T. Rowe Price
INVEST WITH CONFIDENCE

ASSET ALLOCATION
July 2019

Positioning Your Portfolio for 2H 2019

FIVE KEY THEMES – AND HOW TO PLAY THEM

Yoram Lustig
Head of Multi-Asset Solutions, EMEA

The first half of 2019 is behind us. The MSCI All Country World Index (ACWI) returned 16.6% in US dollar terms over the first six months of the year[1] – the highest return in the first half of any year since the index's inception. Most fixed income indices – across government bonds, investment grade credit, high yield, and emerging markets – have delivered handsome returns as interest rates have fallen from already low levels, and spreads have narrowed from already tight levels. The first half of 2019 was a good one for investors.

Now, as we're looking ahead to the second half of 2019 and into 2020, investors face a range of challenges as well as opportunities: a slowing global economy in a mature economic cycle; central banks preparing for stimulus; low or negative interest rates; steep valuations; and a myriad of geopolitical concerns. It is easy to get scared.

We've narrowed these down to five key themes that we believe will continue to dominate headlines and drive the performance of financial assets in the second half of 2019 and the first half of 2020.

At a time of the year when many investors review their portfolio positioning as secular changes impact nearly all aspect of our lives, we outline our investment ideas to help navigate the environment ahead.

[1] MSCI and its affiliates and third-party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast, or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

THEME 1: Slowing economic growth, the end of the cycle – Finding growth in a low growth world

This current expansionary stage of the economic cycle is the longest on record. A mature cycle does not end just because of old age. Typically, recessions begin because of: significant imbalances in the system; rising inflation and aggressive central banks; or a confidence shock leading to a collapse in demand. As long as we cannot be certain that we have any of the above – or indeed that we do not have any of them – predicting the end of cycles and the beginning of recessions are notoriously difficult.

Global economies are slowing down – *slowbalisation*; debt levels are high and rising; inflation remains stubbornly low, although the labour market is tight; short-term and long-term interest rates are low or negative; and corporate earnings are losing steam after a roaring 2018. As time goes by, investors are increasingly concerned about an economic contraction – with every day that passes, we are one day closer to the end of the cycle.

We have not yet identified any clear signals that a recession is imminent. The cycle could continue for another 12-24 months, or perhaps longer with the help of policymakers. Investors who need their portfolio to generate returns must invest – they do not have the privilege of pulling out and risk missing out on a potential final upward-leg of 25% in equities, in particular when cash and government bonds offer meagre returns. Nobody wants to be the one who stops dancing before the music stops.

The three investment ideas here are: to maintain diversification, to maintain exposure to defensive investments (because we do not know when recession hits) and to favour investments offering growth and income because they are likely to be attractive in a low-growth, low-yield environment.

Investment Ideas

IDEA	Diversification	Defence	High Growth, High Yield
RATIONALE	Diversify risks because we do not know when the cycle ends.	Include investments that should do well when equity markets do not.	Overweight investments offering potential for high growth and high yields.
POSITIONING	• Multi-asset portfolio, investing across global equity and bond markets • Active management, aiming to reposition portfolio based on developments	• High-quality, long-duration government bonds • Safe-haven currencies (e.g. US dollar, Japanese yen)	• Emerging markets equity and debt • Global high yield bonds • Growth equities

THEME 2: Monetary policies – End of the hiking cycle, beginning of an easing cycle

Now that the US Federal Reserve (Fed) has paused its hiking cycle of policy rates, an easing cycle may ensue, depending on data. Never in modern history has an easing cycle begun with the 10-year Treasury yield so low (currently around 2.0%). Meagre inflation, political pressure, and the fear of a recession are all potential reasons for the Fed to ease. No group of Federal Open Market Committee members wants to go down in the history books as the one that derailed the global economy. A lot is at stake.

The situation is different for other major central banks – the European Central Bank (ECB), the Bank of Japan (BoJ), the Bank of England (BoE), and the People's Banks of China (PBoC). They have not had the opportunity to begin a hiking cycle, and they are considering easing and stimulus. Just as we thought that markets were beginning to get over their addiction to quantitative easing, easy money and stimulus, they relapse. Policymakers do not want the economic cycle to end under their watch.

The three investment ideas here focus on currencies, high-quality fixed income and risk assets. A renewed easing cycle may have a profound impact on all these asset classes. The risk is now that the markets expect easing, if central banks fail to deliver the disappointment could lead to a selloff. The key risk is a surprising jump in inflation, leading to a realisation that central banks are behind the curve and raising expectations of faster tightening. In this scenario, a correction in both equities and bonds could occur. This would be problematic for portfolios relying on a negative equity/bond correlation for diversification. Higher US yields could also mean a strong US dollar, providing some protection to clients exposed to US assets.

Investment Ideas

IDEA	Currencies	Investment grade bonds	Risk assets
RATIONALE	Easing Fed with more room to cut rates than other central banks, and relatively slower US economy, may lead to a weaker US dollar.	High-quality government bonds and investment grade credit may get a boost from falling rates in a low inflation and slow growth environment.	As rates fall, the discount factor falls, and the prices of assets may rise further. As long as the economy does not derail, risk assets could benefit.
POSITIONING	• Emerging markets currencies • Japanese yen	• US Treasuries, UK gilts • Global investment grade credit	• Equities • High yield bonds, emerging markets debt

THEME 3: Fixed income – The new abnormal and the role of bonds

We are truly in uncharted territory. Not only have some equity markets recently (once again) reached all-time highs, but also the yields of some government bonds have recently (once again) reached all-time lows. The German 10-year bund yield has reached a level below -0.35% for the first time in history. Some investors need safe-haven assets to hedge liabilities so much that they are willing to pay the German government to keep their cash, instead of earning an interest on it. The yield of French 10-year government bonds fell below zero for the first time. Now, investors who lend money to the French government get paid back less than they have lent. The yields on 10-year Greek bonds reached over 25% in the 2011 Eurozone debt crisis. Now, the 10-year Greek yield is roughly the same as the US 10-year Treasury yield.

The ‘new normal’ for government bonds was supposed to be ‘lower-for-longer’ rates. Globalisation, technology and demographics can all explain a world with modest inflation and modest economic growth, justifying low government bond yields. But negative yields are not a new normal – they are abnormal. With central banks pivoting to easing policy, economic growth slowing down, and inflation remaining low, the negative yields can turn even more negative.

The three investment ideas here focus on the role of high-quality bonds in multi-asset portfolios. The traditional roles of bonds were to generate income – which does not work with negative rates – and to diversify equity risk. Protection from bonds is limited when rates are low – how much further can they fall? – and it is expensive to pay interest on bonds rather than collect interest from them.

Investment Ideas

IDEA	Uncorrelated strategies	Income strategies	Unhedged US Treasuries
RATIONALE	Seek uncorrelated strategies to diversify equity risk when government bonds have limited “fire power” to generate returns when equity markets fall.	When bonds do not provide income, add multiple sources of income to portfolio (coupons, dividends, option writing).	While typically the currency exposure of foreign bonds should be hedged, US Treasuries could play a protective role in portfolios given their yields and US dollar exposure.
POSITIONING	• Active investment strategies with proven low correlation with equity markets. • Derivatives to protect against equity selloffs (e.g. options) and dynamically change equity exposure when risk rises (e.g. managed volatility overlay).	• Multi-asset income (developed and emerging bonds, global equity, REITs, option writing).	• Long-duration US Treasuries – expect relatively high volatility because of currency exposure when portfolio’s base currency is not US dollar.

THEME 4: Valuations – When expensive is too expensive

Many financial markets are at historical extremes – either highs or lows. Years of unconventional monetary policies have pushed interest rates lower and asset prices higher. Valuations mostly matter over the long term – although they can impact short-term sentiment – and at extremes.

Public stocks are arguably not overvalued because earnings have kept up with prices and they are not as expensive as bonds. However, it is difficult to argue that bonds are not overvalued when rates are so low and spreads are so tight. Higher prices today mean lower returns tomorrow. Excess returns – alpha – from active management become more precious when market returns are modest.

At times like these – rich valuations, a mature economic cycle – investors tend to become increasingly nervous. And investor behaviour can become paramount. Our three investment ideas focus on how investors should behave during these stressing times. Uncertain times require a diligent and clear head, calmness in the face of volatility and the unknown, and not being too brave.

Investment Ideas

IDEA	Buy on the dips	Stay calm and carry on	Don't be a hero
RATIONALE	If you believe there is another upward leg in equity markets, assess pull backs to potentially buy on the dips.	Markets are likely to be increasingly volatile, especially after years of low volatility. Volatility is not a risk per se, unless you are a forced seller.	When valuations are stretched it is not the time to take large bets against the benchmark or policy.
POSITIONING	• When equity markets correct, consider buying, resisting selling at possible lows	• Do not panic because of volatility. Be cautious and try to assess when rising volatility is a leading signal to the end of the economic cycle when the time to sell really comes.	• Stay close to benchmark • Use good active managers to help you navigate treacherous conditions and generate precious alpha

THEME 5: Geopolitics – Technology, politics, demographics, trade wars

During normal times, geopolitics can create a lot of noise – but they normally have limited impact on the long-term performance of financial markets. We are not living in normal times.

What we are living through is a number of secular shifts in society – a digital revolution, a political revolution, and a demographics revolution. Technology impacts nearly every aspect of our lives – the way we work, shop, bank, commute, communicate and so on. Populism seems to have changed Western politics and our values. An ageing population may mean that the Japanification of Europe will follow. Things are changing, and they are changing fast.

Global trade disputes between the US and China – and perhaps Europe – are set to continue impacting the global economy, supply chains and corporate earnings. With the 2020 US general election on the horizon, we believe President Trump is likely to try to reach a deal with the Chinese. European politics – Brexit, the situation in Italy – are likely to have a major impact. Regardless of how the Brexit saga ends, one certainty is that its end will remove some uncertainty and markets hate uncertainty. Another geopolitical risk is an escalation of tensions between the West and Iran. Although the oil price is not as sensitive as it used to be to the situation in the Middle East because new technologies offer abundant energy sources in the US, a war could still impact oil prices.

In this complex environment, our investment themes focus on what can go wrong in case of deterioration and what can go right in case of resolution.

Investment Ideas

IDEA	Export-oriented markets	Europe	Natural resources
RATIONALE	Consider markets that have suffered because of trade wars and can benefit from a resolution.	Uncertainty in Europe holds the markets back. Once some uncertainties are cleared – with either good or bad outcomes – markets may have a relief rally after recovering from the initial shock.	A war with Iran might cause oil prices to jump.
POSITIONING	• Japan equities • Emerging markets equities	• European equities	• Natural resources equities

INVEST WITH CONFIDENCE®

T. Rowe Price focuses on delivering investment management excellence that investors can rely on—now and over the long term.

To learn more, please visit troweprice.com.

201907-909003