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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

NOVEMBER 2019

MARKET INSIGHTS

As of October 31, 2019

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Down But Not Out

After 21 months of slowing global growth, we are starting to see signs of stabilization, signaled by a potential bottoming in the industrial economy. The J.P. Morgan Global Manufacturing PMI ticked up in October—the indicator's third increase in a row—tempering recession fears. The loosening of global financial conditions starting to kick in, resiliency of the U.S. consumer, receding trade war uncertainty, and progress on Brexit have all contributed to the rosier sentiment shift. However, some economic data remain worrisome and business investment remains on the sidelines, questioning the sustainability of the stabilization.

"Buck-ing" the Trend

Since 2011, the U.S. dollar (USD) has been on a steady upward trajectory as U.S. growth and interest rates have outpaced other developed markets. However, in October, the trade-weighted U.S. dollar index tumbled 2% as easing trade tensions and optimism around Brexit moved demand away from "safe-haven" assets. Perhaps the recent stabilization in global growth and abating recession fears could give other currencies legs versus the USD going forward. Emerging markets would be the primary beneficiaries of this USD regime shift, as it would reduce their USD-linked debt obligations. However, with the Fed indicating a reluctance to cut interest rates, we could see the U.S. dollar hold its ground a bit longer.

Earnings: A Bit Better Than Nothing?

With earnings season winding down, results have been modestly better than expected and may even escape a negative earnings-per-share print for Q3. Weakening revenues, margin pressures, cost savings, and trade tensions have been the focus of many companies' earnings reports. Several companies have also highlighted their reluctancy to deploy capital given the large amount of uncertainty remaining in the macro backdrop. In Q3, weakening energy prices have been a major theme, with energy company earnings down over 30%. Expectations for 2020 earnings remain elevated, with a growth rate still targeting more than 9%, although many predict estimates could be revised lower should growth and capex remain tempered amid trade and election concerns.

FIG. 1: Global Manufacturing PMI
November 30, 2016, through October 31, 2019

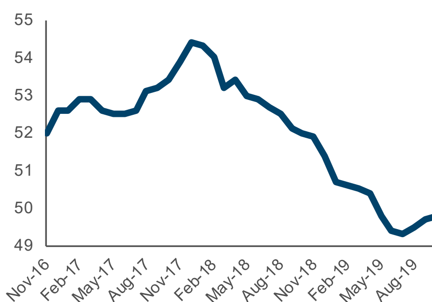


FIG 2: U.S. Dollar Index
December 31, 2018, through October 31, 2019

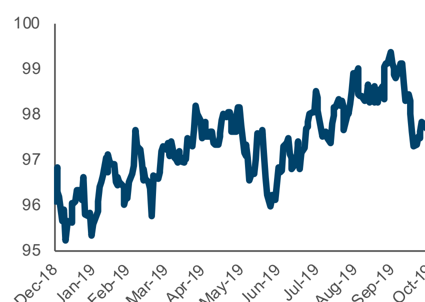
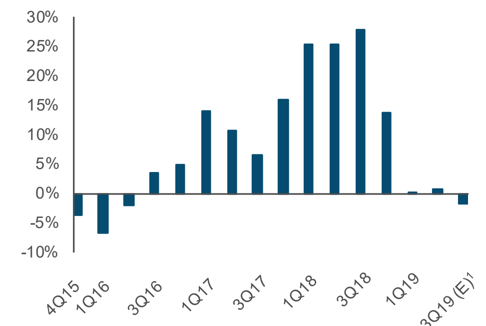


FIG. 3: S&P 500 Quarterly EPS Growth
Year-Over-Year Growth (%), 4Q15 through 3Q19 (E)



[1]Includes a blend of unreported and reported numbers where available.

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REGIONAL BACKDROP

As of October 31, 2019

	Positives	Negatives
Developed Europe	▪ Monetary policy remains very accommodative ▪ Indirect beneficiary of China stimulus ▪ Services sector of the economy resilient ▪ Dividend yields remain strong ▪ Political uncertainty waning	▪ Economic growth is muted, with notable weakness in the manufacturing sector ▪ Limited scope for European Central Bank to stimulate further ▪ Export weakness, vulnerable to trade and China growth ▪ Banking sector remains weak
United Kingdom	▪ Wage growth remains strong, although forward-looking indicators suggest moderation ▪ Inflation remains steady, albeit below target ▪ Abstracting from short-term volatility due to Brexit stocking, the UK's trade balance deficit remains in a range that can be sustained by the net excess returns on the UK's external balance sheet ▪ Britain's fiscal position provides flexibility for government spending to be increased should the economy weaken	▪ The forthcoming election could, regardless of outcome, result in significantly looser fiscal policy and higher government debt ▪ Sterling remains weak amid Brexit concerns ▪ PMI data improved in October, but likely only due to a one-off Brexit destocking effect
United States	▪ Fed likely on hold, inflation low ▪ Growth expected to stabilize ▪ Healthy consumer spending, strong employment, and improving wages ▪ Low interest rates driving a modest rebound in housing ▪ Pause in trade war escalation ▪ Greater share of secularly advantaged companies (e.g., cloud computing, internet retail) than rest of world	▪ Political uncertainty ▪ Modest economic growth with fading fiscal stimulus ▪ Muted near-term earnings expectations ▪ Weak capex spending and corporate confidence ▪ Late-cycle concerns: tight labor market, rising wages, and corporate margins under pressure ▪ Elevated corporate and government debt levels

Japan	▪ Impact of the VAT hike is more contained than in 2014, while domestic sectors appear resilient despite temporary disruptions from typhoons ▪ Flows are looking again at Japanese stocks to add cyclical exposures ▪ Japanese stocks remain attractive from a valuation perspective. Meanwhile, improving governance is seen through buybacks and ROE	▪ Top-line growth and earnings are subdued relative to global peers ▪ Economic momentum remains weak when looking at manufacturing and exports data ▪ Expectations for further support from the Bank of Japan (BoJ) need to be revised as the central bank is unlikely to act beyond its forward guidance
Asia ex Japan	▪ Chinese economy is stabilizing, and leading indicators are pointing to a rebound in manufacturing activity ▪ The renminbi is likely to remain range-bound. At this level, it supports the export-driven side of the economy ▪ The Australian economy is accelerating on the back of a rebound in housing prices ▪ The Reserve Bank of Australia (RBA) still has room for one interest rate cut if needed	▪ Chinese macro policies are intended to stop the downward trajectory in growth, not to revive it. Expectations regarding additional stimulus may be overdone at this time ▪ China's growth momentum is fragile, and risks remain on the downside ▪ Optimistic expectations are already priced in for the RBA ▪ Australian equity valuations appear elevated given the poor earnings outlook
Emerging Markets	▪ Muted (but rising) inflation ▪ Dovish Fed has given central banks flexibility to ease ▪ Equity valuations attractive relative to developed markets ▪ With growing importance of tech sector, less tied to commodity cycle ▪ Beneficiary of China stimulus	▪ Export-driven economies are highly vulnerable to rising trade tensions ▪ Instability in several key markets (Turkey, Argentina, and Brazil) could persist ▪ Long-term China growth trajectory remains a headwind ▪ China stimulus more measured and domestically focused ▪ Commodity prices remain under pressure

ASSET ALLOCATION COMMITTEE POSITIONING

As of October 31, 2019

▼ or ▲ Month-Over-Month Change

		Change	Underweight		Neutral	Overweight		**These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.**
ASSET CLASSES	Equities	▲			■			Limited upside with above-average valuations amid fragile global growth. Equity risk premia at high levels to history.
ASSET CLASSES	Bonds	▼			■			Valuations extended with yields low due to growth concerns, trade uncertainty, and muted inflation; credit spreads tight, but fundamentals supportive.
ASSET CLASSES	Cash	▼			■			U.S. yields most attractive among developed markets but past peak after recent cuts.
	Regions							
EQUITIES	U.S.			■				Earnings growth weak on margin pressure, and valuations above average; consumer and services sectors supportive, but weak demand from capex and exports.
EQUITIES	Europe				■			Growth outlook stabilizing, but concerns over exports and banking system remain; potential tailwind from monetary stimulus.
EQUITIES	UK				■			Valuations attractive relative to the U.S., but uncertainty due to Brexit is elevated and likely to remain so until the January 31 deadline.
EQUITIES	Japan				■			Monetary and fiscal policy supportive; export dependency remains the key driver.
EQUITIES	Asia ex Japan			■				Valuations are still attractive relative to the U.S. While China stimulus measures may flow through to the broader region, the ongoing trade dispute between the U.S. and China weighs on the region.
EQUITIES	Emerging Markets					■		Dovish Fed, cheap currencies, and China stimulus supportive; susceptible to trade concerns and continued earnings weakness.
	Style							
EQUITIES	Global Equity Growth	▼			■			Sector profile has defensive and quality growth bias; valuations extended versus history.
EQUITIES	Global Equity Value	▲			■			Cyclical orientation and financials exposure challenged by macro environment; cheap valuations beginning to look extreme.
	Capitalization							
EQUITIES	Global Equity Large-Cap				■			Central banks supportive, potential beneficiary of further China stimulus; susceptible to global trade weakness.
EQUITIES	Global Equity Small-Cap				■			Weak domestic growth trends and political uncertainty weighing on confidence in key markets.

ASSET ALLOCATION COMMITTEE POSITIONING

As of October 31, 2019

Underweight — *Neutral* — *Overweight*   ▼ or ▲ Month-Over-Month Change

		Change	*Underweight*		*Neutral*	*Overweight*		**These views are informed by a subjective assessment of the relative attractiveness of asset classes and subclasses over a 6- to 18-month horizon.**
BONDS	U.S. Investment Grade			■				Yields low on concerns from growth but limited inflation upside. Investment-grade (IG) corporate spreads still tight relative to history.
	European Investment Grade					■		Historically low yields continue to be underpinned by a dovish ECB. Credit remains in a tug of war between tight valuations and weakening credit fundamentals and ever-looser monetary policy.
	UK Investment Grade				■			Yields are near all-time lows amid weakening growth and modest inflation. No-deal Brexit tail risk has receded, and the base case is now for an orderly withdrawal from the European Union (EU).
	Inflation Linked				■			Inflation expectations low but rising with coordinated central bank easing.
	Global High Yield					■		Yield carry attractive with near-term default expectations low. Vigilant on late-stage risks of credit cycle.
	Floating Rate Loans	▲				■		Yield level remains attractive with near-term recession risk low; but step-ups less likely with Fed easing and liquidity remains a concern.
	EM Dollar Sovereigns					■		Yields are attractive, and central banks supportive; idiosyncratic risks and potential contagion remain concerns.
	EM Local Currency					■		EM currency valuation remains attractive; volatility likely to be driven by trade tensions and further USD strength.
	EM Corporates					■		Yields are attractive relative to fundamentals. Rising country-specific risks are concerning but unlikely to become systemic.
CURRENCIES	U.S. Dollar			■				There has been a reversal in the U.S. dollar over the past month as stabilizing economic data has improved investment flows.
	Euro					■		Growth remains weak in Europe; however, the euro found moderate support from a more benign assessment of the recent data trends. We continue to see a better growth tone.
	UK Sterling				■			Sterling has bounced substantively in recent weeks, as political developments saw risks of a sudden exit from the EU in October fall to effectively zero.
	Japanese Yen	▼			■			The yen's weakness has been driven by an improving global growth outlook and rising risk sentiment. The BoJ will continue to be on hold unless growth significantly deteriorates.

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Currency risk—changes in currency exchange rates could reduce investment gains or increase investment losses.

Default risk—the issuers of certain bonds could become unable to make payments on their bonds.

Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

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ID0002802 (11/2019)
201911-1005748