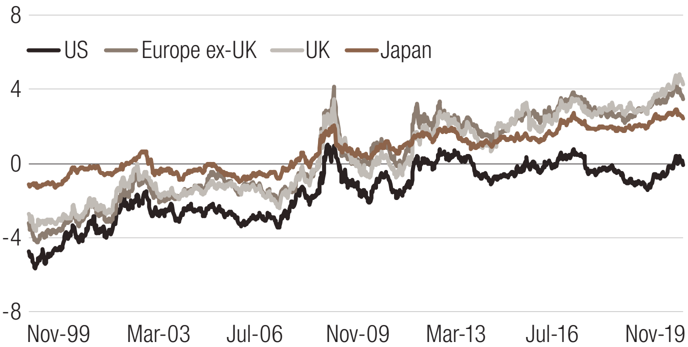
xi IRENA (2018). Global Energy Transformation: A Roadmap to 2050. Accessed at https://www.irena.org/-/media/Files/IRENA/Agency/Publication/2018/Apr/IRENA_Report_GET_2018.pdf

Global search for yield: the case for cyclicals

Didier Rabattu, Head of Equities
Pascal Menges, Client Portfolio Manager

As we enter 2020, there is a striking difference in spreads between risk-free rates and equity dividend yields. Across Europe, UK and Japan, these spreads have almost returned to where they were at the bottom of the 2008 financial crisis when equity valuations were at their lowest, as shown in Figure 9.

FIG. 9 DIVIDEND YIELD VERSUS 10Y YIELD



Source: MSCI, Bloomberg. Yields are subject to change and can vary over time.

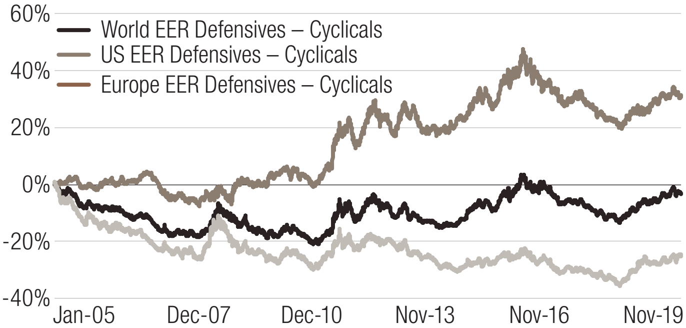
To correct this situation, either dividends need to be cut, interest rates need to move higher, or equity markets' valuation needs to rise. As long as consumer spending continues in its role of key economic support, we do not expect the current capex cycle downturn to drive dividend cuts. Our global strategic team is also of the view that interest rates are unlikely to move higher anytime soon. We are therefore left with the last option – equity markets' valuation needs to move higher.

Although it is difficult to demonstrate that a dividend-yielding strategy structurally outperforms equity markets, they do have periods of outperformance. For instance, from end 2015 to March 2019, the yield curves in Europe and Japan both entered negative territory for the first time ever. During that period, both the European and Japanese equity markets rose 18% and the highest dividend payers (first quintile) moved up approximately 35%.

Cyclicals comeback?

To analyse how cyclical companies have fared versus defensive companies, we compared the performance of companies with the 20% most volatile financial value creation (excess economic returns) with the least volatile over a rolling cycle of 10 years, as shown in Figure 10.

FIG. 10 DEFENSIVE VERSUS CYCLICAL STOCKS 2005-2019



Source: LOIM analysis.

Our view is that cyclicals and defensives have not behaved similarly worldwide. There is a key difference between the US and Europe, for example. In Europe, between 2011 to 2016, defensives materially outperformed cyclicals. Cyclicals then took the lead until mid-2018 when defensives came back. In the US, the patterns are less pronounced but there are some similarities with Europe. However, US cyclicals outperform overall.

Therefore, if macro favors a cyclical rebound, European cyclicals are likely to present an attractive hunting ground, given how materially they have underperformed since 2011 in general, and since mid-2018 in particular. These companies represent the only segment still below its 10 year capital efficiency return on equity (ROE). They are also by far the lowest-valued segment of the equity market from a global standpoint.

Sustainability, a growth opportunity in a low growth world

We have listed seven core sustainable themes, and a transversal one, that are focusing on capturing the opportunities of tomorrow offered by the sustainability challenges of today: sustainable food, sustainable urban systems, sustainable lifestyle, sustainable supply chains, sustainable financials and sustainable healthcare.

We have ranked companies according to their capabilities either to provide solutions or to transition towards more sustainable business models and the rest of the market. Then we have reviewed consensus estimates to compare growth anticipation over the next 2 years across our preferred themes and the rest of the market. Based on our analysis, companies exposed to our themes are expected to show an EPS growth of approximately 11% pa from 2019 to 2021, while the others are closer to 8% pa. Volatility of growth is also much lower for our sustainable themes that for the rest of the markets.

In terms of valuation, this growth is not yet recognized by the market as the price/earnings to growth (PEG) ratio for our thematic universe is at almost a 10% discount. Additionally, our thematic universe also shows strong qualitative characteristics with an aggregated ROE of 14% versus 10.7% for the rest of the markets.

Key views:

- We believe cyclical companies that are at the bottom of their investment cycles are likely to be the most sensitive to a macroeconomic rebound. In Europe, we would typically favour companies in the automotive, energy, capital goods and material sectors. A second derivative would be the European banks, which are evenly split between cyclicals and defensives.
- Some of these European cyclicals also screen well from the cash dividend yield angle in the energy, materials and bank sectors. This analysis hold true on a global basis, with or without share buybacks.

Constructive stance on corporate credit

Yannik Zufferey PhD, Chief Investment Officer, Fixed Income
Leslie Sita, Client Portfolio Manager

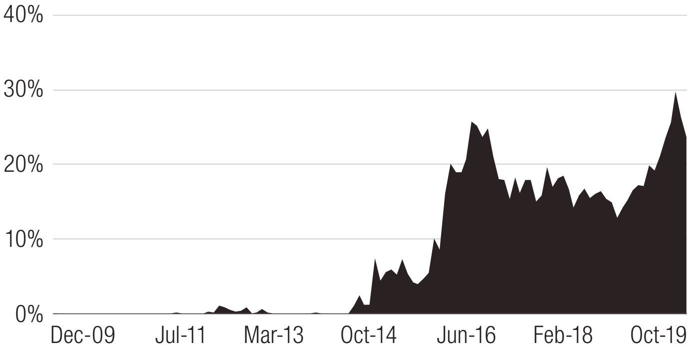
Given slowing growth and subdued inflationary pressures, we see the low rate environment continuing across the globe.

Developed bond yields trade near historical lows, both in terms of levels as well as curve steepness in many regions. It is tempting to argue the richness in valuations may correct at least partially in the coming quarters, and tactically this may well be a profitable strategy in 2020. However, the global economic outlook remains compatible with a low yield environment, and we believe any potential rebound in yields is likely to be contained. Instead, we see a significant risk that bond yields could still hit fresh lows in 2020. For instance, a weakening growth outlook could coincide with the depleted toolkit of many developed central banks, and see authorities only grudgingly come to the rescue with fiscal easing measures.

In that context, the hunt for yield has further to run. We remain constructive on corporate credit in the coming year, given our outlook for technicals, valuations, sentiment and fundamentals.

Providing a powerful steer, technicals are likely to be the main driver of spreads in 2020. The scarcity of positive-yielding paper looks set to remain entrenched (Figure 11), underscored by the highly accommodative stance of central banks. In particular, the ECB will continue quantitative easing by buying corporate debt as part of the Corporate Sector Purchase Programme (CSPP). Such a context is likely to encourage fixed income investors to seek yield by moving farther down the ratings spectrum, in our view.

FIG. 11 BLOOMBERG BARCLAYS GLOBAL AGGREGATE – NEGATIVE YIELDING DEBT (% OF INDEX)



Source: Bloomberg.

Elsewhere, valuations reflect the current, benign environment but we believe that pockets of value can still be found with the right expertise. Sentiment remains volatile due to geopolitical events and uncertainty. Recent developments appear to be moving in a supportive direction – for instance on the US-China trade war and Brexit – and have diminished tail risks for the time being. Lastly, we note that fundamentals (such as leverage in some areas) are deteriorating slowly, albeit from solid levels. As a result, we keep a constructive stance on corporate credit as appetite for yield is likely to persist. For 2020, we particularly favour the crossover ratings space of BB to BBB companies, and subordinated debt from high quality borrowers.

Key views:

- The combination of better valuations, stable fundamentals, moderate risk and diversification makes crossover the sweet spot of the credit spectrum, in our opinion.
- The advanced stage of the current economic cycle makes us prefer enhancing yield by moving down the capital structure of investment grade companies, rather than by adding senior bonds of lower-rated issuers.

Convertibles for an upturn in volatility

Maxime Perrin, Client Portfolio Manager

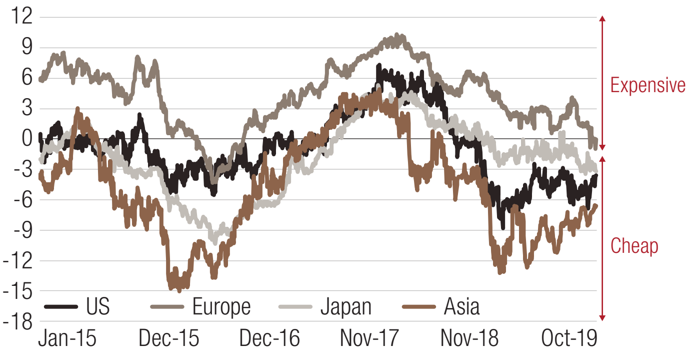
After three years of below-trend volatility, we expect the 2020 markets to bring a return of equity volatility and risk assets in general. This volatility could come, in our view, from a combination of high equity valuations, an uncertain macro and political environment (trade wars, Brexit, US elections), and the reduced effectiveness of monetary stimulus.

In such a context, the risk-reward characteristics of the convertible bond asset class could prove particularly useful for investors. In particular, we see balanced, global convertible bond strategies focusing on the most asymmetric profiles as best-placed to benefit. We also recommend a focus on the better-quality credit instruments within the convertible bond asset class because they provide superior protection against potential corrections.

In regional terms, we see Europe providing the most balanced technical profiles (with investment grade quality); the US universe presenting more high-yield and high equity sensitivity instruments; and the Asia-Pacific region being an attractive source of convertible bonds with appealing yields.

A comparison of the implied volatility and realised volatility within the convertible bond universe shows the asset class looking cheap from the optionality point of view, as shown in Figure 12. The asset class has clearly benefited historically from rising equity volatility:

FIG. 12 VALUATION OF CONVERTIBLE BONDS
Spread by region (Implied vol – Realised vol)[1]



[1] Source: LOIM. Spread (difference in percentage points) by region between IV (Implied volatility) and RV (260 days Realised volatility). Past performance is not a guarantee of future results.

Key views :

- Balanced, global convertible bond strategies stand to benefit from an expected return of equity volatility and risk assets in 2020.
- A focus on the better-quality credit instruments could provide superior protection against corrections.

EM: a selective approach to hard currency credit

Dhiraj Bajaj, Portfolio Manager and Head of Asian credit
Vincent Megard, Portfolio Manager

We see growth as the main challenge for emerging markets (EM) in 2020, and highlight attractive valuations in hard currency credit markets as part of a selective approach.

Early signs of economic stabilization are emerging in various countries, including China, and we expect EM countries to benefit further from easier financials conditions in the wake of the global easing cycle in 2019. In particular, loose US monetary policy allows EM to continue their easy domestic stance.

Trade tensions will remain an important driver, as most EM countries are trade-dependent and have ties to China. Progress on the US-China trade dispute is needed to support EM FX and bond markets, and we expect this to happen, despite electoral tensions in the US. As such, we see lower pressure on EM currencies in 2020.

Politically, we expect a lull period in the EM electoral cycle next year because most major EM economies have held elections in 2018-2019. That said, we note the on-going risk to financial and socio-economic stability from low growth, and the accompanying risks of populist outsiders potentially gaining power.

Due to the global search for yield, we expect a pronounced need for USD-denominated duration, and significant displacement of domestic buyers in Europe and Japan who are expected to seek USD-denominated fixed income in both IG and HY. EM and hard currency credit from Asian borrowers is also likely to be supported by this demand, and we note low leverage dynamics in EM corporate credit markets.

Hard currency bond markets still display interesting valuations as spreads remain attractive even after this year's tightening. We believe the widening gap between the very high yield and the rest of the market reflects a deterioration of the credit quality of riskier names, however. As such, we favour a very selective approach to this segment of the market.

Local EM fixed income markets should still benefit from positive real rates and an important rate differential with DM. FX carry should remain attractive, although it has been eroded by the sizeable EM easing cycles, in our view.

Key views

- We are extremely positive on the search for yield in USD-denominated corporate bonds, especially in EM hard currency credit where we expect spread duration to continue to do well into 2020.
- We are cautious on cyclical and levered sectors in EM HY, as export growth is low across EM.

[1] Capital protection represents a portfolio construction goal and cannot be guaranteed.

Multi-asset: re-balancing risk for tricky times

Aurèle Storno, Lead Portfolio Manager

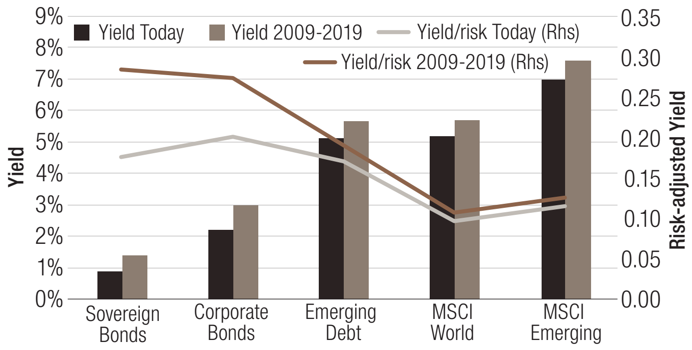
After a year of solid returns across asset classes, a tricky crossroads has emerged as global rates turned lower once more. This may have surprised investors who had been expecting rates to rise for some time. Low rates reflect structural, economic and geopolitical changes, and for multi-asset investors, the challenge is to diversify asset allocation when uncorrelated assets are scarce.

In the low rate environment, investors shift assets around to improve yield, while trying to maintain some diversification. Figure 13 shows the current situation compared to the past 10 years. The bar charts (left axis) show measures of forward-looking yield: they stand lower than their 2009-2019 average, but not meaningfully so. The change is more striking when yield is divided by risk (measured as realized historical maximum drawdown). Sovereign bonds become much less attractive, and corporates remain somewhat more interesting.

Despite their unfavourable yield/risk ratio, equities remain preferred by investors due to their significantly higher earnings yield. We note that emerging debt presently offers the best compromise because it is comparable to corporates from the yield/risk point of view, but offers significantly higher yield that is potentially competitive with equities. However, shifting assets towards credit and emerging debt comes with a correlation risk to risky assets, and a consequent lack of diversification in major market shocks.

We believe these considerations can help investors rebalance their portfolios with a more structural view, while taking into account more tactical elements.

FIG. 13 YIELD AND RISK-ADJUSTED YIELD



Source: LOIM. For illustrative purpose only. All data computed monthly.
Indices: FTSE World Government Bond Index, Barclays Global Aggregate Corporate, JP Morgan Emerging Market Bond Index, MSCI World, MSCI Emerging
Yield computation: yield-to-worst for bond indices, earnings yield for equity indices
Risk measure: maximum realized drawdown (monthly).

Key views:

- In the current, tricky environment, we seek further diversification and high flexibility for multi-asset portfolios
- We favour risk-based rebalancing and seek structurally higher diversification involving, for example, alternative risk premia and convexity
- We advise actively managing drawdowns as correlation shocks become more frequent.