Applied philosophy
Are banks the real deal?

Banks have been one of the best performing sectors since the middle of October driven by hopes of a quick economic recovery. It would be logical to expect strong outperformance from the sector in the early part of an expansion on the expectation of improving margins and higher demand for loans. However, we think that low rates are here to stay for the foreseeable future and banks may have taken on loans that they would avoid in other circumstances. Valuations are attractive, but we fear this is not enough to warrant too much enthusiasm for the sector in the long term, though we think short-term momentum may continue.

Banks outperformed global equities by 12.5% between 14th October 2020 and 26th November leading us to wonder if the highly anticipated rotation into so-called value stocks has begun. We view the enthusiasm for the sector as primarily a reflection of hopes for higher economic growth and higher inflation. Higher inflation would mean that central banks could start pausing and reversing easy monetary policy eventually leading to higher interest rates. That environment has been better for banks' profitability in the past. Should we consider changing our Neutral stance on banks?

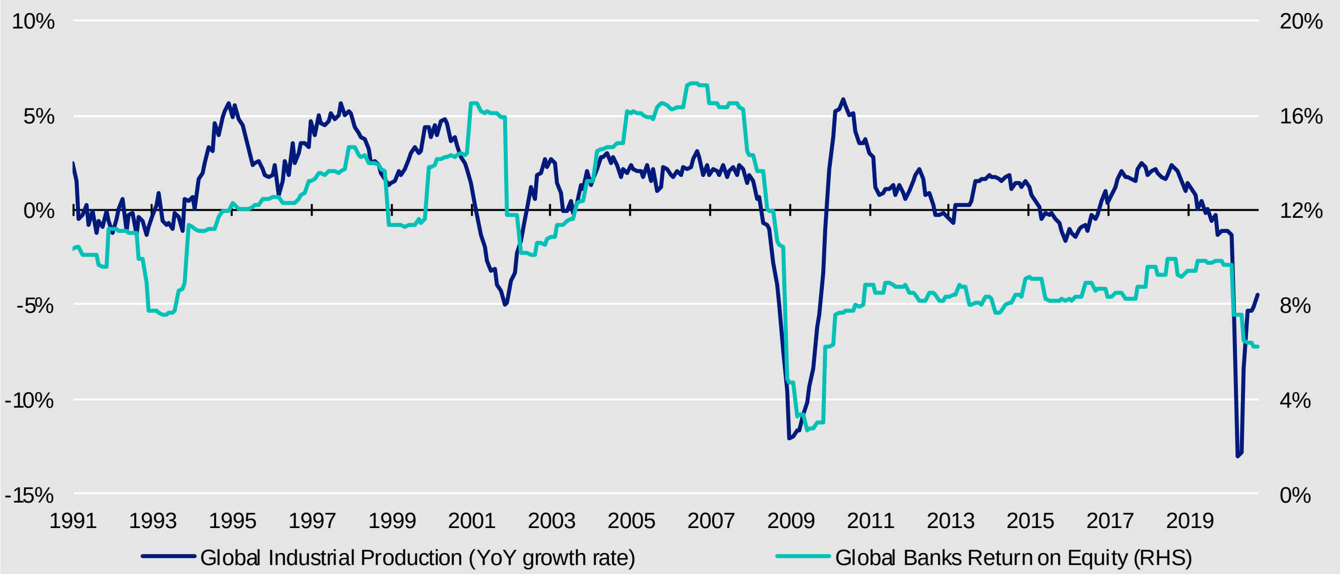
In theory, there are many arguments why this trade should work. First, we consider banks early cyclicals, which tend to outperform in the early stages of a recovery, precisely the period we find ourselves in right now. We would also expect early cyclicals to be among the cheapest assets near the trough of the economic cycle.

Second, recessions tend to hit banks' profitability as corporate and consumer defaults rise. There also tends to be less demand for new loans while companies preserve cash and the unemployment rate rises. Eventually when a recession ends, we would expect share prices in the sector to reflect the forthcoming recovery leading to lower delinquency and default rates and higher demand for loans as both consumers and corporates spend more.

Third, the steepening of the yield curve in the early part of a recovery would, in our view, be an early sign of potential margin expansion for banks. The spread between the long and short end of the curve can be used to represent the difference between banks' potential revenues and funding costs. We would expect this hope for margin expansion to drive returns in the sector as the economy emerges from a recession.

We illustrate the cyclicality of the profitability of the banks sector in **Figure 1** using a global measure of industrial production growth as our proxy for the economic cycle versus banks' return on equity. Sector profitability used to improve gradually during expansions peaking just before, then falling during recessions. However, this relationship seems to have weakened after the Global Financial Crisis (GFC) driven by, we suspect, the large-scale interventions from central banks that kept yields low.

Figure 1 – Global industrial production growth and global banks sector return on equity



Note: We calculate a global measure of industrial production growth using data from four regions or countries representing 65% of global Gross Domestic Product: United States, Europe, Japan and China. The global figure is a weighted average using Datastream global index market capitalisations as weights. We use return on equity (ROE) data for the Datastream Global Banks Index. The data series are monthly and start on 31st December 1988. Data as of 31st October 2020. Past performance is no guarantee of future returns.
Source: Refinitiv Datastream and Invesco

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Unfortunately, we think a reversal of easy monetary policy and a normalisation of interest rates is unlikely to happen in the next 12 months. The global economy started slowing down even before the COVID-19 pandemic struck. Most economies are still struggling to contain the virus and we think the Northern hemisphere winter will be tough. How the recovery will progress depends on the rapid distribution of vaccines still in development. Current signs are encouraging as several companies have reported high efficacy during phase III trials. However, even if some of them are approved before the end of 2020, vaccinating billions of people will take a long time. We think economic activity will only improve gradually after the initial "snapback" over the summer. This is bad news for banks' profitability.

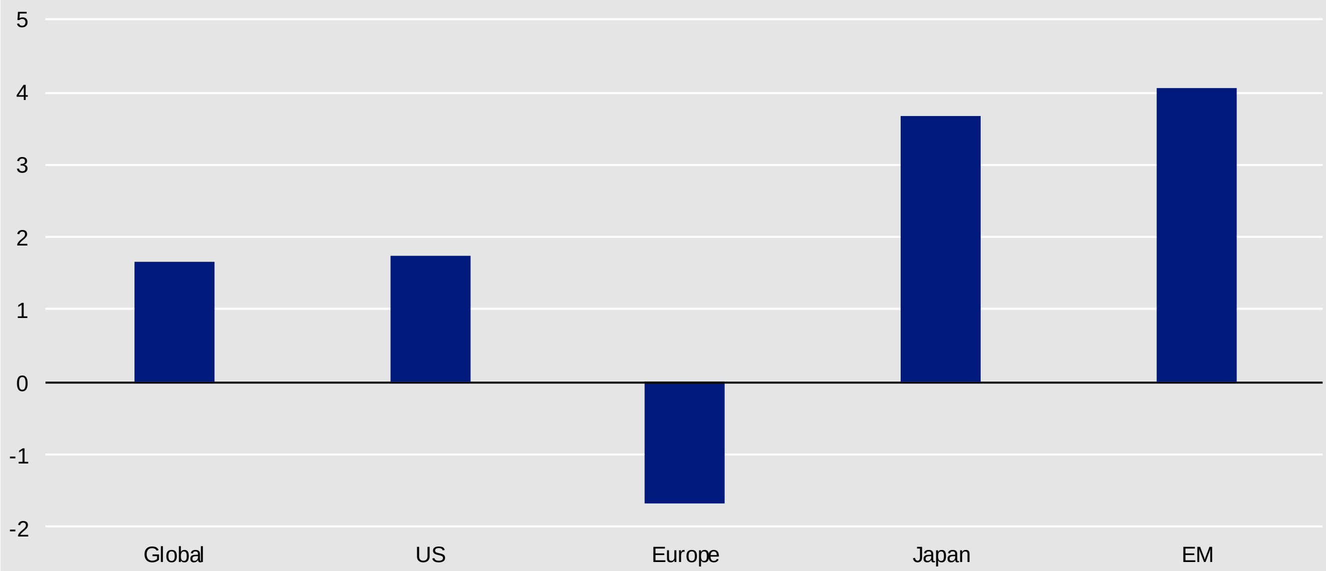
There has also been pressure on banks to offer loans to borrowers they probably would have deemed too risky before the pandemic arrived. This may impact the quality of their balance sheets and perhaps even lead to higher levels of capital preservation. The good news in the short term is that because of their already strong balance sheets they have been able to reduce loan loss provisions and may even be able to restart paying dividends subject to stress tests. However, we do not expect this to last.

Nevertheless, it is not all bad news for the sector. We do not expect banks to be the centre of the storm like during the GFC. They are much better capitalised and can withstand more pressure. Although their margins may remain depressed in the medium term, we believe they will not fall much further. Governments have been providing a lot of financial support to those falling on hard times and have pledged to keep fiscal expansion going. We have been advocating that for a while and did not think it would take a global pandemic to bring it about.

Sector valuations are also attractive, in our opinion. Banks have priced in virtually no growth into perpetuity based on what is implied by their current dividend yields as of the end of October (this is much lower than the 1.6% growth implied for the market). Our proprietary multiple regression model also suggests that the sector is 34% undervalued based on dividend yields relative to the market. Those relative dividend yields are higher than their historical average implying a discount (**Figure 2**). The only region where these valuations suggest a premium is Europe. Based on this regional comparison, emerging market banks look the most attractive.

So, should we change our allocation as outlined in the last edition of our Strategic Sector Selector? In our view, the outlook for the sector is balanced. The prospect of a recovery is real, but we think it may be slower and more gradual than what would be necessary for sustained outperformance. Valuations are attractive, but they have been for most of the past decade and we think that may be because of the impact a low interest rate environment can have on the profitability of banks. Of course, we may be wrong and inflation could return faster than we currently expect leading to higher rates. Although, we think the probability of that is low, and therefore we remain sceptical that the sector can be a long-term outperformer, we think it makes sense to have it as a tactical Overweight.

Figure 2 – Banks sector dividend yields relative to the market versus historical averages (z-score)



Notes: We calculate a z-score comparing the latest relative dividend yield to its historical average, which gives us a standardised way to measure how far valuations are from those averages in each region. Data as of 26th November 2020.
Source: Refinitiv Datastream and Invesco

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Figure 3 – Asset class total returns (%, annualised)

Data as at 27/11/2020	Index	Current Level/RY	Total Return (USD, %) 1w	1m	QTD	YTD	12m	Total Return (Local Currency, %) 1w	1m	QTD	YTD	12m
Equities												
World	MSCI	624	2.4	9.3	10.6	12.6	16.0	2.2	8.8	9.6	11.4	13.8
Emerging Markets	MSCI	1231	1.8	8.6	13.9	12.9	19.9	1.6	7.4	11.5	14.8	20.0
China	MSCI	108	1.1	4.3	11.3	29.8	38.2	1.1	4.0	10.9	28.5	36.3
US	MSCI	3542	2.5	7.9	9.1	17.0	20.0	2.5	7.9	9.1	17.0	20.0
Europe	MSCI	1775	1.8	12.9	11.5	2.1	5.7	1.1	11.6	8.9	-2.9	-1.9
Europe ex-UK	MSCI	2238	2.2	12.6	11.2	7.6	11.1	1.3	11.5	8.9	0.9	1.8
UK	MSCI	995	0.7	14.1	12.6	-13.8	-9.8	0.3	11.7	9.1	-14.4	-13.0
Japan	MSCI	3775	3.5	11.9	12.8	12.4	13.9	3.7	11.5	11.1	7.6	8.3
Government Bonds												
World	BofA-ML	0.22	0.2	0.6	1.2	8.0	8.2	-0.1	0.0	0.0	4.8	4.0
Emerging Markets	BBloom	4.05	0.0	4.1	4.4	4.7	8.0	0.0	4.1	4.4	4.7	8.0
China	BofA-ML	3.25	0.0	1.9	3.4	7.4	9.3	0.2	-0.1	-0.1	1.5	2.4
US (10y)	Datastream	0.84	-0.1	-0.5	-1.4	13.2	11.9	-0.1	-0.5	-1.4	13.2	11.9
Europe	Bofa-ML	-0.22	0.8	1.3	3.2	11.8	13.1	0.0	0.4	1.2	5.1	4.1
Europe ex-UK (EMU, 10y)	Datastream	-0.59	0.8	0.6	2.5	10.9	11.2	0.0	-0.3	0.5	4.2	2.3
UK (10y)	Datastream	0.33	0.5	1.7	2.6	6.5	8.1	0.0	-0.5	-0.6	5.7	4.3
Japan (10y)	Datastream	0.03	-0.4	0.5	1.4	4.3	4.1	-0.2	0.0	0.0	-0.2	-1.1
IG Corporate Bonds												
Global	BofA-ML	1.49	0.4	1.8	2.8	8.8	9.8	0.1	1.4	2.0	7.1	7.3
Emerging Markets	BBloom	3.94	0.7	3.0	4.2	9.8	11.6	0.7	3.0	4.2	9.8	11.6
China	BofA-ML	4.19	0.0	2.0	3.8	8.3	10.1	0.1	-0.1	0.4	2.4	3.1
US	BofA-ML	1.91	0.1	1.7	2.3	9.1	9.4	0.1	1.7	2.3	9.1	9.4
Europe	BofA-ML	0.33	0.9	1.9	3.8	9.1	11.3	0.1	0.9	1.8	2.5	2.4
UK	BofA-ML	1.60	1.2	3.5	5.5	7.7	10.9	0.7	1.3	2.2	6.9	7.0
Japan	BofA-ML	0.46	-0.2	0.6	1.7	4.6	5.1	0.0	0.2	0.2	0.1	-0.1
HY Corporate Bonds												
Global	BofA-ML	5.16	0.9	3.5	4.9	5.4	7.8	0.7	3.3	4.4	4.2	6.1
US	BofA-ML	5.32	0.7	3.2	4.4	4.1	6.3	0.7	3.2	4.4	4.1	6.3
Europe	BofA-ML	3.35	1.5	4.3	6.5	8.4	12.0	0.7	3.3	4.5	1.8	3.1
Cash (Overnight LIBOR)												
US		0.08	0.0	0.0	0.0	0.4	0.5	0.0	0.0	0.0	0.4	0.5
Euro Area		-0.59	0.9	1.4	2.0	6.1	8.1	0.0	-0.1	-0.1	-0.5	-0.6
UK		0.05	0.2	2.1	3.1	0.6	3.3	0.0	0.0	0.0	0.2	0.2
Japan		-0.12	-0.3	0.3	1.2	4.2	5.1	0.0	0.0	0.0	-0.1	-0.1
Real Estate (REITs)												
Global	FTSE	1755	0.9	12.3	10.9	-10.7	-9.7	0.5	11.7	9.3	-15.8	-16.5
Emerging Markets	FTSE	1985	-0.4	9.5	7.9	-16.4	-8.5	-0.8	8.8	6.3	-21.2	-15.4
US	FTSE	2800	1.1	13.1	11.8	-10.5	-11.9	1.1	13.1	11.8	-10.5	-11.9
Europe ex-UK	FTSE	3554	1.4	13.2	9.5	-3.0	0.9	1.0	12.5	7.9	-8.5	-6.8
UK	FTSE	1278	-0.9	11.7	13.7	-18.0	-11.4	-1.2	9.4	10.2	-18.5	-14.4
Japan	FTSE	2566	1.3	7.8	5.7	-12.2	-13.3	1.8	7.6	4.4	-15.7	-17.3
Commodities												
All	GSCI	1877	3.8	7.6	8.7	-27.6	-24.5	-	-	-	-	-
Energy	GSCI	253	7.1	11.9	10.6	-49.2	-46.9	-	-	-	-	-
Industrial Metals	GSCI	1390	1.8	9.8	13.1	14.1	16.2	-	-	-	-	-
Precious Metals	GSCI	2054	-5.1	-7.0	-5.8	14.9	20.0	-	-	-	-	-
Agricultural Goods	GSCI	371	0.9	3.1	10.4	6.5	12.7	-	-	-	-	-
Currencies (vs USD)*												
EUR		1.20	0.9	1.4	2.1	6.7	8.8	-	-	-	-	-
JPY		104.12	-0.2	0.3	1.3	4.3	5.2	-	-	-	-	-
GBP		1.33	0.4	2.1	3.2	0.7	3.6	-	-	-	-	-
CHF		1.11	0.8	0.5	1.9	7.0	10.5	-	-	-	-	-
CNY		6.58	-0.2	2.0	3.3	5.9	6.9	-	-	-	-	-

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

Data as at 27/11/2020	Global				
	1w	1m	QTD	YTD	12m
Energy	**2.0**	**5.6**	**2.0**	**-30.8**	**-29.3**
Basic Materials	**1.3**	**1.7**	**2.0**	**3.5**	**5.5**
Basic Resources	1.5	1.2	2.3	3.9	8.3
Chemicals	1.1	2.3	1.5	3.1	2.6
Industrials	**0.0**	**3.2**	**2.1**	**-0.3**	**-1.8**
Construction & Materials	-0.7	3.4	3.1	-1.6	-1.8
Industrial Goods & Services	0.1	3.2	2.0	-0.1	-1.8
Consumer Discretionary	**0.4**	**-0.9**	**0.4**	**10.7**	**9.9**
Automobiles & Parts	3.8	11.3	13.1	29.6	27.9
Media	-0.2	1.2	1.4	-2.3	-4.6
Retailers	-0.2	-8.3	-6.3	21.9	20.8
Travel & Leisure	0.6	5.5	4.7	-14.6	-14.4
Consumer Products & Services	-0.8	1.0	2.4	10.8	10.6
Consumer Staples	**-1.7**	**-3.5**	**-5.1**	**-6.9**	**-8.2**
Food, Beverage & Tobacco	-1.7	-2.1	-3.8	-9.4	-10.2
Personal Care, Drug & Grocery Stores	-1.7	-6.0	-7.4	-2.1	-4.4
Healthcare	**-1.1**	**-4.5**	**-6.1**	**2.7**	**2.5**
Financials	**0.7**	**6.2**	**7.2**	**-15.3**	**-15.0**
Banks	1.5	8.9	12.0	-20.8	-20.0
Financial Services	0.8	3.1	3.5	-7.5	-7.5
Insurance	-1.1	5.1	3.2	-13.0	-13.6
Real Estate	**-1.7**	**-0.3**	**-3.0**	**-15.4**	**-15.9**
Technology	**0.1**	**-3.0**	**-1.3**	**27.0**	**28.8**
Telecommunications	**-0.3**	**-0.2**	**-1.5**	**-3.7**	**-4.8**
Utilities	**-1.0**	**-3.5**	**-0.3**	**-5.3**	**-4.8**

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 5a – US factor index total returns (%)

Data as at 27/11/2020	Absolute					Relative to Market				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Growth	3.1	11.5	13.2	24.5	25.8	0.8	3.7	4.4	8.7	7.1
Low volatility	0.8	3.9	5.2	13.8	15.2	-1.5	-3.3	-3.1	-0.6	-2.0
Price momentum	1.4	4.8	6.9	15.1	16.2	-0.9	-2.5	-1.4	0.5	-1.1
Quality	2.7	11.4	12.1	9.9	12.8	0.4	3.7	3.3	-4.1	-4.0
Size	5.4	24.9	27.7	2.6	5.3	3.0	16.2	17.8	-10.4	-10.4
Value	6.5	30.1	31.0	-0.3	4.0	4.1	21.0	20.8	-13.0	-11.5
Market	2.3	7.5	8.5	14.5	17.5					
Market - Equal-Weighted	2.9	12.8	14.9	9.4	11.9					

Notes: All indices are subsets of the S&P 500 index, they are rebalanced monthly, use data in US dollars and are equal-weighted. Growth includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio); Low volatility includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months; Price momentum includes stocks in the top quintile based on their performance in the previous 12 months; Quality includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value); Size includes stocks in the bottom quintile based on their market value in US dollars. Value includes stocks in the bottom quintile based on their price to book value ratios. The market represents the S&P 500 index. Past performance is no guarantee of future results.
Source: Refinitiv Datastream and Invesco

Figure 5b – European factor index total returns relative to market (%)

Data as at 27/11/2020	Absolute					Relative to Market				
	1w	1m	QTD	YTD	12m	1w	1m	QTD	YTD	12m
Growth	-0.4	10.0	9.3	18.4	20.8	-1.4	-1.5	0.2	22.1	22.6
Low volatility	-0.5	5.1	3.3	0.0	0.4	-1.4	-5.9	-5.3	3.2	2.0
Price momentum	0.0	4.3	3.0	11.3	14.7	-1.0	-6.6	-5.6	14.8	16.4
Quality	0.6	13.8	12.5	1.2	4.3	-0.4	1.9	3.1	4.4	5.9
Size	0.8	17.4	14.8	-2.0	1.0	-0.2	5.1	5.2	1.0	2.5
Value	3.2	29.9	29.3	-11.0	-9.4	2.2	16.4	18.5	-8.2	-8.0
Market	1.0	11.7	9.1	-3.0	-1.5					
Market - Equal-Weighted	1.1	13.3	11.7	-0.8	1.2					

Notes: All indices are subsets of the STOXX 600 index, they are rebalanced monthly, use data in euros and are equal-weighted. Growth includes stocks in the top third based on both their 5-year sales per share trend and their internal growth rate (the product of the 5-year average return on equity and the retention ratio); Low volatility includes stocks in the bottom quintile based on the standard deviation of their daily returns in the previous three months; Price momentum includes stocks in the top quintile based on their performance in the previous 12 months; Quality includes stocks in the top third based on both their return on invested capital and their EBIT to EV ratio (earnings before interest and taxes to enterprise value); Size includes stocks in the bottom quintile based on their market value in euros; Value includes stocks in the bottom quintile based on their price to book value ratios. The market represents the STOXX 600 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
Cash Equivalents	**5%**	**0-10%**		**10%**	
Cash	2.5%			10%	
Gold	2.5%			0%	
Bonds	**40%**	**10-70%**	↓	**20%**	
Government	25%	10-40%		15%	
US	8%		↓	2%	
Europe ex-UK (Eurozone)	7%		↑	4%	
UK	1%		↑	2%	
Japan	7%		↓	3%	
Emerging Markets	2%			4%	
China**	0.2%			1%	
Corporate IG	10%	0-20%	↓	0%	
US Dollar	5%		↓	0%	
Euro	2%		↓	0%	
Sterling	1%		↓	0%	
Japanese Yen	1%		↓	0%	
Emerging Markets	1%		↓	0%	
China**	0.1%			0%	
Corporate HY	5%	0-10%	↑	5%	
US Dollar	4%		↓	4%	
Euro	1%		↓	1%	
Equities	**45%**	**20-60%**	↑	**50%**	
US	25%		↑	18%	
Europe ex-UK	7%		↑	12%	
UK	4%		↑	6%	
Japan	4%			6%	
Emerging Markets	5%		↑	8%	
China**	2%			3%	
Real Estate	**8%**	**0-16%**	↑	**16%**	
US	2%		↑	3%	
Europe ex-UK	2%		↑	4%	
UK	1%			3%	
Japan	2%		↓	3%	
Emerging Markets	1%		↑	3%	
Commodities	**2%**	**0-4%**	↑	**4%**	
Energy	1%		↑	2%	
Industrial Metals	0.3%		↑	1%	
Precious Metals	0.3%			0%	
Agriculture	0.3%		↑	1%	
Total	**100%**			**100%**	
Currency Exposure (including effect of hedging)					
USD	48%		↓	36%	
EUR	20%		↑	23%	
GBP	7%		↑	12%	
JPY	15%		↓	13%	
EM	9%		↑	15%	
Total	**100%**			**100%**	

Notes: **China is included in Emerging Markets allocations. 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

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

Invesco

Appendix

Definitions of data and benchmarks for Figure 3

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.

Authors

András Vig
Multi-Asset Strategist
T. +44 (0)20 3370 1152
E. andras.vig@invesco.com

Paul Jackson
Global Head of Asset Allocation Research
T. +44 (0)20 3370 1172
E. paul.jackson@invesco.com

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Data as of 26th November 2020 unless stated otherwise.

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Telephone calls may be recorded.

Authors

Paul Jackson
Global Head of Asset Allocation Research
Telephone +44(0)20 3370 1172
paul.jackson@invesco.com
London, EMEA

András Vig
Multi-Asset Strategist
Telephone +44(0)20 3370 1152
andras.vig@invesco.com
London, EMEA

Global Market Strategy Office

Kristina Hooper
Chief Global Market Strategist
Kristina.Hooper@invesco.com
New York, Americas

Brian Levitt
Global Market Strategist, Americas
Brian.Levitt@invesco.com
New York, Americas

Talley Léger
Investment Strategist, Equities
Talley.Leger@invesco.com
New York, Americas

Ashley Oerth
Investment Strategy Analyst
Ashley.Oerth@invesco.com
London, EMEA

Arnab Das
Global Market Strategist
Arnab.Das@invesco.com
London, EMEA

Luca Tobagi, CFA*
Product Director / Investment Strategist
Luca.Tobagi@invesco.com
Milan, EMEA

Paul Jackson
Global Head of Asset Allocation Research
paul.jackson@invesco.com
London, EMEA

András Vig
Multi-Asset Strategist
andras.vig@invesco.com
London, EMEA

David Chao
Global Market Strategist, Asia Pacific
David.Chao@invesco.com
Hong Kong, Asia Pacific

Tomo Kinoshita
Global Market Strategist, Japan
Tomo.Kinoshita@invesco.com
Tokyo, Asia Pacific

* Affiliated member

Telephone calls may be recorded.