Solutions

Diversification expected to gain in importance for 2020 and beyond

Duy Nguyen
CIO,
Invesco Investment Solutions

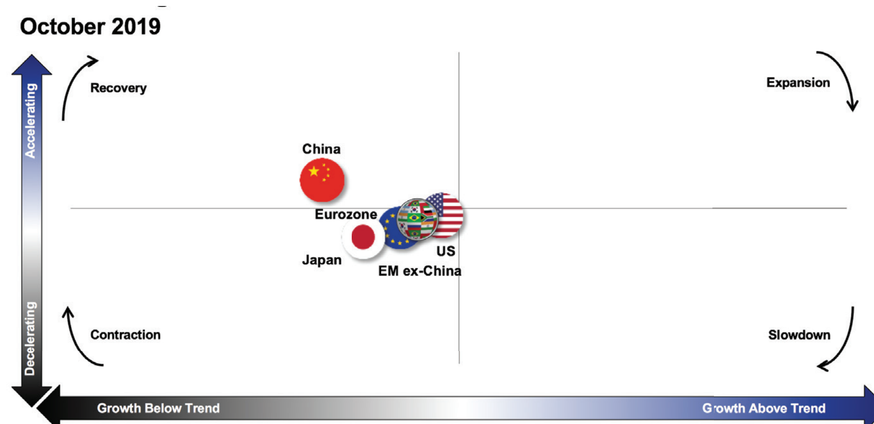
Alessio de Longis
Senior Portfolio Manager,
Invesco Investment Solutions

Key Takeaways

- We think a global recession is unlikely in 2020, but we may experience a recession in some parts of the world.
- We expect the next decade to be vastly different from the past one. Those who rely on a traditional 60/40 asset allocation could face a very different return experience going forward.
- We believe diversification can help portfolios weather pockets of uncertainty and can allow investors to find opportunities beyond traditional assets.

The global economy is rapidly decelerating, and we expect all major regions and countries around the world to grow below trend at least through the first half of 2020. For the past six months, our team's macro regime framework has indicated that the global business cycle is entering a "contraction" (defined as growth below trend and decelerating), as our proprietary leading economic indicators (LEIs) have fallen sharply across most regions (Exhibit 1).

Exhibit 1: The global economy is growing below trend and still decelerating.



Source: Invesco Investment Solutions proprietary research 10/01/2019.

Will we see a global recession in 2020? We think it's unlikely, but we may experience a recession in some parts of the world.

- In our opinion, Europe exhibits the weakest cyclical dynamics, and currently runs the highest recession risks among major economies. Given its high exposures to global trade risk, Brexit uncertainty, and already negative interest rates, Europe has limited room to offset economic shocks.
- On the opposite side, the U.S. has been the most resilient among major economies, but we are starting to see evidence that the global slowdown is affecting the new continent as well, similarly to what we experienced between 2015-2016, when the rest of the world led the slowdown and the U.S. followed. Given its lower exposure to trade risk, and higher exposure to domestic demand, at this stage the risk of a U.S. recession in 2020 looks premature.
- As for emerging markets, after the steady deceleration of the past two years, we are seeing tentative signs of stabilization in China, led by improving orders in the industrial sectors. Clearly, the evolution of these cyclical indicators is strongly affected by ongoing trade policy developments, but Chinese policy makers have been successfully managing this economic transition, by and large. Based on our indicators, it is too soon to tell whether we are at an inflection point, as the rest of emerging markets ex-China are still decelerating, both in Asia, Latin America and EMEA.

Alternative income assets look particularly attractive at this late stage in the economic cycle, in our view.

A distinguishing feature of this business cycle is the lack of inflationary pressures. This has allowed central banks to proactively ease policy with a combination of interest rate cuts and renewed asset purchases (i.e., quantitative easing). The large decline in global bond yields has provided meaningful support to equity markets, despite strong deceleration in earnings growth. Our analysis of global market sentiment suggests monetary policy has contributed to the stabilization in global risk appetite which, according to our research, tends to lead inflection points in the global business cycle by a few months, providing today some indication that global growth may stabilize in the next few quarters.

Investment implications for 2020

In the near term, we expect a similar convergence in performance among asset classes, with higher quality assets such as government bonds and investment grade credit expected to deliver comparable returns and possibly higher risk-adjusted returns than risky assets, despite low yields.

We think credit markets offer limited capital appreciation potential, but expect a stable environment for carry strategies, given generous lending standards and a supportive policy environment.

Alternative income assets look particularly attractive at this late stage in the economic cycle, in our view, due to higher yields than traditional assets and low correlations to credit and equity markets.

While we believe developed equities outside the U.S. offer more attractive valuations and higher long-term expected returns compared to U.S. equities, cyclical catalysts for this relative outperformance are still missing given the weak macro backdrop in Europe. Hence, we still expect U.S. equities to outperform other developed markets over the next few quarters, at least until the deterioration in European economic data comes to a halt.

On the other hand, we believe that early signs of a cyclical turnaround in emerging economies offer the potential for outperformance of emerging equities relative to developed equities in the medium term, a development that would also be consistent with the more favourable long-term return expectations for the asset class.

The recent improvement in global market sentiment is supportive of pro-cyclical factors such as size and value, which are also supported by cheap valuations.

We hold a neutral view on the U.S. dollar in the near term, despite its expensive valuations across macro frameworks. In our view, a sustained dollar depreciation cycle requires a cyclical rebound in growth outside the U.S., as a catalyst for a major reversal of private capital flows from the U.S. to the rest of the world. Within currency markets, we expect value and carry to perform well, particularly in emerging markets, given a stable environment for risk appetite.

Long-term strategic asset allocation implications

In addition to this near-term view, Invesco Investment Solutions develops Capital Market Assumptions (CMAs)[1] that provide long-term estimates for the behaviour of major asset classes globally. The assumptions, which are based on a 10-year investment time horizon, are intended to guide these strategic asset class allocations. Looking out at the long term, the obvious perspective is that we think the next 10 years will be very different from the last 10 years.

Over the last 10 years:

+ U.S. equities were the favoured trade, a complete reversal from the prior decade, along with equity-correlated credit strategies.
+ Subdued volatility favoured risky assets across both equities and fixed income as few drawdowns or market sell-offs occurred.
+ Alternatives lagged as their low correlations and illiquidity premiums were not rewarded in this environment.
+ Passive strategies had dominant returns, and thus benchmarks were extremely difficult to outperform. Essentially, investors were penalized for diversification.

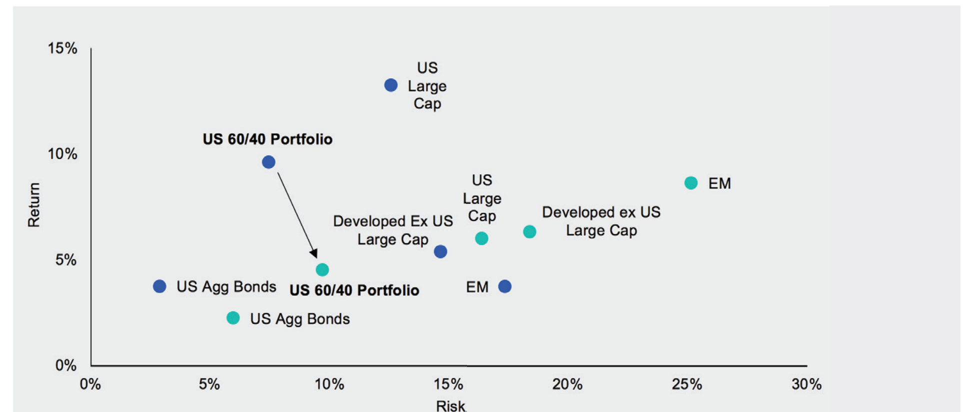
We believe the next decade will be vastly different. After experiencing a downward trend following the Global Financial Crisis and bottoming in early 2018, volatility has begun to trend upwards to what we would consider normalized levels. If volatility continues its current trajectory, we believe investors' return-oriented goals will face challenges, stressing the importance of diversification.

Therefore, those who rely on a traditional 60/40 asset allocation could face a very different return experience going forward. As shown in Exhibit 2, we expect a portfolio consisting of 60% S&P 500 Index and 40% Bloomberg Barclays U.S. Aggregate Bond Index to have about half the return and higher risk over the next 10 years than it would have experienced over the past 10 years. A similar but less dramatic experience is expected for global equities and fixed income.

If volatility continues its current trajectory, we believe investors' return-oriented goals will face challenges, stressing the importance of diversification.

Exhibit 2: We expect a U.S. 60/40 portfolio to deliver less return and more risk over the next 10 years

■ Historical ■ Expected



Sources: Invesco Investment Solutions proprietary research 10/01/2019.
Past performance is not a guarantee of future results. There can be no assurance that any estimated returns or projections can be realized, that forward-looking statements will materialize or that actual returns or results will not be materially lower than those presented. Source: Invesco as of 10/01/2019. Data is unhedged USD. An investment cannot be made into an index. Historical returns for the 10 years ended 9/30/2019. Index proxies listed in "Important Information" section below.

What's the answer? We believe diversification can help portfolios weather pockets of uncertainty and can allow investors to find opportunities beyond traditional assets.

+ Given more attractive valuations and higher levels of income, we believe equities outside the U.S. are signaling higher return potential over the next decade, albeit with slightly higher levels of volatility.
+ We believe alternatives offer the potential to diversify away from low-expected return targets, pick up incremental yield above fixed income, and potentially navigate the challenges of increased volatility ahead.
+ From a risk-adjusted perspective, we believe U.S. large cap is more attractive than their smaller counterparts, but from absolute perspective we favour small caps.
+ Equities in the U.K. and Asia Pacific have attractive properties but are expected to have above average volatility, in our view.
+ From a fixed income perspective, we prefer shorter duration and credit risk. We acknowledge the potential benefits of duration, but because of how flat, negative or inverted the yield curves are around the world, the long-term horizon for its prospects are less attractive, in our view.

1 About the CMAs:
For each selected asset class, we develop assumptions for estimated return, estimated standard deviation of return (volatility), and estimated correlation with other asset classes. For additional details regarding the methodology used to develop these estimates, please see our white paper 2020 Long-Term Capital Market Assumptions.

This information is not intended as a recommendation to invest in a specific asset class or strategy, or as a promise of future performance. These asset class assumptions are passive, and do not consider the impact of active management. Assumptions and estimates are provided for illustrative purposes only. They should not be relied upon as recommendations to buy or sell securities. Forecasts of financial market trends that are based on current market conditions constitute our judgment and are subject to change without notice. Estimated returns can be conditional on economic scenarios. In the event a particular scenario comes to pass, actual returns could be significantly higher or lower than these estimates.

Indices are unmanaged and used for illustrative purposes only. They are not intended to be indicative of the performance of any strategy. It is not possible to invest directly in an index.

The CMAs included are based on Invesco's return expectations for the asset classes shown. The indices referenced are included as proxies for the asset classes and have been selected because they are well known and are easily recognisable by investors. The inclusion of these indices is not linked to the promotion of any investment products or services.

Important information
Diversification does not guarantee a profit or eliminate the risk of loss.

U.S. Large Caps represented by the S&P 500 Index, which is an unmanaged index considered representative of the U.S. stock market.

U.S. Aggregate represented by the Bloomberg Barclays U.S. Aggregate Index, which is an unmanaged index considered representative of the U.S. investment-grade, fixed-rate bond market.

Emerging Market represented by the MSCI Emerging Markets Index, which captures large- and mid-cap representation across 26 emerging markets countries.

Developed ex-U.S. Large Cap represented by the MSCI EAFE Index, which is an unmanaged index designed to represent the performance of large- and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

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