Applied philosophy
Emerging markets, commodities and the USD

Emerging market assets have had a mixed performance so far in 2020. Equities and corporate investment grade outperformed global benchmarks, while sovereign debt and real estate underperformed. We think a rally in commodity prices and a weakening US dollar have helped. The positive impact of the former may not persist, but we do not expect headwinds from a strengthening US dollar in the next 12 months. Valuations remain attractive compared to other regions, except for equities. We view EM as a play on the recovery and we admit that the risk of another downturn is not insignificant in the near term, but we remain constructive on EM assets.

Emerging markets (EM) as a region has had a mixed year so far. Its corporates have done well as reflected by its equity and investment grade credit performance: they have outperformed global indices by 2.7% and 2% respectively (as of 13th November). However, it has performed in line with its global benchmark in the sovereign debt space and has been the worst performer in real estate underperforming its benchmark by 4% (as of 13th November).

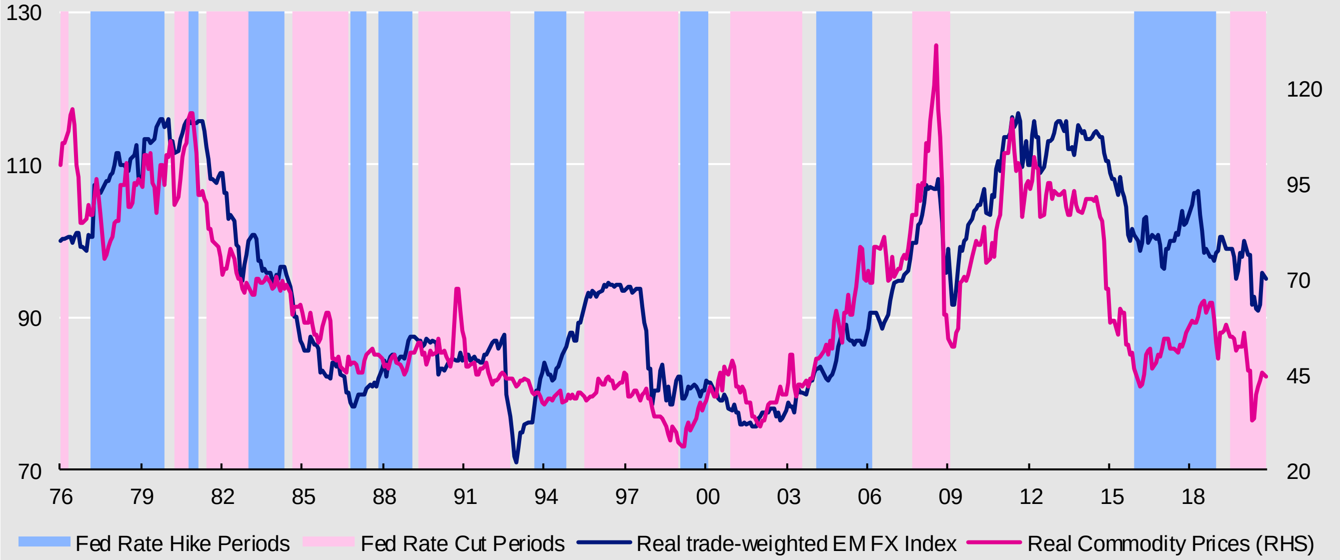
The COVID-19 pandemic has not impacted the region uniformly. Certain countries, such as China or Vietnam controlled the virus quickly and effectively, while Brazil and India, for example, have had a tougher time.

Broadly, East and Southeast Asia has suppressed the virus efficiently and has maintained low levels of infections so far, while Latin America has been less successful. Eastern European countries did well in the spring, but their infection rates have spiked rapidly in the autumn. Finally, although testing remains sporadic in Africa, we suspect their healthcare systems are better set up to handle infectious diseases than those of developed economies, for example.

So far, the economic impact has also varied based on how governments have attempted to suppress the spread of the virus. Among the largest four emerging economies, the decline in real GDP over the worst phase in the first half of 2020 varied between -23.9% year-on-year in India in Q2 and -6.8% in China in Q1. We expect the severity of the economic impact to remain connected to infection rates – even if restrictions are less stringent – and considering the overwhelming size of China within the region and its good handling of the pandemic, we expect EM to outperform developed economies in the near term.

Since the Q1 trough, a quick recovery in China has boosted the prices of industrial commodities, which have done well since the March 2020 trough. In our view, commodity prices are an important factor in driving the performance of emerging market assets, for example their currencies (see **Figure 1**). Apart from the

Figure 1 – Emerging market currencies, commodities and the Fed



Note: monthly data from January 1976 to August 2020. Real trade-weighted EM FX index is a trade weighted average of national currencies versus US dollar (trade weights are based on total trade flows for each country). There are 18 currencies in the EM basket – those of China, Brazil, South Korea, Mexico, Singapore, India, Russia, Poland, Thailand, Turkey, Czech Republic, Malaysia, Indonesia, Hungary, Philippines, South Africa, Chile and Nigeria (ordered by size of trade flows). Real adjustments use national CPI indices versus that of the US. Real commodity price index is based on the S&P GSCI Commodity Spot Price Index, adjusted by the US CPI index. All indices rebased to 100 as of January 1976. Data as of October 2020. Past performance is no guarantee of future returns.
Source: IMF, OECD, Oxford Economics, S&P GSCI, Bloomberg L.P., Refinitiv Datastream and Invesco

boost in demand from China and a recovering developed world, the recent weakness of the US dollar has been a tailwind for both commodities and EM currencies (even on a trade-weighted basis). The prospect of a Biden presidency has not changed that, even if a potential fiscal boost may not be as high as previously expected.

Figure 2 gives us an idea of how important the movement in the US dollar may be for EM assets. On average, EM assets have been negatively correlated to the trade-weighted US dollar index since July 2003. That correlation has not been strong, but it has persisted and deepened after the Global Financial Crisis (GFC). This correlation may be similar to certain developed market assets, but that does not take away its importance.

On the surface, this should be good news for EM assets, especially if the US dollar continues to weaken as it has so far in 2020. We certainly consider it overvalued, so would not be surprised if this trend continued. As we previously mentioned, a Biden presidency could mean more fiscal expansion than a second-term Trump presidency would have meant based on what we know about how much the two parties in the US seem to believe is necessary to compensate for the impact of lockdowns. However, we do not expect the road to another round of fiscal stimulus to be smooth.

What may dampen the potential impact of a lower-than-expected stimulus package are two things, in our view: 1) the Federal Reserve does not show any signs of suddenly reversing its easy monetary policy stance, and we think they may even ease further if necessary, especially if vaccine development and distribution encounters unexpected hurdles and economic activity has to stay limited throughout the winter; 2) we expect the incoming Biden administration to reverse the confrontational and unpredictable trade policy of the Trump White House.

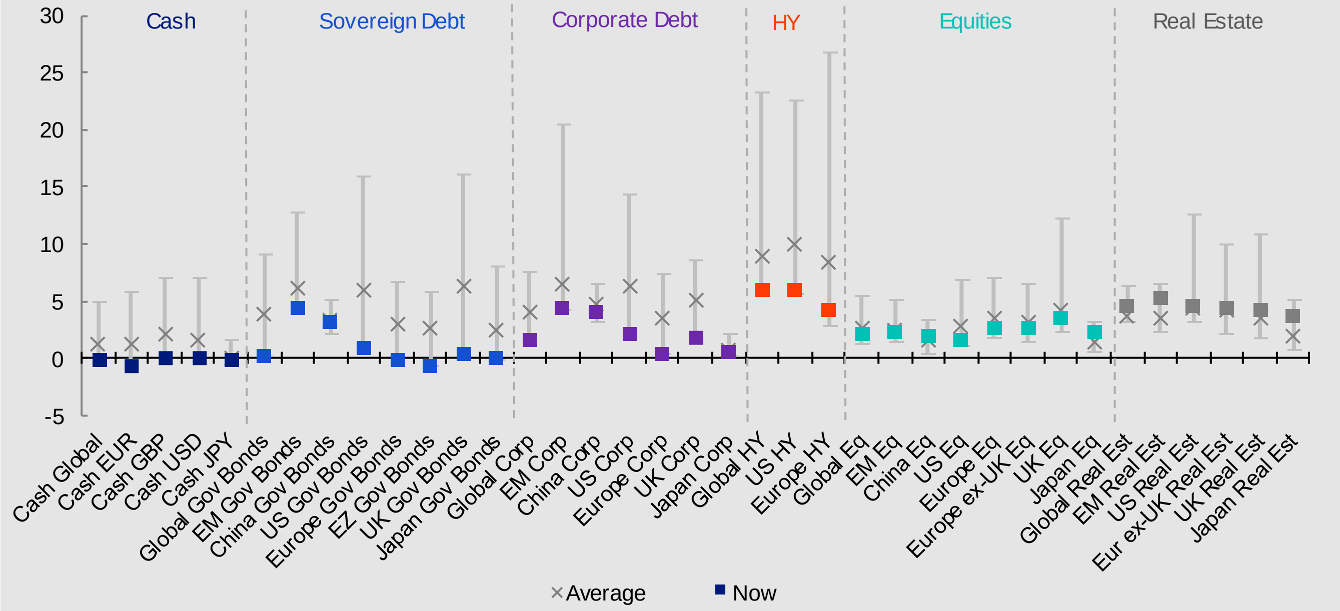
We wrote about EM equities in May and were wondering if the stars were aligning for them. They kept pace with US equities, which is a good achievement considering that they have been one of the best performers this year. At that time, we found EM equities attractively valued and thought it was time to be more constructive on the asset class. As of the end of October, they have moved to a slight premium compared to their historical average and they now look less attractive compared to other regional equity markets.

Based purely on valuations (see **Figure 3** on the next page), we would prefer real estate among EM risk assets. They offer the highest yields compared to other regions and compared to other EM assets, too. Both EM sovereign debt and investment-grade credit look attractive compared to other regions, but they are close to the lows within their respective historical ranges (this is not unusual right now).

Figure 2 – Emerging market assets average correlation versus the trade-weighted US dollar

Notes: We calculate the average 5-year rolling correlation of monthly total returns for Emerging Market assets versus the trade-weighted dollar index. We use the following benchmarks for EM indices: MSCI EM Local Currency Index, Bloomberg Barclays EM USD Sovereign Aggregate Index, Bloomberg Barclays EM USD Corporate Aggregate Index, FTSE EPRA/NAREIT Emerging Markets Local Currency Index, DXY US Dollar Index Spot. Data as of 31st October 2020 close. Source: Refinitiv Datastream and Invesco

Figure 3 – Regional yields within historical ranges



Notes: As of 31 August 2020. Past performance is no guarantee of future results. See appendices for definitions, methodology and disclaimers. Source: Bloomberg Barclays, BofAML, FTSE, JP Morgan, Refinitiv Datastream, Invesco

Overall, we remain constructive on EM assets. However, there is a risk that the nascent recovery will fade away or that the pandemic will continue to negatively impact EM economies either directly or indirectly through lower demand from developed economies that are struggling to contain COVID-19 in the winter. Nevertheless, we remain optimistic that the recovery will continue and that should support an environment that will be good for EM assets. Valuations look attractive for most assets compared to other regions and we think a potentially weaker US dollar and a more benign trade environment will also help.

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Figure 4 – Asset class total returns (%, annualised)

Data as at 13/11/2020	Index	Current Level/RY	Total Return (USD, %) 1w	1m	QTD	YTD	12m	Total Return (Local Currency, %) 1w	1m	QTD	YTD	12m
Equities												
World	MSCI	606	2.3	3.0	7.4	9.3	14.3	2.5	2.7	6.9	8.6	12.8
Emerging Markets	MSCI	1188	1.0	4.6	10.0	9.0	16.8	1.0	3.8	8.3	11.5	17.8
US	MSCI	3469	1.8	1.9	6.8	14.5	19.9	1.8	1.9	6.8	14.5	19.9
Europe	MSCI	1719	4.9	4.8	7.9	-1.2	3.2	5.4	4.1	6.7	-4.9	-3.0
Europe ex-UK	MSCI	2161	4.1	4.0	7.3	3.9	7.9	4.8	3.4	6.3	-1.5	0.2
UK	MSCI	974	7.7	7.9	10.1	-15.7	-10.4	7.6	6.5	8.2	-15.1	-12.6
Japan	MSCI	3568	1.8	4.9	6.6	6.2	7.6	3.1	4.0	5.7	2.3	3.6
Government Bonds												
World	BofA-ML	0.25	-0.8	0.1	0.2	7.0	7.7	-0.3	-0.4	-0.4	4.5	4.4
Emerging Markets	BBloom	4.13	1.5	2.0	3.9	4.1	7.9	1.5	2.0	3.9	4.1	7.9
US (10y)	Datastream	0.88	-0.5	-1.3	-1.8	12.7	12.5	-0.5	-1.3	-1.8	12.7	12.5
Europe	Bofa-ML	-0.18	-0.8	0.7	1.6	10.2	11.9	-0.3	0.0	0.8	4.6	4.2
Europe ex-UK (EMU, 10y)	Datastream	-0.55	-1.2	0.5	1.0	9.3	10.2	-0.7	-0.1	0.2	3.8	2.6
UK (10y)	Datastream	0.37	-0.5	0.5	0.8	4.5	7.3	-0.6	-0.9	-1.0	5.2	4.7
Japan (10y)	Datastream	0.02	-1.3	0.9	0.9	3.8	3.5	0.0	0.1	0.0	-0.1	-0.4
IG Corporate Bonds												
Global	BofA-ML	1.58	-0.1	0.7	1.4	7.3	9.0	0.1	0.5	1.0	6.1	7.0
Emerging Markets	BBloom	4.13	0.9	1.3	2.7	8.2	10.6	0.9	1.3	2.7	8.2	10.6
US	BofA-ML	2.03	0.0	0.4	1.0	7.7	9.1	0.0	0.4	1.0	7.7	9.1
Europe	BofA-ML	0.39	-0.3	1.4	2.2	7.5	9.6	0.2	0.7	1.4	2.1	2.1
UK	BofA-ML	1.75	0.2	1.6	2.4	4.6	8.5	0.1	0.2	0.6	5.3	5.8
Japan	BofA-ML	0.47	-1.3	1.0	1.0	3.9	4.1	0.0	0.1	0.1	0.0	0.2
HY Corporate Bonds												
Global	BofA-ML	5.44	0.6	1.6	3.2	3.7	6.3	0.7	1.5	3.0	2.8	4.9
US	BofA-ML	5.57	0.5	1.5	3.1	2.8	5.1	0.5	1.5	3.1	2.8	5.1
Europe	BofA-ML	3.65	0.6	2.3	3.8	5.6	9.5	1.1	1.7	2.9	0.3	2.0
Cash (Overnight LIBOR)												
US		0.08	0.0	0.0	0.0	0.4	0.6	0.0	0.0	0.0	0.4	0.6
Euro Area		-0.59	-0.3	0.7	0.9	5.0	6.9	0.0	-0.1	-0.1	-0.5	-0.6
UK		0.04	0.2	1.9	2.1	-0.4	2.9	0.0	0.0	0.0	0.2	0.3
Japan		-0.12	-1.2	0.8	0.7	3.7	3.9	0.0	0.0	0.0	-0.1	-0.1
Real Estate (REITs)												
Global	FTSE	1729	6.9	5.7	9.2	-12.1	-8.9	7.3	5.0	8.4	-16.5	-15.1
Emerging Markets	FTSE	2005	3.2	5.7	8.9	-15.6	-5.6	3.7	5.0	8.1	-19.9	-12.1
US	FTSE	2779	9.9	6.5	11.0	-11.2	-10.5	9.9	6.5	11.0	-11.2	-10.5
Europe ex-UK	FTSE	3450	4.6	3.9	6.3	-5.8	0.0	5.0	3.2	5.5	-10.6	-6.9
UK	FTSE	1288	8.9	10.5	14.3	-17.6	-7.2	8.7	9.0	12.3	-17.0	-9.5
Japan	FTSE	2472	0.6	0.8	1.8	-15.4	-13.7	1.9	-0.1	0.9	-18.5	-17.0
Commodities												
All	GSCI	1763	3.4	0.7	2.1	-32.0	-28.7	-	-	-	-	-
Energy	GSCI	228	7.1	-1.3	-0.2	-54.2	-51.4	-	-	-	-	-
Industrial Metals	GSCI	1313	1.1	4.5	6.8	7.7	9.0	-	-	-	-	-
Precious Metals	GSCI	2183	-3.4	-0.1	0.1	22.1	26.9	-	-	-	-	-
Agricultural Goods	GSCI	360	1.0	4.4	7.3	3.5	8.6	-	-	-	-	-
Currencies (vs USD)*												
EUR		1.18	-0.3	0.7	1.0	5.5	7.5	-	-	-	-	-
JPY		104.64	-1.2	0.8	0.8	3.8	4.0	-	-	-	-	-
GBP		1.32	0.1	1.3	1.8	-0.7	2.5	-	-	-	-	-
CHF		1.10	-1.3	0.3	0.9	6.1	8.5	-	-	-	-	-
CNY		6.61	0.1	2.1	2.8	5.4	6.3	-	-	-	-	-

Notes: *The currency section is organised so that in all cases the numbers show the movement in the mentioned currency versus USD (+ve indicates appreciation, -ve indicates depreciation). Past performance is no guarantee of future results. Please see appendix for definitions, methodology and disclaimers.
Source: Refinitiv Datastream and Invesco

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Figure 5 – Global equity sector total returns relative to market (%)

Data as at 13/11/2020	Global				
	1w	1m	QTD	YTD	12m
Energy	**3.9**	**0.9**	**-1.6**	**-33.3**	**-31.9**
Basic Materials	**-1.3**	**0.5**	**-0.2**	**1.3**	**3.3**
Basic Resources	-2.0	0.8	0.2	1.7	6.0
Chemicals	-0.3	0.1	-0.7	0.8	0.4
Industrials	**1.8**	**1.9**	**1.6**	**-0.8**	**-2.3**
Construction & Materials	1.9	3.7	3.5	-1.2	-1.5
Industrial Goods & Services	1.8	1.7	1.3	-0.7	-2.5
Consumer Discretionary	**-1.9**	**-2.0**	**-1.2**	**8.9**	**8.1**
Automobiles & Parts	1.0	3.1	2.6	17.5	16.0
Media	-0.1	-1.8	0.3	-3.4	-5.7
Retailers	-5.3	-7.5	-5.6	22.9	21.7
Travel & Leisure	3.9	4.2	3.1	-15.9	-15.7
Consumer Products & Services	-1.3	1.6	1.5	9.8	9.7
Consumer Staples	**1.3**	**-0.7**	**-2.3**	**-4.1**	**-5.4**
Food, Beverage & Tobacco	2.3	-0.5	-1.8	-7.5	-8.3
Personal Care, Drug & Grocery Stores	-0.6	-1.2	-3.1	2.4	0.0
Healthcare	**-1.4**	**-1.5**	**-2.7**	**6.5**	**6.3**
Financials	**4.3**	**5.4**	**5.1**	**-17.1**	**-16.8**
Banks	5.7	7.9	8.1	-23.5	-22.7
Financial Services	1.6	2.0	2.1	-8.8	-8.8
Insurance	5.3	5.0	3.2	-13.0	-13.6
Real Estate	**1.9**	**0.9**	**-0.3**	**-13.1**	**-13.6**
Technology	**-3.7**	**-2.9**	**-0.7**	**27.8**	**29.6**
Telecommunications	**1.2**	**0.4**	**-0.7**	**-3.0**	**-4.1**
Utilities	**0.6**	**1.7**	**2.6**	**-2.6**	**-2.0**

Notes: Returns shown are for Datastream sector indices versus the total market index. Past performance is no guarantee of future results.
Source: Refinitiv Datastream and Invesco

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Figure 6 – Model asset allocation

	Neutral	Policy Range		Allocation	Position vs Neutral	Hedged	Currency
Cash	**5%**	**0-10%**		**10%**			
Cash	2.5%			10%			
Gold	2.5%			0%			
Bonds	**45%**	**10-80%**	↓	**45%**			
Government	30%	10-50%	↓	15%			
US	10%		↓	4%			
Europe ex-UK (Eurozone)	8%		↑	2%			
UK	2%		↓	0%			
Japan	8%			5%			
Emerging Markets	2%			4%			
Corporate IG	10%	0-20%		20%			
US Dollar	5%		↓	5%			
Euro	2%		↑	3%			
Sterling	1%			4%			
Japanese Yen	1%		↑	4%			
Emerging Markets	1%		↑	4%			
Corporate HY	5%	0-10%	↑	10%			
US Dollar	4%		↑	8%			
Euro	1%		↑	2%			
Equities	**40%**	**20-60%**	↑	**30%**			
US	24%			14%			
Europe ex-UK	6%		↑	5%			
UK	3%			3%			
Japan	3%		↑	6%			
Emerging Markets	4%		↓	2%			
Real Estate	**8%**	**0-16%**	↑	**15%**			
US	2%			2%			
Europe ex-UK	2%		↑	4%			
UK	1%		↑	3%			
Japan	2%		↓	4%			
Emerging Markets	1%		↓	2%			
Commodities	**2%**	**0-4%**	↓	**0%**			
Energy	1%		↓	0%			
Industrial Metals	0.3%			0%			
Precious Metals	0.3%			0%			
Agriculture	0.3%		↓	0%			
Total	**100%**			**100%**			
Currency Exposure (including effect of hedging)							
USD	49%		↓	38%			
EUR	20%		↑	18%			
GBP	7%		↓	11%			
JPY	15%		↑	21%			
EM	8%		↓	12%			
Total	**100%**			**100%**			

Notes: This is a theoretical portfolio and is for illustrative purposes only. See the latest The Big Picture document for more details. It does not represent an actual portfolio and is not a recommendation of any investment or trading strategy. Arrows indicate the direction of the most recent changes.
Source: Invesco

Figure 7 – Model allocations for Global sectors

	Neutral	Invesco	Preferred Region
Energy	**6.0%**	**Neutral**	**US**
Basic Materials	**4.1%**	**Neutral**	**Europe**
Basic Resources	2.2%	Underweight	Europe
Chemicals	1.9%	Overweight	US
Industrials	**12.6%**	**Underweight**	**US**
Construction & Materials	1.6%	Neutral	Europe
Industrial Goods & Services	11.1%	Overweight	US
Consumer Discretionary	**16.3%**	**Underweight**	**Japan**
Automobiles & Parts	2.3%	Underweight	Japan
Media	1.3%	Underweight	US
Retailers	6.9%	Neutral	EM
Travel & Leisure	2.0%	Underweight	Japan
Consumer Products & Services	3.9%	Neutral	Japan
Consumer Staples	**7.0%**	**Overweight**	**Europe**
Food, Beverage & Tobacco	4.5%	Overweight	Europe
Personal Care, Drug & Grocery Stores	2.5%	Underweight	US
Healthcare	**10.9%**	**Neutral**	**Europe**
Financials	**12.8%**	**Neutral**	**EM**
Banks	5.8%	Neutral	EM
Financial Services	3.8%	Overweight	US
Insurance	3.2%	Underweight	Japan
Real Estate	**3.7%**	**Overweight**	**Europe**
Technology	**18.9%**	**Overweight**	**US**
Telecommunications	**4.2%**	**Neutral**	**US**
Utilities	**3.5%**	**Neutral**	**Europe**

Notes: These are theoretical allocations which are for illustrative purposes only. They do not represent an actual portfolio and are not a recommendation of any investment or trading strategy. See the latest Strategic Sector Selector for more details.
Source: Refinitiv Datastream and Invesco

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Appendix

Definitions of data and benchmarks for Figure 3 and 4

Sources: we source data from Datastream unless otherwise indicated.

Cash: returns are based on a proprietary index calculated using the Intercontinental Exchange Benchmark Administration overnight LIBOR (London Interbank Offer Rate). The global rate is the average of the euro, British pound, US dollar and Japanese yen rates. The series started on 1st January 2001 with a value of 100.

Gold: London bullion market spot price in USD/troy ounce.

Government bonds: Current levels, yields and total returns use Datastream benchmark 10-year yields for the US, Eurozone, Japan and the UK, and the Bank of America Merrill Lynch government bond total return index for the World and Europe. The emerging markets yields and returns are based on the Bloomberg Barclays emerging markets aggregate government bond index.

Corporate investment grade (IG) bonds: Bank of America Merrill Lynch investment grade corporate bond total return indices. The emerging markets yields and returns are based on the Bloomberg Barclays emerging markets aggregate corporate bond index.

Corporate high yield (HY) bonds: Bank of America Merrill Lynch high yield total return indices

Equities: We use MSCI benchmark gross total return indices for all regions.

Commodities: Goldman Sachs Commodity total return indices

Real estate: FTSE EPRA/NAREIT total return indices

Currencies: Global Trade Information Services spot rates

Factor index definitions

We focus on relatively large-cap stocks, as we suspect that most investors will be conscious of liquidity constraints when implementing such strategies. We have chosen six factors, that we think cover the classic definitions used by most investors. We aim to capture roughly a fifth of the market in each of our factor indices using the historical constituents of the STOXX 600 since August 1999 and the S&P 500 since September 1989, with monthly rebalancing. All our rankings are based on data in euros for Europe and in US dollars for the US. All factor indices are equal-weighted. We use the following definitions:

Growth: stocks in both the top third based on their 5-year sales per share trend and the top-third based on their internal growth rate (the product of the 5-year average return on equity and the retention ratio).

Low volatility: stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months.

Price momentum: stocks in the top quintile based on their performance in the previous 12 months.

Quality: stocks in both the top third based on their return on invested capital and the top third based on their EBIT to EV ratio (earnings before interest and taxes to enterprise value). This follows Joel Greenblatt’s “magic formula” from his 2005 book: The little book that beats the market.

Size: stocks in the bottom quintile based on their market value.

Value: stocks in the bottom quintile based on their price to book value ratios.

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Data as of 31st October 2020 unless stated otherwise.

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