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CIO Viewpoint

Ten investment convictions for H2 2020

Investment Solutions

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Six months ago, investors were looking for signs of a recession; a global pandemic was not high on anyone's list of catalysts. As we enter the second half of 2020, many aspects of our lives have altered, and as economic recoveries begin, the Covid-19 pandemic is still very much with us. While infections are contained in many countries, we are also better equipped to manage fresh outbreaks.

Unprecedented policy responses to support economies are paving the way for revival. We expect a 'square root'-shaped recovery, with a steep renewal in activity, followed by a tailing off as some sectors such as leisure, hospitality and tourism take much longer to resume. There is a long way to go, but most developed nations with the possible exception of the US, are on track to recovery in the third quarter. Once the initial spurt is past, economies will likely return to a slow-growth, low-inflation environment, with high debt and low-to-negative interest rates. We are wary of any indication of broad second-wave infections, protectionist policies, and above all any premature end to the policy support provided by central banks and governments.

For investors, Covid-19 has accelerated existing economic and social trends. We have identified four structural trends that are profoundly changing the world and as a result, present investment opportunities.

Firstly, Covid-19 underlined our inescapable dependence on technology, and rapidly changing consumer preferences. The increase in online commerce, distance working and education tools has accelerated digitalisation. Secondly, profound demographic changes imply greater demands on healthcare, with many countries poorly prepared for the pandemic. As a result, we expect significant investments in this sector.

Thirdly, with China accounting for almost one-fifth of the global economy and the inclusion of Chinese equities and bonds into a number of indices in 2019, we see the country as worthy of a standalone investment allocation.

Finally, the world faces the urgent need to de-carbonise quickly. Consumer pressure, regulation and innovations are all shaping the investment landscape as we transition to a more sustainable economy.

The second half of the year will be dominated by the US presidential election as well as the evolution of the Covid-19 pandemic. As the US race unfolds and candidates unveil their programmes, we'll be able to better assess the impact on financial markets. Asset allocations capable of managing more volatility will be crucial. The following ten investment ideas are designed to help portfolios weather foreseeable, and less predictable, developments.

Key dates

- **17-20 August**
  US Democratic National Convention
- **24-27 August**
  US Republican National Convention
- **6 September**
  Hong Kong legislative elections
- **3 November**
  US Presidential election
- **21/22 November**
  G20 scheduled to meet (hosted by Saudi Arabia)
- **31 December**
  End of UK's Brexit transition

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1. Keep exposure to risk assets

The sharp recovery following the pandemic-induced fall underlined the importance of staying invested in equities. Investors should now make sure that they hold enough risk assets in their portfolios. In the circumstances, there is no substitute for preparing tactical responses to the inevitable surprises that will demand changes to portfolio risk profiles.

2. Add defensive allocations

Every portfolio needs investments designed to offer a shield from the unexpected. There are a number of possibilities to make tactical allocations to defensive assets. We have increased our exposure to US Treasury bonds in non-USD portfolios, taking advantage of the lower cost of hedging in the wake of the Covid-19 crisis. In addition, it makes sense to have some exposure to gold and the Japanese yen and, whenever markets experience a period of low volatility, take advantage of put options on equity indices.

3. Investment-grade credit enjoys a solid backstop

In this low-growth, low-yield environment, investment-grade credit offers an opportunity to generate portfolio yield. On a relative basis, investment-grade credit remains attractive compared with sovereign debt with a solid backstop in the form of central bank asset purchases.

4. Identify attractive high-yield fixed income

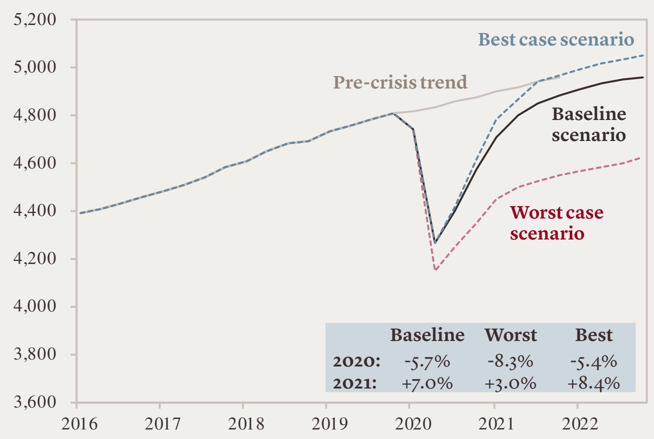
In fairly-valued markets with capped yields there is little potential upside and so it makes sense to add high-yield bonds as part of a carry strategy. Most of the next default cycle is already priced in, although we continue to avoid the transport, retail, leisure and US energy sector. We are also cautious on emerging world debt outside Asia, as nations such as Brazil and Mexico continue to be affected by low oil prices and the pandemic. In particular, these same economies will suffer from the downturn in global trade. Our preference is for ‘BB’ rated credit, and some single-B rated names in quickly recovering sectors.

US and euro area growth dynamics

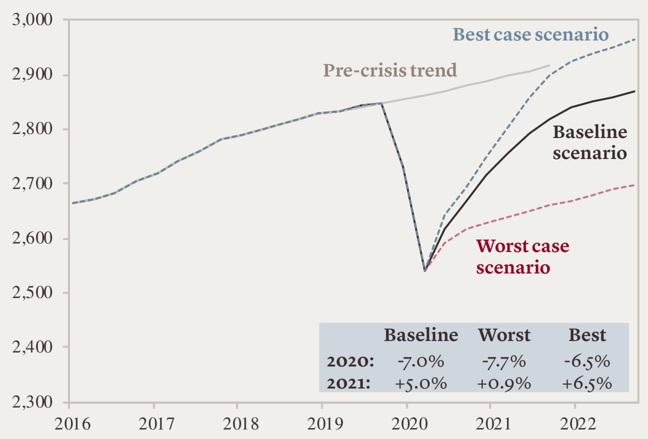
Baseline scenario: deep contraction in H1 2020 and sharp recovery in H2 2020

Worst case scenario: protracted depression / Best case scenario: scientific breakthrough

Quarterly US GDP, in USD bn



Quarterly euro area GDP, in EUR bn



Sources: US Bureau of Economic Analysis (BEA), Lombard Odier calculations

5. Focus on sustainable equity growth, healthcare and IT

Expectations for equity markets in the second half of the year point to very low returns, given the second-quarter rally. We favour corporate stocks with sustainable growth prospects and resilient balance sheets, such as information technology and healthcare, which should outperform value stocks. We also like utilities that are working on sustainable solutions, offering attractive opportunities as state spending trickles down into infrastructure projects. Post Covid-19, we expect the government spending splurge to increase investments in medical infrastructure and treatments. Medical technology, including tracking, testing and monitoring tools will all benefit. Information technology stocks more widely have excellent post-pandemic growth prospects, including in areas such as the internet's physical architecture and security.

6. Favour Asian equities in emerging markets

Our outlook for emerging market equities overall is cautious since global trade growth will be subdued with lower commodity prices, less effective central bank fiscal stimulus and greater uncertainty over the impact of Covid-19. This said, China and Asia do offer many attractive investment opportunities. The region was able to return more quickly to economic activity and industrial activity is back on track with sizeable fiscal stimulus and infrastructure spending on telecommunications, power, transport and IT. In addition, China's growth looks more V-shaped than many economies as domestic demand increasingly drives GDP.

7. Real assets offer stability in turbulent markets

Real assets such as private equity, real estate and infrastructure offer diversification. This year in real estate high quality residential and logistics properties stand out, with core-nation European property looking the most attractive in terms of resistance and yield for both EUR and CHF portfolios. Investor demand, boosted by the search for yield, has not weakened, which continues to support prices. Valuations are not cheap, but are still short of a bubble. In contrast with the recovered Swiss listed market, European real estate stocks still offer some potential with markets pricing a decrease in Net Asset Values. US-based Real Estate Investment Trusts (REITs) also offer broader sector diversity and access to property such as data centres that diversify a European allocation at attractive valuations. In this slow-growth, low-rate environment, infrastructure should see support from government-backed investments. Investors cannot afford to overlook private equity, which can offer exposure to the real economy, additional portfolio diversification, and the potential for enhanced returns.

8. Weaker dollar

The pandemic and the subsequent economic shock challenged our bearish dollar view. With activity now recovering and the risk premia that buoyed the dollar priced out, we continue to expect a weaker USD and see upside in other G10 currencies. These currencies are undervalued, exposed to China's business cycle and/or supported by a favorable balance of payments. We expect the euro, the Japanese yen and Australian dollar to outperform and appreciate against the USD by year-end.

9. A roller-coaster for sterling

The pandemic-related hit to the UK economy together with poor political management make us very cautious on sterling. A lack of Brexit progress means that the risk of a year-end "no-deal" has risen, although we expect a late "skeleton" agreement with the European Union to support GBP. In the meantime, political posturing and skeptical headlines mean that things will get worse for sterling before they improve.

10. Select emerging currencies against the USD

Emerging markets have suffered from the energy price collapse this year and currencies appear broadly in line with valuations now. With the virus still affecting many emerging markets and many facing a worsening fiscal path, EM currency investors need to be highly selective. We like currencies with lower debt levels, decent external balances and exposure to improving growth from the eurozone (such as the Czech koruna and Israeli shekel), or to China (Indonesian rupiah, Korean won, Taiwanese dollar and Chilean peso). On the other hand, we are still cautious on the Turkish lira, South African rand, Brazilian real and Colombian peso, where fiscal and external balances are more challenging.

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