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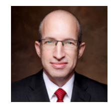
GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

SEPTEMBER 2019

MARKET INSIGHTS

As of August 31, 2019



Yoram Lustig
Head of Multi-Asset Solutions, EMEA

Brexit: Mess Gets Messier

With only weeks left until the October 31 deadline, UK Prime Minister Boris Johnson moved to suspend Parliament to thwart opposition lawmakers' chances of blocking a no-deal Brexit, causing both consumer and business confidence to tumble. Johnson's gamble was designed to put pressure on the EU but instead pitted himself against Parliament, which moved swiftly to block his proposed no-deal Brexit. While the probability of a near-term disorderly exit has significantly decreased, neither side seems to have a plan to resolve the key sticking points with Brussels. In the meantime, the move promises further economic uncertainty with another delay and an election likely this year.

Mind the (Trade) Gap

Risk assets have had a turbulent August amid renewed anxieties surrounding trade, with the U.S. announcing new tariffs and Chinese authorities allowing the yuan to weaken against the dollar while halting U.S. agricultural purchases. However, markets rallied into month-end as trade rhetoric abated on both sides despite additional tariffs on key consumer goods, such as electronics and footwear, which are due to go into effect on September 1. While a resumption of dialogue provides hope, the gap that has formed between the two sides from retaliatory tariffs has made the possibility of a near-term substantive deal even more remote. Meanwhile, trade continues to weigh on growth, and the lingering uncertainty is already impacting capital decisions.

Shop Till the Economy Drops

Amid continued manufacturing weakness and a slowing economy, the U.S. consumer appears unfazed as spending (which accounts for more than two-thirds of U.S. economic activity) grew at its fastest rate since 2014. The consumer has benefited from solid wages, a tight labor market, low interest rates, and low inflation as existing tariffs have been largely absorbed by companies to date. However, with the most recently announced tariffs that are expected to take effect in September and December being largely consumer goods focused, the consumer may no longer be immune to the trade war. If companies pass the tariff impacts on to the consumer and demand suffers, recession odds could sharply tick upward.

FIG. 1: British Pound Cross Rates
Five Years Ended August 31, 2019

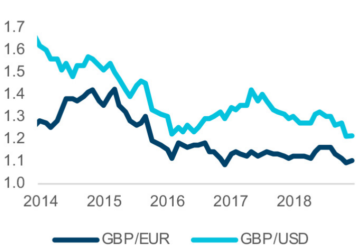


FIG. 2: Inflation: Tariffed vs. Non-tariffed Goods
December 31, 2015, Through July 31, 2019

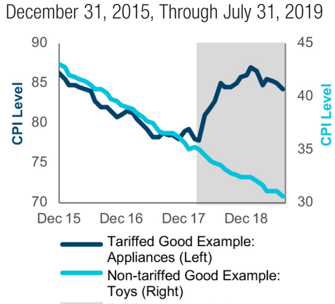
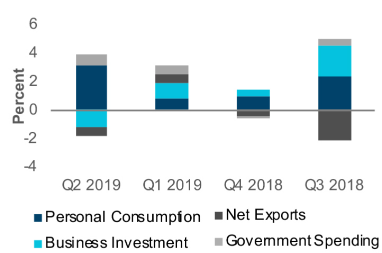


FIG. 3: U.S. GDP Breakdown



Past performance is not a reliable indicator of future performance.
Sources: Bloomberg Finance L.P., financial data and analytics provider FactSet. Copyright 2019 FactSet. All Rights Reserved. Please see additional disclosures on the final page.

REGIONAL BACKDROP

As of August 31, 2019

Developed Europe

Positives

- Monetary policy increasingly accommodative
- Indirect beneficiary of China stimulus
- Dividend yields remain strong

Negatives

- Economic growth remains under pressure
- Geopolitical risks remain elevated (e.g., Brexit)
- Export weakness, vulnerable to trade and China growth
- Limited scope for European Central Bank (ECB) to stimulate further
- Banking sector remains challenged

United Kingdom

Positives

- Wage growth has risen despite Brexit fears
- Inflation has remained on target
- Britain's trade deficit with the rest of the world has stabilized as companies have reduced stockpiling, although this leaves little room for complacency
- Britain's fiscal position provides flexibility for government spending to be increased should the economy weaken

Negatives

- The arrival of new Prime Minister Boris Johnson has increased the chance of a no-deal Brexit, which—if it occurs—could trigger a recession
- Sterling remains very weak amid Brexit concerns
- Purchasing managers' index data continueto suggest slowing business activity

United States

Positives

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

Negatives

- Trade negotiations remain adversarial
- 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
Japan	▪ Expectations for economy and corporate earnings have been marked down significantly given poor economic momentum, creating upside surprise risk ▪ Public investment and domestic consumption should still be positive contributors to economic activity ▪ 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 global economy, which is, at best, stabilizing at below-potential pace ▪ Despite ongoing commitment from the Bank of Japan (BoJ) for ultra-loose monetary policies, there is not much room left for additional easing in case of abrupt economic downturn ▪ Japanese yen (JPY) 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 U.S. dollar (USD) raises earnings concerns
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 ▪ Latest reform on Chinese loan prime rate should improve transmission of monetary policy. Expect some easing but not as significant as in 2015 and during global financial crisis ▪ The Australian economy seems resilient, with business and consumer confidence stabilizing and housing-related downside risks diminishing ▪ The Reserve Bank of Australia (RBA) can continue easing cycle given low inflation and global monetary easing trend. Fiscal stimulus should also help	▪ Full impact of Chinese trade tensions with U.S. yet to be seen, especially regarding capex plans, supply chains, and trade activity. Companies have expressed concerns, while negative impacts from current frontloading expected to be felt later this year ▪ China's firm political stance versus the U.S. might create undesired consequences domestically in the medium term ▪ Optimistic expectations already priced in for the RBA and newly elected government ▪ Year-to-date gains in local equity markets have exceeded peers, limiting further upside. Meanwhile, earnings outlook is stable and unlikely to provide a positive catalyst
Emerging Markets	▪ Muted inflation, more dovish Fed give central banks flexibility to ease ▪ Beneficiary of 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 ▪ Gross domestic product (GDP) forecasts for emerging market (EM) economies continue to decline ▪ Instability in several key markets (Turkey, Argentina) could persist ▪ Slowing long-term China growth trajectory remains a headwind ▪ China stimulus more measured and domestically focused

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

		Change					**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		■				Above-average valuations with risks elevated; equities vulnerable to further political uncertainty and slowing global growth.
	Bonds				■		Yields lower amid slowing global growth, credit fundamentals still supportive, provides buffer to equity volatility.
	Cash				■		U.S. yields most attractive among developed markets but past peak with Fed easing.
	Regions						
EQUITIES	U.S.		■				Earnings growth weakening with valuations elevated. U.S. market less vulnerable to slowing global growth.
	Europe			■			Growth outlook under pressure amid concerns over exports, banking system, and elevated political risks.
	UK			■			Valuations attractive relative to the U.S., but uncertainty due to Brexit is elevated and likely to remain so until the October 31 deadline.
	Japan			■			Trends in corporate governance and monetary policy supportive. Export dependency and stronger yen potential headwinds.
	Asia ex Japan		■				Valuations are still attractive relative to the U.S. While China stimulus measures may flow through to the broader region, the trade dispute between the U.S. and China weighs on the region.
	Emerging Markets				■		More dovish Fed, China stimulus measures, and local currency strength supportive but susceptible to growing trade concerns and earnings weakness.
	Style						
	Global Equity Growth				■		Quality growth bias, less exposed to global growth slowdown, but valuations extended versus history.
	Global Equity Value		■				Cyclical orientation and financials exposure challenged by persistently low rate environment and fading growth outlook.
	Capitalization						
	Global Equity Large-Cap			■			Susceptible to global trade weakness but could benefit from impact of China stimulus.
	Global Equity Small-Cap			■			Valuations reasonable. Weak domestic growth trends and political uncertainty weighing on confidence in key markets.

ASSET ALLOCATION COMMITTEE POSITIONING

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

		Change	Underweight	Underweight	Neutral	Overweight	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.
BONDS	European Investment Grade					■		Yields at all-time lows owing to the rising prospect of a deflationary global economic downturn and a dovish ECB. IG corporate spreads trade tight relative to history.
BONDS	UK Investment Grade	▼			■			Yields touching all-time lows amid weakening growth and modest inflation. Bank of England is likely to stay put until resolution of Brexit.
BONDS	Inflation Linked				■			Inflation expectations low with decelerating growth and hawkish pivot by the Fed.
BONDS	Global High Yield					■		Yield carry attractive with near-term default expectations low but late stage of credit cycle a risk.
BONDS	Floating Rate Loans				■			Yield level remains attractive but step-ups less likely with Fed easing, and liquidity remains a concern.
BONDS	EM Dollar Sovereigns					■		Yields are attractive, central banks supportive, but heightened political uncertainty in several key markets remains a headwind.
BONDS	EM Local Currency					■		Emerging market currency valuation remains attractive, but volatility likely to be elevated over the near term.
BONDS	EM Corporates					■		Yields are attractive relative to fundamentals. Rising country-specific risks are concerning but unlikely to become systemic.
CURRENCIES	U.S. Dollar			■				The USD continues to be relatively well supported on broad measures. Valuations remain a headwind to dollar strength, as does likely upcoming easier monetary policy.
CURRENCIES	Euro					■		Political uncertainties and global trade concerns have grown in recent weeks. Weak economic indicators also continue to weigh on the currency.
CURRENCIES	UK Sterling				■			The recent trends for GBP, a weak economic backdrop, and ongoing uncertainty regarding Brexit fallout have further pressured sterling of late. It has continued to underperform.
CURRENCIES	Japanese Yen					■		The JPY 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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Equity risk—in general, equities involve higher risks than bonds or money market instruments.

Credit risk—a bond or money market security could lose value if the issuer's financial health deteriorates.

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.

Foreign investing risk—investing in foreign countries other than the country of domicile can be riskier due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments.

Interest rate risk—when interest rates rise, bond values generally fall. This risk is generally greater the longer the maturity of a bond investment and the higher its credit quality.

Real estate investments risk—real estate and related investments can be hurt by any factor that makes an area or individual property less valuable.

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Style risk—different investment styles typically go in and out of favor depending on market conditions and investor sentiment.

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