Sub-Manager's Commentary

Market Overview

Equity prices around the world continued to recover in June, led by emerging markets. An uptick in manufacturing activity and consumer demand boosted the global economic outlook, but some markets suffered from the persistent threat of COVID-19. Emerging market (EM) Asia led gains, helped by the resilience of the Chinese economy, while a strong performance from European equities boosted developed markets.

US equities made measured gains in June, but they lagged other developed markets as COVID-19 suppressed economic activity in several US states. Weak consumer sentiment further undermined the US economy, which shrank by an annualised rate of 5% in the first quarter of 2020 compared to an expansion of 2.1% in the fourth quarter of 2019, according to the Bureau of Economic Analysis. In response, the US Federal Reserve kept interest rates at zero in June and underlined its commitment to support the flow of credit to households and businesses. Benchmark 10-year US Treasury yields finished the month unchanged, while corporate bonds gained, led by investment-grade issues.

Equity markets in France, Germany and Italy all experienced robust growth in June as their economies began to stabilise. The IHS Markit Manufacturing Purchasing Managers' Index (PMI) for the eurozone rose steeply, as did PMIs for all three countries, indicating improved manufacturing output. The European Central Bank kept interest rates unchanged at its June meeting and announced a significant expansion of the Pandemic Emergency Programme (PEPP), while the European Commission pressed ahead with the dispersal of a €750 billion recovery package across member states. Benchmark 10-year German Bund yields rose sharply in early June, reflecting the improved economic outlook, but fell back to finish the month largely unchanged. Yield spreads between Italian and German sovereign debt narrowed, and European corporate bonds gained in June, led by high-yield issues.

EM equities led global gains in June, driven by Asia, as economic activity across the region improved. Chinese stocks added value, demonstrating the country's resilience to export weakness. The Caixin China General Manufacturing PMI rose sharply in June and improved domestic demand helped increase production for the fourth month running. Latin American stocks also rose, led by Brazil, as the market continued its recovery from steep losses in the first quarter. Russia struggled to contain its COVID-19 epidemic, which affected the performance of EM Europe in June.

Oil prices continued to rise from lows reached in late-April, helped by improved demand, supply cuts and a fall in US shale production, while gold rose on safe-haven demand.

Outlook

Momentum in the global economy is improving, but it is too early to call an end to the deep recession caused by the COVID-19 crisis, in our view. Although we maintain a modestly higher conviction toward global equities than bonds, we remain cautious, given increasingly stretched valuations. We have a growing reluctance to overlook short-term economic problems and are therefore engaged in fewer opportunistic stock purchases.

We retain a constructive view of US equities, but have lowered the level of our conviction, given the extent of recent gains and ongoing headwinds to local and global growth. The US equity market has been buoyed by the success of technology stocks, but it has begun to lose momentum and Treasury yields remain very low, suggesting investors are conscious of the challenges that lie ahead. In contrast, we have moderated our cautious stance on Canadian equities as commodities headwinds abate, while we are also less bearish on Japanese stocks, since valuations have become more attractive relative to other markets.

We are cautiously optimistic that Europe's Next Generation Fund might be a game-changing moment. The relative strength of European equity markets in June is evidence of an easing of investor concerns, and we have moved to increase our conviction in European government bonds, driven by higher-yielding markets such as Italy that stand to benefit from this recovery fund. We have also reassessed our stance on Japanese government bonds, becoming more optimistic as the Bank of Japan targets low yields as part of its unconventional strategy for economic stimulus.

Sukuk markets stand at an intersection, influenced by both The Fed and the Organisation for Petroleum Exporting Countries. Elevated differentials between Sukuk and the US investment-grade market offer opportunities at present, due to Fed stimulus, while the Gulf Cooperation Council region is set to benefit from an improvement in oil prices as the global economy recovers. Sukuk markets are also leaning towards austerity and fiscal consolidation rather than spending during the current environment, which should provide reassurance for Sukuk investors. Demand for new Sukuk issues continues to be strong and we prefer sovereign issues to corporate at present as we reassess some of the longer-term implications of this downturn.