



# GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

JULY 2019

## MARKET INSIGHTS

As of June 30, 2019

### It's The Central Banks, Stupid!

Global manufacturing data continued to sow doubts on the outlook for economic growth as the impact of lingering trade uncertainty on corporate sentiment became more pronounced. Data have continued to weaken over the first half of the year with the global manufacturing PMI falling below the expansion threshold in June, marking the lowest level since February 2016. Weakness was broad-based with the headline number and new orders falling in all regions. Despite these persistent signs of a weakening global environment, markets seem confident that central banks will provide a backstop. So far, central bank rhetoric has supported markets, but, if needed, will the response be sufficient to reverse the economic trend?



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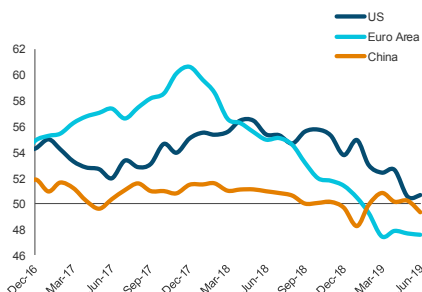
### Synchronized Pivot

Macro risks remain to the downside as business sentiment and global capex have been adversely impacted by trade uncertainty, leading expectation for central bank easing to become increasingly synchronized. Following the pivot by the Federal Reserve, recent comments from European Central Bank (ECB) President Mario Draghi increased expectations that monetary easing would be forthcoming in the eurozone, and Australia has moved to an easing stance. This could be good news for emerging markets as dovishness in developed markets and signs that the U.S. dollar strengthening trend may have peaked would provide cover to cut rates amid still-low inflation.

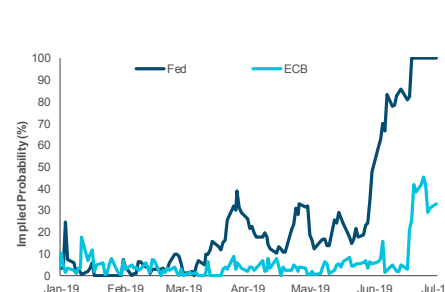
### Truce, But Not Real Progress

While expectations for the meeting between U.S. President Donald Trump and Chinese President Xi Jinping at the G-20 summit were low, the resulting truce is a positive development following months of escalating tensions. But will it be enough to support markets from here? Risk assets had already rallied strongly year-to-date on the back of dovish comments from the Fed and the ECB, with U.S. equities posting the best start to the year since 1997. However, the recent strength of safe-haven assets such as gold and sovereign bonds raises some concerns. While the truce avoided further escalation, the core issues (e.g., intellectual property) remain unresolved. Markets rejoice in the detente, but there are no clear signs that the trade war is over.

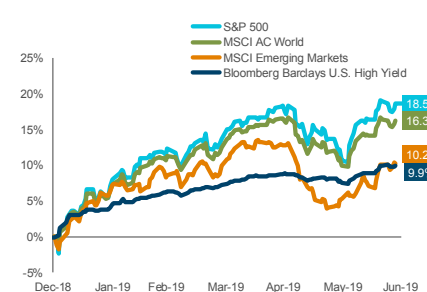
**FIG. 1: Manufacturing PMI**  
December 2016 to June 2019



**FIG. 2: Futures Market Expectations for Rate Cut in July**  
December 31, 2018 to June 30, 2019



**FIG. 3: Year-to-Date Total Return**  
As of June 30, 2019



**Past performance is not a reliable indicator of future performance.**

Sources: The European Union, MSCI, Standard & Poor's, FactSet, and Bloomberg Index Services Limited (see Additional Disclosures).



 **Positives**

 **Negatives**

**Developed Europe**

- Monetary policy remains very accommodative
- Indirectly benefiting from China stimulus
- Dividend yields remain strong

- Economic growth is muted
- Limited scope for ECB to stimulate further
- Export weakness, vulnerable to trade and China growth
- Banking sector remains challenged
- The composition of the new European Union Parliament could lead to difficulties

**United Kingdom**

- The number of people working in the UK recently reached a record high
- Unemployment remains at its lowest level in around 44 years
- The extension of Article 50 to October 31, 2019, has deferred the prospect of a disorderly Brexit

- PMI data suggest that the UK economy may have contracted during the second quarter
- The prospect of a no-deal Brexit is rising, which—if it occurs—could trigger a recession
- Weak economic outlook likely to continue weighing on sterling

**United States**

- Dovish Fed, stable inflation
- Healthy consumer spending, strong employment, and improving wages
- Lower rates driving a rebound in housing
- Pause in trade war escalation
- Greater share of secularly advantaged companies (e.g., cloud computing, internet retail) than rest of world

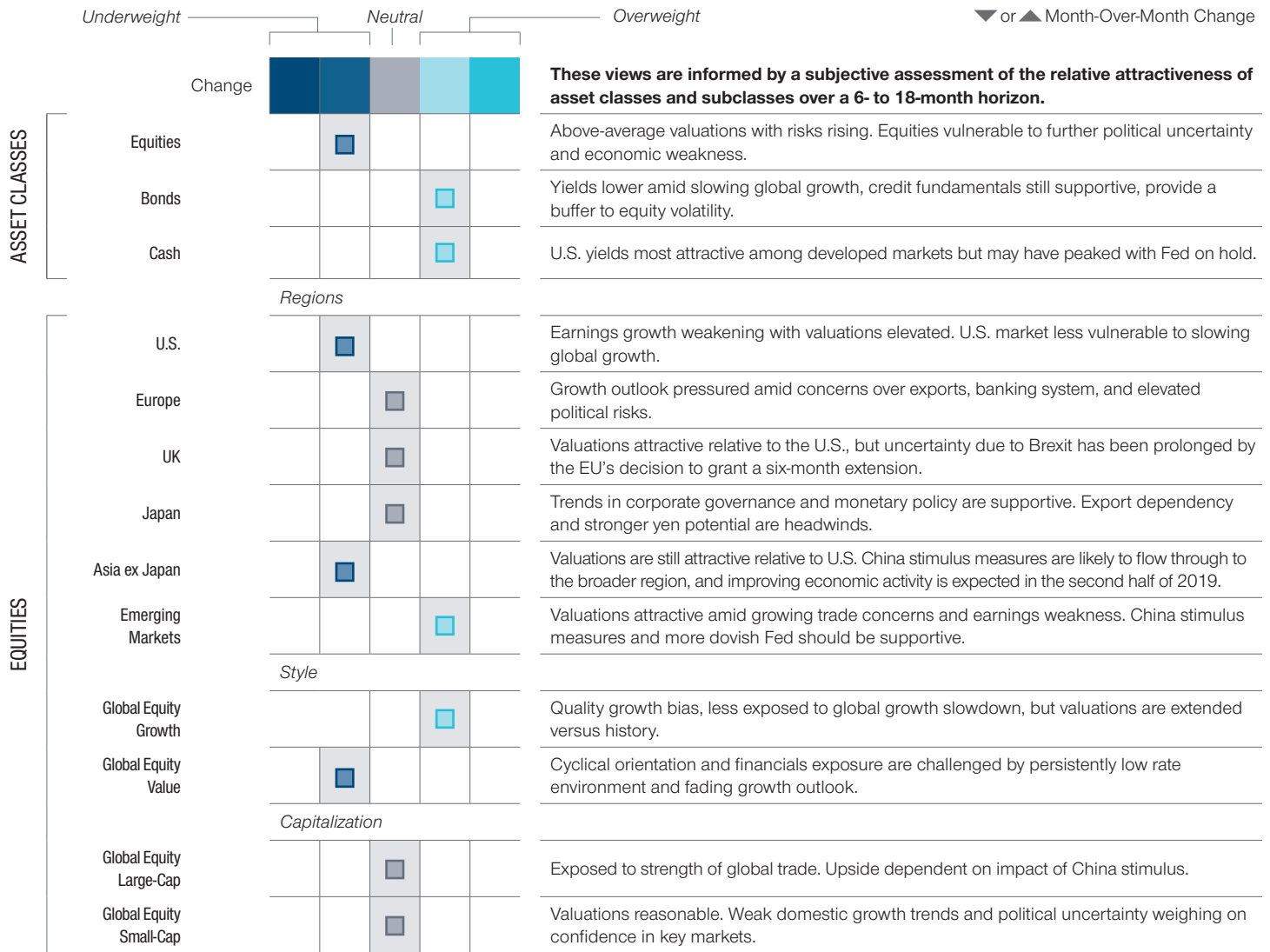
- Election in 2020
- Slowing economic growth with fading fiscal stimulus
- Muted near-term earnings expectations
- Faltering capex spending and corporate confidence
- Late-cycle concerns: tight labor market, rising wages, and elevated margins
- Elevated corporate and government debt levels

 **Positives** **Negatives**

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- Japan**
- Expectations for economy and corporate earnings have been marked down significantly given poor economic momentum, creating upside surprise risk
  - Recent data suggest economic slowdown may have found a bottom
  - Japanese stocks have rarely been cheaper. Meanwhile, improving governance seen through buybacks and return on equity, along with increasing number of start-ups, remains underappreciated
- Corporate earnings are highly sensitive to the global economy, which is, at best, stabilizing at below-potential growth rate
  - Japan is left out of global monetary easing trend. Despite the Bank of Japan's (BoJ) commitment to an ultra-loose monetary policy, there is not much room left for additional easing
  - The yen is likely to appreciate given weak valuation, uncertain risk sentiment, and lower interest rate differential with the U.S. An exchange rate below 109 versus the U.S. dollar raises earnings concerns

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- Asia ex Japan**
- Benefits from Chinese stimulus measures yet to be seen. Recent data have been mixed, but it is too early to call a bottom in growth trajectory
  - Chinese monetary policy is labeled as prudent, but new proactive measures can still be expected to address specific stress areas for small businesses and banks
  - Australian economy seems resilient with business confidence stabilizing and housing-related downside risks diminishing
  - The Reserve Bank of Australia delivered on the first rate cut as expected. Given the explicit focus on the NAIRU measure of unemployment, more rate cuts are expected
- Uncertainty in Chinese trade talks with the U.S. presents the major risk. The impact on capex, supply chains, and trade activity are still difficult to fully evaluate
  - A firm political stance from China versus the U.S. might create undesired consequences domestically in the medium term
  - Recent buoyant price movements in Australia seem disconnected with below-potential economic growth and could reflect overly optimistic expectations for the RBA and newly elected government
  - Commodity prices are set to roll over as the global economy slows and specific supply disruptions are progressively resolved

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- Emerging Markets**
- Muted inflation, more dovish Fed give central banks flexibility to ease
  - Benefit from Chinese stimulus
  - Equity valuations attractive relative to developed markets
  - With growing importance of tech sector, less tied to commodity cycle
- 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
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|                   |                           | Positioning |   |         |  |            | Change |                         |  |
|-------------------|---------------------------|-------------|---|---------|--|------------|--------|-------------------------|--|
|                   |                           | Underweight |   | Neutral |  | Overweight | ▼ or ▲ | Month-Over-Month Change |  |
|                   |                           | Change      |   |         |  |            |        |                         |  |
| <b>BONDS</b>      | 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 |             |   | ■       |  |            |        |                         | Yields lower year-to-date driven by dovish ECB. IG corporate spreads tight relative to history, but technical backdrop is supportive.  |
|                   | UK Investment Grade       |             |   |         |  | ■          |        |                         | Yields lower year-to-date amid slowing growth and modest inflation. Bank of England is likely to stay put until resolution of Brexit.  |
|                   | Inflation Linked          |             |   | ■       |  |            |        |                         | Inflation expectations low but could drift higher with support from more dovish Fed.   |
|                   | Global High Yield         |             |   |         |  | ■          |        |                         | Yield carry attractive with near-term default expectations low, but the late stage of credit cycle is a risk.  |
|                   | Floating Rate Loans       |             |   | ■       |  |            |        |                         | Yield level remains attractive, but step-ups are less likely with Fed pivot.   |
|                   | EM Dollar Sovereigns      |             |   |         |  | ■          |        |                         | Yields are attractive, but heightened political uncertainty in several key markets remains a significant headwind.   |
|                   | EM Local Currency         |             |   |         |  | ■          |        |                         | Emerging market (EM) currency valuation remains attractive, but volatility likely to be elevated over the near term.   |
|                   | EM Corporates             |             |   |         |  | ■          |        |                         | Yields are attractive relative to fundamentals. Rising country-specific risks are concerning but unlikely to become systemic.  |
| <b>CURRENCIES</b> | U.S. Dollar               | ▼           | ■ |         |  |            |        |                         | The U.S. dollar continues to be relatively well supported on broad measures. Valuations remain a headwind to dollar strength as does easing growth and fiscal support.       |
|                   | Euro                      |             |   |         |  | ■          |        |                         | Political uncertainties, largely related to Brexit, remain. Weak economic indicators and a dovish tilt to ECB policy continue to hold the common currency in check.          |
|                   | UK Sterling               |             |   | ■       |  |            |        |                         | The weak economic backdrop for GBP allied with ongoing uncertainty regarding UK political direction and Brexit fallout continue to cloud the outlook for sterling.           |
|                   | Japanese Yen              |             |   |         |  | ■          |        |                         | The Japanese yen has recently been buoyed by risk aversion, and we expect this support to dissipate. We expect little from the BoJ in terms of policy changes into year-end. |

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

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

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