CITY OF LONDON
Investment Management Company Limited

# Cross-Asset Quarterly Outlook

**December 2020***

## Overview

### The Light, Finally!

- *Uncertainty has receded and the advent of three Covid vaccines promises a sharp economic rebound in 2021 on the back of pent-up demand.*
- *However, this goldilocks period will be preceded by a "dark winter" of rising infections and fatalities and likely followed by a period when the economic scars left by the pandemic begin to reappear.*
- *At the same time, risk assets appear richly priced and risks abound, from excessive reflation and sharply rising bond yields to a premature fiscal tightening.*

Much of the fog of uncertainty that dominated our analysis in the September Cross-Asset Quarterly lifted over the past three months: Joe Biden won the election for the US Presidency, holding the promise of more predictable policies and less strained foreign relations, while the early and successful advent of three Covid vaccines suggests an end to the pandemic's scourge and a return to economic normality before soon.

The confluence of these forces has underpinned a narrative of a strong economic rebound in 2021. A few difficult months still lie ahead – the story goes – but then a strong recovery fuelled by the vaccine rollout, ultra-loose monetary policy and the release of pent-up demand (on the back of soaring household savings) would take hold. Indeed, the IMF forecasts world economic growth of 5.2% in 2021 (3.9% in DMs and 6.0% in EMs), following a smaller-than-previously expected contraction of 4.4% this year. The OECD too has revised its outlook, now expecting a smaller economic contraction in 2020 (as the world experiences multiple waves of contagion) than it did under its single-wave scenario earlier in the year.

Markets have taken the news in their stride, all the more so on the back of the nomination of Janet Yellen as the next US Treasury Secretary and some recovery in corporate profits. The hallmark of this was a major rally in global stocks with several indices, notably the US, reaching record highs. US inflation expectations reached their highest level in 18 months, the broad dollar index dropped to a 30-month low and gold lost its shine, dropping some 9% from its November high. Industry surveys point to strong inflows into money managers, a sharp reduction in cash held by fund managers and a sharp drop in short positions on US stocks. In addition to major equity indices reaching new highs, there has also been a significant rotation into previously shunned stocks such as European bank shares, global energy stocks and airlines, whereas the run on US technology stocks (often regarded as "Covid insurance") has come to a sudden halt.

### Asset Allocation

| | Chg | -3 | -2 | -1 | 0 | +1 | +2 | +3 |
|---|---|---|---|---|---|---|---|---|
| **Equities** | ↑ | | | | | ■ | | |
| **Rates** | – | | | ■ | | | | |
| **Credit** | – | | | ■ | | | | |
| **Real estate** | – | | | | | ■ | | |
| **Commodities** | – | | | | | ■ | | |

### Allocation Breakdown

| | Chg | -3 | -2 | -1 | 0 | +1 | +2 | +3 |
|---|---|---|---|---|---|---|---|---|
| **EQUITIES** | ↑ | | | | | ■ | | |
| US | – | | | | ■ | | | |
| Eurozone | ↑ | | | | | | ■ | |
| UK | ↑ | | ■ | | | | | |
| Japan | ↑ | | | | | ■ | | |
| EM | – | | | | | | ■ | |
| **RATES** | – | | | ■ | | | | |
| USTs | – | | | ■ | | | | |
| TIPS | – | | | | ■ | | | |
| Bunds | – | ■ | | | | | | |
| JGBs | ↓ | | ■ | | | | | |
| EM Local | – | | | | | | ■ | |
| **CREDIT** | – | | | ■ | | | | |
| US IG | ↑ | | | ■ | | | | |
| US HY | ↓ | | ■ | | | | | |
| European IG | – | | | ■ | | | | |
| European HY | ↓ | | ■ | | | | | |
| EM Sov $ | – | | | | ■ | | | |
| EM Corp $ | – | | | | ■ | | | |
| **REAL ESTATE** | – | | | | | ■ | | |
| **COMMODITIES** | – | | | | | ■ | | |
| Energy | ↑ | | | | | ■ | | |
| Industrial metals | – | | | | ■ | | | |
| Precious metals | ↓ | | | ■ | | | | |
| Agricultural | – | | | | | ■ | | |

*Note: Up/down arrows indicate a positive or negative change in our asset allocation compared to the previous quarter. A dash indicates no change.*

*Source: CLIM*

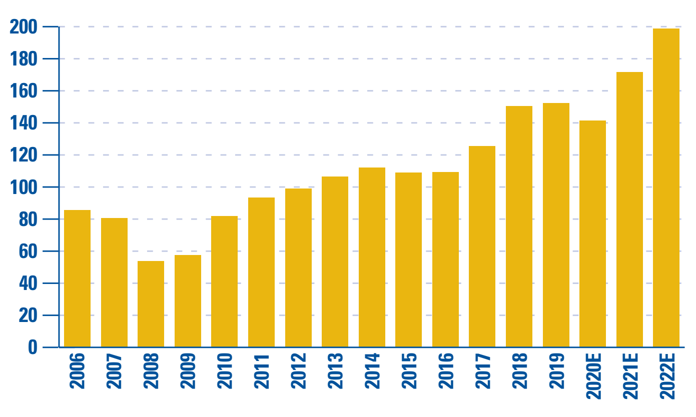
**The publication reflects asset performance up to November 30, 2020, and macro events and data releases up to December 9, 2020, unless indicated otherwise.*

So much for the good news. Looking ahead, analysts generally expect higher stock markets next year, somewhat higher bond yields, a weaker US dollar and broadly a good year for corporate credit. Where opinions differ, it is principally about the extent of the rally in stocks or the anticipated scale of the plunge in the dollar. For their part, markets have priced in the most positive version of this scenario.

Yet, several caveats are in order, relating both to the period preceding this "goldilocks" moment and the one after. First, there is the immediate economic danger that relates to the second or third wave of infections that is currently ravaging many economies and unravelling much of last summer's tentative recovery. This could last until a sufficiently large proportion of the world population is inoculated, which could take up to a year. The bounce back will not have to await the end of this period, but it is simply the inevitable consequence of the reopening of many businesses, rehiring of employees and 'normalization' of economic life. Second, there is the longer term damage the pandemic has inflicted on economies, either by exacerbating pre-existing concerns or by adding new ones. This "economic scarring" refers to the lack of investment, decline in productivity, jobs lost and the increasing debt overhang that has resulted from the pandemic.

This matters given the market's expectations for the period beyond 2021. The anticipated 17% increase in earnings in 2022 (following a 22% gain in 2021) is not unlike the 15% recorded in 2011, two years after the trough. But that put earnings just 11% above their 2007 peak, whereas the current outlook expects earnings 21% above the 2019 levels.

## Chart 1: S&P 500 EPS, USD




*Source: Bloomberg*

## Market Strategy

The outlook can be decomposed into three parts: 1) the immediate "dark winter" months, marked by rising infections and deaths as well as economic setbacks, 2) a period of sharp economic rebound as vaccines are rolled out and inoculations reach a critical mass and 3) a more difficult period thereafter, which has been richly priced but could suffer from long-term economic damage.

As our allocation horizon mostly coincides with the second period, our views changed only marginally from those expressed in the previous Quarterly. We concur with the generally positive outlook for 2021, but find risk assets richly priced. True, policy support and an economic rebound can provide powerful forces for a market rally. But previous such cycles started with deeply scarred financial markets, marked by high yields or low equity valuations. Yet, neither bond, nor equity markets display these characteristics this time. Instead, they have already heavily discounted future performance and it is the economy that remains scarred.

What is more, there has been a growing disconnect between the sanguine scenario embedded in surging equity prices and the much more moderate pace of rising long-term yields. Partly, this could be explained by the new-found tolerance for higher inflation (by the Fed) if it withstands the encounter with reality. But given the decline in potential output and productivity growth, together with a release of pent-up demand, pricing in the two sectors remains inconsistent. We believe that an eventual reconciliation will have to occur from both ends.

Even though economic visibility through 2021 has improved, the current level of asset prices means that our asset allocation requires only limited changes. We envisage that much of the return will be generated from within asset classes next year.

- We shift **Equities** to a small *overweight* given the improvement in external factors. But economies will deteriorate before they improve, whereas asset prices imply better conditions in 2022 than even in 2019;
- We remain *underweight* **Rates** and prefer inflation protected- to outright bonds, we see opportunity only in EMs;
- We also stay *underweight* **Credit**, where extensive spread compression appears complacent; we only take exposure in EMs;
- We keep our *overweight* in **Commodities**, but rotate out of safe havens and into pro-cyclical sectors;
- We are *overweight* **Real Estate** as it offers decent income flow versus bonds and broader equity markets and stands to benefit from the emergence from lockdowns.

There certainly are risks to this benign medium term scenario: growth could keep outperforming (reaching 2019 levels in 2021), reflation could take off or the 'bond vigilantes' could awaken to the rise in public debt and undo the  equity rally through a sharp rise in yields. This, or the fear of it, could lead to too early a withdrawal of fiscal support, as happened during the GFC, and snuff out the recovery. Conversely, a victory for the Democrats in Georgia in January, which could hand them control of the Senate, could prompt a larger-than-anticipated fiscal stimulus, providing upside risk to our central scenario.

# Equities

*Overweight (↑)*

*The case for equities remains strong, given low interest rates. But valuations favour non-US exposure.*

| | 3Y history | Latest | |
|---|---|---|---|
| Global P/E | | 30.5 | Nov |
| DM P/E | | 32.1 | Nov |
| US P/E | | 29.2 | Nov |
| Europe P/E | | 48.9 | Nov |
| Japan P/E | | 30.3 | Nov |
| EM P/E | | 22.5 | Nov |

*Source: Bloomberg, MSCI*

Major stock indices across the world – and in the US in particular – have reached new record highs in the wake of the announcement of Joe Biden's victory in the Presidential election and the successful trial of several COVID-19 vaccines (that is, from early November onwards). While a bounce-back from the previous 34% collapse was expected in light of massive monetary policy support, the recent rally has two important corollaries.

First, again partly thanks to heavy central bank intervention, the dramatic underperformance of equities versus long-dated Treasury bonds has almost completely reversed and the ratio between the two is back to where it was at the beginning of the year. This is remarkable considering that many economies have undergone one of their worst contractions on record.

Second, a significant re-allocation (commonly referred to as "rotation") has taken place within equities, which bears all the characteristics of a strong cyclical recovery. Most commented on has been the outperformance of "value" over "growth" stocks since early November. As another factor, momentum has also lost some of its outperformance over value. At the sector and stock level, European banks, energy stocks and airlines have outperformed strongly, whereas 'new economy' stocks (or FAANGs), which had been bought as 'Covid insurance' dramatically underperformed the average S&P500 stock. What is more, industry surveys suggest that fund managers have recorded strong capital inflows and turned very bullish, reducing cash levels sharply and expecting small cap stocks and emerging markets to outperform.

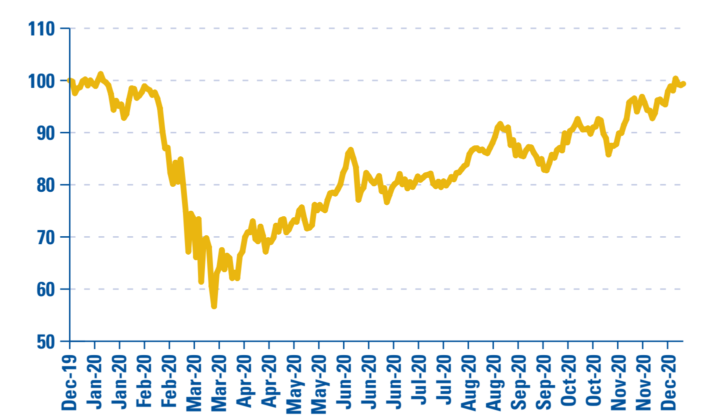
This sentiment is also reflected outside US stocks, notably in the sharp rally in South Korea and Taiwan, Asia's biggest exporters, recovering in the slipstream of China's economy, the surge in industrial metals, a weakening US dollar and a (moderate) rise in inflation expectations.

**Market Strategy**: Against this financial backdrop and the (stalled) economic recovery, how to position? Valuations certainly appear high, with the P/E of the S&P500 near the peak attained during the 'dotcom' bubble. The difference to then is of course that long-term yields are now much lower. This makes bonds more expensive by comparison and future earnings from equities can be discounted at a lower rate, boosting their value today. However, in terms of the cyclically-adjusted P/E (CAPE), the US market appears less stretched: a CAPE of 33 remains some distance from the then-peak near 44. To gauge the effect of lower interest rates, Robert Shiller has calculated a type of equity premium based on his CAPE measure, called the Excess Cape Yield (ECY). This is the inverse of the CAPE measure minus the real 10yr Treasury yield. At 4%, it suggests a decent annual return for US equities. It is even higher at 6% for Europe and Japan and at a record high of 10% in the UK.

These calculations confirm the persistent attractiveness of equities versus bonds and non-US equities in particular. Of course, it is plausible that at very low levels of interest rates (near zero) and under the expectation that they will remain "lower for longer" the relationship between bonds and equities breaks down. But to some extent they nevertheless allow markets to borrow returns from the future and support prices.

Given the material change in external circumstances (Biden, vaccine), we shift our **equity** allocation to a small *overweight*. However, as stated in the introduction, we expect much of the return to be generated from within asset classes over the coming year. As such, it is worth pointing out that we recently shifted our allocation to the **US** to *underweight* (see Developed Markets Quarterly) in global equities, and reaffirmed our *overweights* to **Europe** and **Emerging Markets**. We remain *underweight* the **UK** and *neutral* **Japan**.

## Chart 2: US Equities and Treasuries*




**SPDR S&P 500 ETF Trust/iShares 20+ Treasury Bond ETF; 100 = 31-Dec-19*

*Source: Bloomberg*

# Rates

*Underweight*

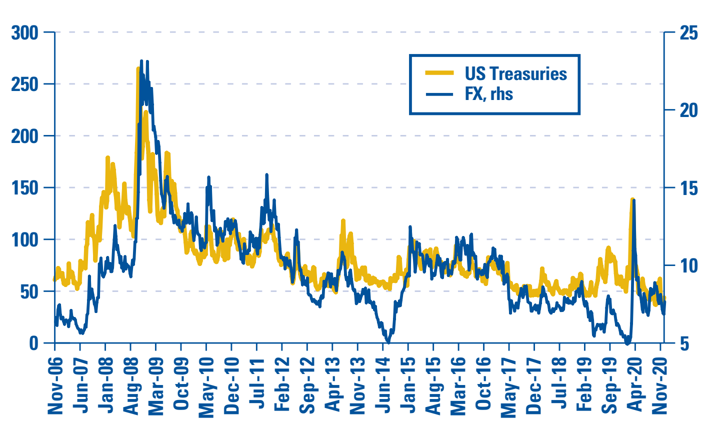
*Central bank commitment to close-to-zero policy rates dampens interest rate- and currency volatility. Combined with low starting yields, this suggests poor returns from holding government bonds outside EM. Inflation-linked bonds offer cheap hedges against inflation risks.*

| | 3Y history | Latest | |
|---|---|---|---|
| Global Govt Yield | | 0.5 | Nov |
| UST 10Y Yield | | 0.8 | Nov |
| TIPS 10Y Real | | -0.9 | Nov |
| Bund 10Y Yield | | -0.6 | Nov |
| Italy 10Y Yield | | 0.6 | Nov |
| JGB 10Y Yield | | 0.0 | Nov |
| EM Local Yield | | 3.3 | Nov |

*Source: Bloomberg Barclays Indices. Yield in %.*

Global central banks have signalled a strong commitment to anchoring policy rates near zero for an extended period. According to the latest (September) dot plot, the vast majority of FOMC members project no single change in the Fed Funds Rate over the next three years. Meanwhile, former Fed Chair Yellen has been nominated by President-elect Joe Biden to be the next US Treasury Secretary. It is expected to herald an era of close coordination between US monetary and fiscal policy to combat the significant labour market and economic slack. Such close monetary-fiscal coordination has already been seen this year in the UK and increasingly in the Eurozone, aided by ECB President Lagarde's previous experience as France's finance minister.

## Chart 3: Implied Volatility for US Treasuries and FX

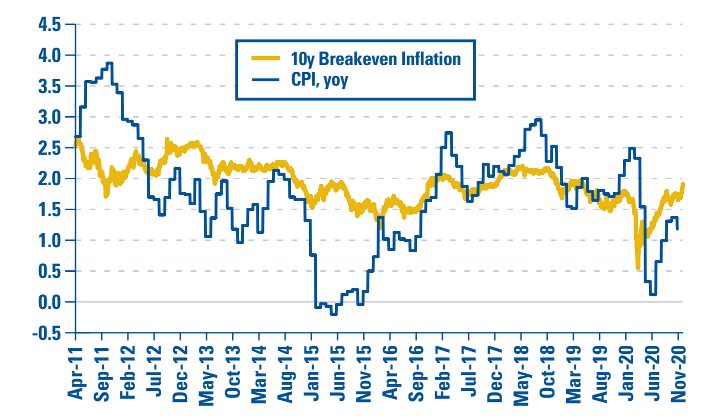



*Source: Bloomberg, Bank of America, Deutsche Bank. As of December 4, 2020.*

**Nominal bonds (UW DM, OW EM)**: Near-zero interest rates – and strong commitment to keeping them there – have significantly dampened bond market volatility. Despite an unprecedented fall in global GDP in H1, implied volatility in US Treasury yields (Chart 3) has quickly dropped to a historical low after a brief spike in March. Low interest rate differentials across countries and low volatility in long-term interest rates have also dampened currency volatility (Chart 4). For instance, the largest peak-to-trough decline in the EURUSD was only 7% this year. The same measure was three times larger (22%) in H2 2008.

Low volatility in bond yields and currencies suggests that the current yield is the predominant driver of expected returns from holding government bonds. Therefore, the current yield and its difference among countries underpin our *underweight* view on rates and our regional allocation. More specifically, we prefer EM bonds that offer positive inflation-adjusted yields. We prefer US Treasuries to the Japanese (JGBs) and German equivalents, and downgrade JGBs to *underweight*.

## Chart 4: US Inflation, %




*Source: Bloomberg. As of December 4, 2020.*

**Inflation-linked bonds (NW)**: We prefer TIPS to nominal US Treasuries as the former offers fairly inexpensive insurance against inflation risks. The US 10-year breakeven inflation is still below the Fed's 2% inflation target. Annual CPI inflation has been below the target for most of the past 5 and 10 years (Chart 4). Therefore, inflation has to meaningfully overshoot 2% in the future for the Fed to achieve its new mandate of flexible average inflation targeting.

Monetary policy alone does not lead to 2% inflation, though. The Bank of Japan and the ECB have had similar mandates in place for many years, and yet still fail to achieve their targets. Fiscal policy is the key, as well as policies that facilitate income redistribution amidst rising inequality. The US Congress is still debating the next fiscal package. The price tag around $1 trillion suggests that the package is more about stabilising the economy than stimulating growth. Meanwhile, 10-year breakeven inflation has already recovered to the pre-COVID level, whereas the unemployment rate remains elevated at 8.8%, more than double the pre-COVID level. All suggest that inflation is a longer-term issue than something to worry about in 2021. Hence, we are *neutral* TIPS.

# Credit

*Underweight*

*We downgrade high yield (HY) and upgrade investment grade (IG) bonds following the former's outperformance since March. The HY market seems complacent about the default rate in 2021, in contrast to the stark warnings by credit analysts and banks.*

| | 3Y history | Latest | |
|---|---|---|---|
| Global IG OAS | | 1.1 | Nov |
| US IG OAS | | 1.0 | Nov |
| US HY OAS | | 4.1 | Nov |
| Euro IG OAS | | 0.9 | Nov |
| Euro HY OAS | | 3.6 | Nov |
| EM Sov $ OAS | | 3.2 | Nov |
| EM Corp $ OAS | | 3.5 | Nov |

*Source: Bloomberg Barclays Indices. Yield in %.*

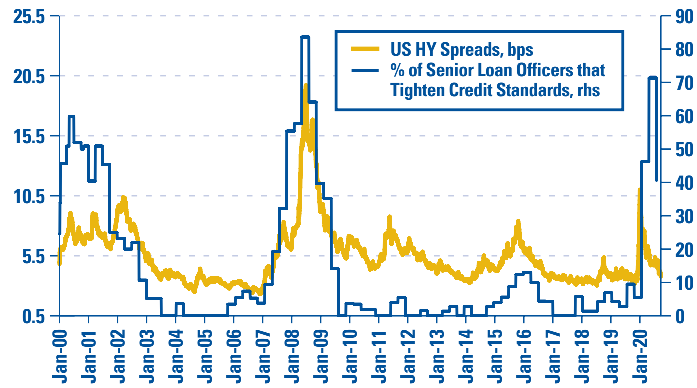
We are *underweight* credit as corporate bond yields barely cover expected inflation while we see higher risks in holding HY bonds. We have become more defensive (preferring IG to HY) following strong performance of HY since March.

**DM HY (↓UW)**: Bond defaults spike in recessions. This can occur for different reasons, e.g. the 1990 oil price shock due to Iraq's invasion of Kuwait, the 2000 dot-com bubble, the 2001 terrorist attacks or the 2008 Global Financial Crisis (GFC). But the US HY bond default rate peaked at a similar level (10-14%) in those episodes and credit analysts expect something similar for the current downturn: both Moody's and S&P estimate that the bond default rate will continue to rise and peak around mid-2021 at 9-11%.

Banks provide an alternative source of financing if companies fail to tap capital markets. However, lending conditions are unfavourable. According to the Senior Loan Officer Opinion Survey compiled by the Fed (Chart 5), 71% of loan officers tightened their lending standards in Q2, comparable to 84% and 60% in the peak of the GFC and the 2001 recession, respectively. The measure dropped in Q3, but may rise again as the pandemic leads to increasing hospitalisations and mobility restrictions this winter.

The HY market, in contrast, expects a much lower default rate. Both bond and CDS spreads have swiftly recovered to the pre-COVID-19 level, something that took four years to achieve in early 2000 and six years in the aftermath of the GFC. The Markit CDX North America High Yield Index tracks CDS contracts on 100 HY entities and currently trades at 300bps, approximately 250bps wider than the equivalent IG measure. It corresponds to 3.3-4.2% annual default rate assuming a recovery value between 25-40%. That is much lower than what credit analysts and bank managers are expecting for the next two years.

## Chart 5: Bond Spreads and Credit Standards




*Source: Bloomberg. As of December 4, 2020.*

Meanwhile, capital market activity is booming. HY issuance so far this year is larger than in 2019 and has even surpassed the previous annual record ($345bn in 2012). Nowhere seen this time is the slump in annual issuance typical in every downturn, suggesting investor euphoria. Therefore, we downgrade HY further, now the least favoured asset in credit.

**DM IG (↑UW)**: We reverse our relative recommendation, preferring IG to HY, and trimming the *underweight* in US IG. While US Treasury Secretary Mnuchin abruptly ended some of the Fed's emergency lending programs, IG spreads did not budge as the market envisages closer fiscal-monetary coordination under the leadership of Secretary-elect Yellen and Fed Chair Powell. For instance, central bank purchases with Treasury guarantees may increase again in the next liquidity crunch. The Fed's increasing dominance in US IG caps the upside risks in spreads.

**EM USD (NW)**: We prefer EM to DM for the former's wider spreads and a brighter outlook for oil prices in the wake of positive news on COVID-19 vaccines. But two issues prevent us from overweighting EM in the cross-asset context. First, EMs significantly lag behind DM in vaccine pre-orders, which means significant fiscal support will still be needed in 2021. However, after hefty spending this year, the fiscal room in many EMs is increasingly limited without triggering a sovereign rating downgrade. Second, signs of investor exuberance have recently emerged. Despite elevated political uncertainty, mass protests and two presidents being ousted in one week, Peru successfully sold its first 100-year USD bond with a four-time oversubscription in November. The previous issuance of EM USD century bonds (Mexico in October 2010 and Argentina in June 2017) signalled peak investor euphoria and heralded marked spread widening (150-200bps) 6-9 months later.

# Real Estate

*Overweight*

*COVID-19 and vaccine development remain critical drivers of occupier demand in 2021. Real estate provides high dividend yields relative to the broader equity market.*

| | 3Y history | Latest | |
|---|---|---|---|
| Net TR index* |  | 5.9% | Nov |
| EPS, % yoy |  | -48.3 | Nov |
| Dividend yield, % |  | 4.1 | Nov |

*Source: Bloomberg. 3M return is shown in "Latest". *FTSE EPRA/NAREIT Global Index.*

Overbuilding and monetary policy tightening, the two ingredients for the previous real estate downturns, are lacking in today's crisis. The public health crisis has been the main driver instead. The real estate building cycle was cut short, with a modest property supply going into this year's recession.

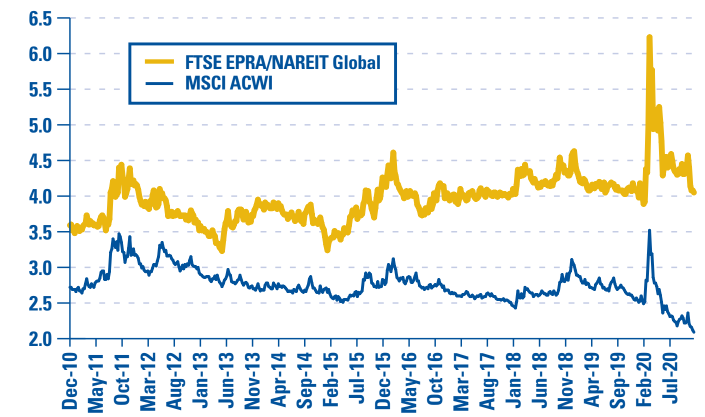
Property sectors experienced mixed fortunes under COVID-19. In the office sector, the modest supply in most countries sets a good foundation for rental recovery when the disease is controlled and demand revives. Asia, for instance, has seen most workers go back to offices. In contrast, home working has become substantially more prevalent in Europe and North America. It remains to be seen how permanent the shift will be and to what extent it will affect occupier demand for office space in the longer term.

Non-essential physical retailers are worst hit by the pandemic and the resulting mobility restrictions. While DM governments provide generous income support to households, customers spend their savings on goods (via online orders) and rent rather than in-person services such as restaurants, hotels and cinemas. Still, retail in Asia is likely to fare better. And retail and entertainment venues remain an essential location for social gatherings in EM.

Industrial real estate enjoys a healthy outlook. Good internet and transport infrastructure in DM has facilitated a boom in online retail sales. The vacancy rate for logistics spaces remains tight in virtually all metropolitan cities. Global manufacturing activity has recovered faster and stronger than services as the former is less affected by physical distancing and mobility restrictions. Unlike the previous downturn in the GFC, shipping and freight costs have held up well this year, suggesting resilient demand for goods transport.

The residential sector has been surprisingly resilient during the pandemic, primarily due to the generous fiscal support. Notwithstanding the rising unemployment rate, most tenants continue to pay rents thanks to government furlough schemes. Housing prices continue to grow around the world as mortgage rates have declined to historical lows in many countries. Tax policies (e.g. the stamp duty holiday in the UK) and the loosening of mortgage policies (e.g. Malaysia and Thailand) have provided further stimulus.

## Chart 6: Dividend Yield, %




*Source: Bloomberg. As of December 4, 2020. Forward 12m dividend yield is shown.*

Global listed real estate offers decent income flow versus bonds and broader equity markets. The estimated dividend yield of global equities (as measured by the MSCI ACWI Index) declined to a historic low of 2.2%, a large drop from the c.a. 3% less than two years ago (Chart 6). In contrast, the estimated dividend yield of the FTSE EPRA/NAREIT Global Index is currently at 4.2%, similar to the pre-COVID-19 level.

In addition, high dividend yield does not necessarily mean poor dividend growth. During the 10-year recovery and expansion period (2010-2019), listed real estate delivered dividend growth of 5.6% per annum, not dissimilar to global equities (6.4%). To be sure, real estate has been hit harder this year than global equities in terms of the size of fall in prices and dividends. But the outlook for occupier demand is set to improve in 2021 on the back of smarter lockdowns, wider testing and progress on vaccine development and distribution. Therefore, we are *overweight* real estate.

# Commodities

*Overweight*

*Cyclical commodities are set to benefit from a recovering global economy.*

| | 3Y history | Latest | |
|---|---|---|---|
| Commodities* | | 4.1% | Nov |
| Brent Oil | | 5.1% | Nov |
| Copper | | 13.7% | Nov |
| Aluminum | | 13.6% | Nov |
| Gold | | -9.7% | Nov |
| Corn | | 20.4% | Nov |
| Soybeans | | 22.8% | Nov |

*Source: Bloomberg. 3M return is shown in "Latest". *S&P GSCI Total Return Index.*

A number of favourable developments, including positive news on vaccines and Biden's victory in the US presidential election, have benefitted cyclical commodities the most. Gold prices have fallen as the heightened uncertainty present during most of 2020 has begun to diminish. The outlook points to a continuation of these trends, and we remain overweight commodities. However, we raise our exposure to areas that stand to benefit from the economic upturn and reduce exposure to precious metals amid rich pricing and reduced global uncertainty.

**Energy (↑OW)**: The price of Brent crude managed to move above the $42-46/barrel range it had been stuck in for most of June to September. Despite a resurgence of COVID-19 in DM and resulting lockdowns, the positive news on vaccines and a potential solid upturn in 2021 pushed the price up to $49 for the first time since March. However, demand is set to remain weak and the EIA does not expect it to recover to pre-pandemic levels before 2022. This is likely to be a powerful headwind for prices.

Supply restrictions by OPEC+ helped limit excess supply during the pandemic. The group met in December and agreed to increase its output by 0.5mn barrels/day (b/d) from January, reducing the agreed cuts to 7.2mn b/d. This was a compromise amid disquiet within the group at a time of weakened government revenues. The Gulf states appear to favour output cuts while countries like Russia and Nigeria opposed them. However, in the past few years the cuts appear to have had limited price impact. A study by the ECB suggests that the average oil price would only have been 6% lower during 2016-20 if OPEC+ had not restricted output. The limited impact was partly due to some producers exceeding their quota as well as increased production outside OPEC+, particularly US shale.

However, the recovery in US shale production this year has been lacklustre as many projects remain economically unviable. Shale output is expected to fall by 3.1% in 2020 and a further 2-3% in 2021, if prices stay around current levels, according to energy research firm Rystad. Moreover, potential regulations from the incoming Biden administration make capital expenditure less likely in the next few months. Thus, global supply is likely to remain restricted. Meanwhile, positioning has risen but remains towards the lower end of the five-year range. Given a likely demand recovery and capped supply in 2021, we raise our weight to *overweight*.

**Industrial metals (NW)**: Tailwinds including ongoing Chinese infrastructure-related fiscal stimulus supported industrial metals prices in the September to November period. Copper was a key beneficiary and rose to its highest level since 2013, reflected in positioning rising to a three-year seasonal high. Positioning across the complex is more modest and just above the five-year average.

Meanwhile, China blocked copper imports from Australia, though this only accounts for 5% of China's copper imports. A reorientation towards Latin American producers is likely in 2021. Copper and aluminium production are set to increase next year as more production comes online. Although the demand picture has improved from three months ago, we stay neutral given rising supply, the risk of a tapering in Chinese fiscal stimulus and above-average positioning.

**Precious metals (↓UW)**: Gold was the only commodities subsector to post a loss in the September to November period, speaking to the risk-on environment. Meanwhile, positioning remains stretched, at the top of the five-year seasonal range. The current market narrative of reflation is likely to act as a strong headwind to gold prices. Hence, while it is likely to hold its value in the event of tail risks, positioning and the early stage of the cycle suggest that precious metals are vulnerable to losses. We downgrade to *underweight*.

**Agricultural commodities (OW)**: COVID-19 has increased the global focus on food security, particularly in China. This trend may be a structural shift towards higher demand that was not present pre-pandemic. The rise in demand has fed through to prices, with agricultural commodities the best performing sub-sector in the September to November period.

Meanwhile, La Niña poses significant production risks across the complex. The impact ranges from delayed rains, affecting soybean and corn production in Latin America, to drier-than-normal conditions for wheat production in the US and Russia. Overall, despite positioning at a five-year high, we believe the demand and supply outlook is favourable for prices and stay *overweight*.

# KEY ASSET ALLOCATION INDICATORS *(All data shown are as at end-November 2020 unless otherwise stated)*

| | ASSET ALLOCATION | | | | | | | PERFORMANCE | | | | | | BENCHMARK INDEX & WEIGHTS | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | -3 | -2 | -1 | 0 | +1 | +2 | +3 | 5Y | 3Y | 1Y | 2019 | Ytd | Sep-Nov | | |
| **EQUITIES** | | | | | ■ | | | **67.3** | **29.5** | **15.0** | **26.6** | **11.1** | **6.1** | **MSCI ACWI** | **50%** |
| US | | | | ■ | | | | 90.4 | 45.7 | 19.3 | 30.9 | 16.0 | 4.5 | MSCI USA | 25% |
| Eurozone | | | | | | ■ | | 33.2 | 5.9 | 6.5 | 23.0 | 3.3 | 8.6 | MSCI EMU | 7% |
| UK | | ■ | | | | | | 3.6 | -7.4 | -10.7 | 21.0 | -15.1 | 5.4 | MSCI UK | 3% |
| Japan | | | | | ■ | | | 45.9 | 15.4 | 12.2 | 19.6 | 9.9 | 11.8 | MSCI Japan | 5% |
| EM | | | | | | ■ | | 66.4 | 15.5 | 18.4 | 18.4 | 10.2 | 9.7 | MSCI EM | 10% |
| **RATES** | | | ■ | | | | | **25.0** | **13.6** | **8.4** | **5.6** | **7.9** | **1.5** | **Bloomberg Barclays Global Treasury Total Return Index Value Unhedged** | **27%** |
| USTs | | | ■ | | | | | 20.4 | 17.0 | 7.6 | 6.9 | 8.3 | -0.5 | Bloomberg Barclays US Treasury Total Return Unhedged USD | 10% |
| US TIPS | | | | ■ | | | | 25.7 | 18.6 | 10.1 | 8.4 | 9.7 | 0.1 | Bloomberg Barclays US Treasury Inflation-Linked Bond Index | 3% |
| Bunds | ■ | | | | | | | 10.3 | 8.1 | 1.6 | 3.0 | 3.0 | 1.4 | Bloomberg Barclays Euro Aggregate Treasury Germany TR Index Unhedged USD | 3% |
| JGBs | | ■ | | | | | | 6.0 | 1.9 | -1.2 | 1.7 | -0.9 | 0.3 | Bloomberg Barclays Asian-Pacific Japan Treasury TR Index Unhedged USD | 5% |
| EM Local | | | | | | ■ | | 32.0 | 10.6 | 4.4 | 13.2 | 1.1 | 3.9 | Bloomberg Barclays EM Local Currency Liquid Govt TR Index Unhedged USD | 6% |
| **CREDIT** | | | ■ | | | | | **32.9** | **18.2** | **10.0** | **11.5** | **9.0** | **2.2** | **Bloomberg Barclays Global Aggregate Credit Total Return Index Value Unhedged USD** | **13%** |
| US IG | | | ■ | | | | | 36.9 | 23.3 | 9.8 | 14.5 | 9.4 | 2.3 | Bloomberg Barclays US Corporate Statistics Index | 4% |
| US HY | | ■ | | | | | | 44.5 | 18.0 | 7.2 | 14.3 | 5.1 | 3.4 | Bloomberg Barclays US Corporate High Yield Statistics Index | 3% |
| European IG | | | ■ | | | | | 14.5 | 7.3 | 2.5 | 6.2 | 2.6 | 2.1 | Bloomberg Barclays EuroAgg Corporate Statistics Index | 2% |
| European HY | | ■ | | | | | | 24.3 | 8.7 | 2.6 | 11.3 | 1.5 | 3.7 | Bloomberg Barclays Pan-European High Yield (Euro) Index Statistics | 1% |
| EM Sov $ | | | | ■ | | | | 32.6 | 12.9 | 5.8 | 13.3 | 3.4 | 1.3 | Bloomberg Barclays Emerging Markets Sovereign TR Index Value Unhedged USD | 2% |
| EM Corp $ | | | | ■ | | | | 38.9 | 18.7 | 7.6 | 13.1 | 6.5 | 2.2 | Bloomberg Barclays Emerging Markets Corporates TR Index Value Unhedged USD | 1% |
| **REAL ESTATE** | | | | | ■ | | | **19.6** | **1.9** | **-11.3** | **22.5** | **-12.6** | **5.9** | **FTSE EPRA/NAREIT Global Index Net TRI TR USD** | **5%** |
| **COMMODITIES** | | | | | ■ | | | **-21.5** | **-23.8** | **-23.0** | **17.6** | **-28.0** | **4.1** | **S&P GSCI Total Return Index** | **5%** |
| Energy | | | | | ■ | | | -42.3 | -42.5 | -44.7 | 29.7 | -49.5 | 1.1 | S&P GSCI Energy Total Return Index | 2% |
| Industrial metals | | | | ■ | | | | 51.8 | 4.6 | 18.5 | 2.6 | 15.1 | 11.6 | S&P GSCI Industrial Metals Total Return Index | 1% |
| Precious metals | | | ■ | | | | | 56.6 | 33.4 | 18.6 | 17.6 | 14.4 | -11.5 | S&P GSCI Precious Metals Index Total Return Index | 1% |
| Agricultural | | | | | ■ | | | -20.4 | -5.3 | 8.8 | -0.3 | 4.1 | 12.4 | S&P GSCI Agriculture Index Total Return Index | 1% |

**Regional allocation relative to other asset classes*
*Source: Bloomberg, CLIM*

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