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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

DECEMBER 2019

MARKET INSIGHTS

As of November 30, 2019

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Let's Get Cyclical!

Cyclical stocks have had an impressive comeback since September, outperforming defensive stocks as investors have become increasingly more confident in the global economy. Trade war abatement, improvement in economic data, and higher bond yields have allowed sectors such as financials and industrials and business services to recover, while other more rate-sensitive sectors such as utilities and real estate have lagged. Global equities outside the U.S., which are more trade-dependent, have also seen a pickup as progress in trade talks has improved sentiment. Although it is difficult to identify catalysts that can support a sustained rally in cyclicals, a potential Phase I U.S.-China trade deal could boost global risk-taking.

What Lies Beneath?

While equity markets are reaching all-time highs, investors in the lowest-quality portion of the high yield market (CCCs) are demanding the highest credit spreads in over three years. A range of challenges, such as secular shifts in consumer spending and low commodity prices, are weighing on some lower-tier companies, causing their spreads to balloon. Fortunately, the broader high yield market has seen its overall quality increase in recent years, with BBs making up nearly half the market. While the risks among CCCs appear contained for now, these companies will be increasingly vulnerable to a downturn.

Changing of La-Garde

As markets question the effectiveness of monetary policy and its diminished range of tools, particularly in the eurozone, the new European Central Bank (ECB) chief, Christine Lagarde, is calling for a new policy mix to combat slowing economic growth and weak inflation. With interest rates already at extremely low (negative) levels and bond buying back, she believes it is an attractive time for countries to increase fiscal spending to provide another means to boost growth. This is easier said than done, as countries with budget surpluses, such as Germany and the Netherlands, have been reluctant to increase their debt levels. If it does materialize, fiscal spending could augment monetary policy by increasing the number of bonds available for the ECB to purchase.

FIG. 1: MSCI ACWI Industrials vs. Utilities
September 30, 2019, through November 30, 2019

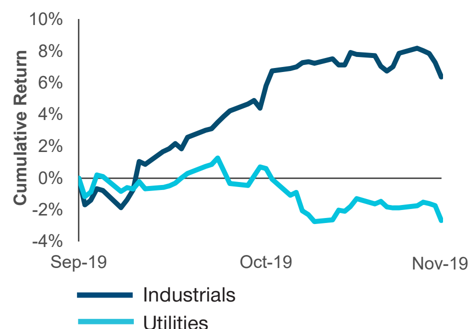


FIG. 2: Global High Yield Index Bifurcation
December 31, 2018, through November 30, 2019

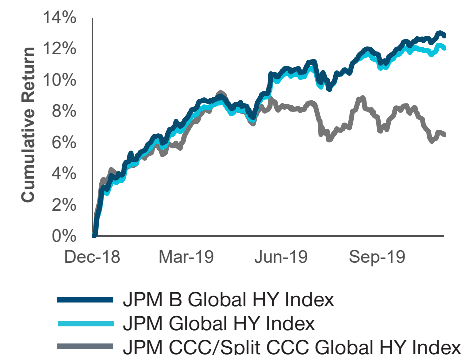
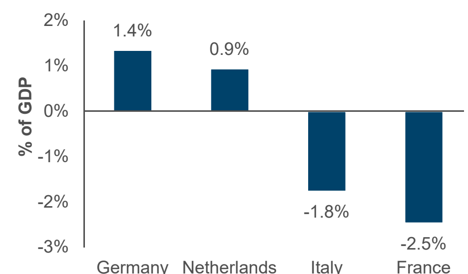


FIG. 3: Fiscal Surplus/Deficit
As of December 31, 2018



Past performance is not a reliable indicator of future performance.

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REGIONAL BACKDROP

As of November 30, 2019

	Positives	Negatives
Developed Europe	▪ Monetary policy remains very accommodative ▪ Beneficiary of trade-related supply chain disruptions ▪ Signs of stabilization in manufacturing ▪ Services sector of the economy resilient ▪ Dividend yields remain strong ▪ Political uncertainty waning	▪ 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
United Kingdom	▪ Wage growth remains positive despite continued uncertainty over Brexit ▪ Inflation remains steady, albeit below target ▪ The 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	▪ Investment remains weak due to persistent Brexit uncertainty ▪ Sterling will continue to make hard yards ▪ PMI data continues to suggest sluggish business activity
United States	▪ Fed likely on hold, inflation low ▪ Growth stabilizing ▪ Healthy consumer spending, strong employment, and improving wages ▪ Low interest rates driving a modest rebound in housing ▪ 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

	Positives	**Negatives**
Japan	▪ Consumer confidence shows signs of rebound after months of slowdown. Need to see a trend develop after the disruptions from the VAT hike and typhoons ▪ The fiscal stimulus should become additive to growth in 2020, focusing on the domestic economy ▪ Japanese stocks remain attractive from a valuation perspective. Meanwhile, corporate and foreigners' buying activities support local markets	▪ Topline 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	▪ The Chinese economy is stabilizing, and leading indicators are pointing to a rebound in manufacturing activity ▪ China's fiscal and monetary policy have room to accommodate further if needed ▪ The Australian economy is expected to improve next year on the back of a rebound in housing prices ▪ Australian business and consumer confidence indices are pointing upward	▪ Macro policies are intended to stop the downward trajectory in growth, not to revive it. The focus is on deleveraging, so expectations for additional stimulus should be measured ▪ Weak industrial production and fixed asset investment data suggest sluggish economic momentum ▪ Beware of overly optimistic expectations already being priced in for the Reserve Bank of Australia ▪ Equity valuations are at record high levels since the global financial crisis, requiring strong earnings growth to compensate for potential price multiple contraction
Emerging Markets	▪ Muted (but rising) inflation and a more dovish Fed have 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 November 30, 2019

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.
ASSET CLASSES	Equities				■			Limited upside with above-average valuations amid fragile global growth. Equity risk premia at high levels to history.
	Bonds				■			Valuations extended with yields low due to growth concerns, trade uncertainty, and muted inflation; credit spreads tight, but fundamentals supportive.
	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.
	Europe				■			Growth outlook stabilizing, but concerns over exports and banking system remain; potential tailwind from monetary stimulus.
	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 and beyond.
	Japan				■			Monetary policy supportive, but VAT increase a near-term headwind; export dependency remains the key driver with recent trends improving.
	Developed 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.
	Emerging Markets					■		Supportive monetary policies, attractive valuations, cheap currencies; susceptible to trade concerns and commodity weakness.
			Style					
	Global Equity Growth					■		Sector profile has defensive and quality growth bias; valuations extended versus history.
	Global Equity Value	▼		■				Stabilization in economic outlook has improved sentiment; longer-term headwinds remain from financial sector concentration, cyclical orientation, and trade.
			Capitalization					
	Global Equity Large-Cap				■			Stabilizing growth outlook and monetary policy supportive but remain susceptible to trajectory of global trade.
	Global Equity Small-Cap				■			Weak domestic growth trends and political uncertainty weighing on confidence in key markets.

ASSET ALLOCATION COMMITTEE POSITIONING

As of November 30, 2019

Underweight — *Neutral* — *Overweight* | ▼ or ▲ Month-Over-Month 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 Class	Change	Underweight (−−)	Underweight (−)	Neutral	Overweight (+)	Overweight (++)	Comment
BONDS	U.S. Investment Grade			■				Yields low on concerns from growth but limited inflation upside. IG corporate spreads still tight relative to history.
	European Investment Grade					■		Historically low yields continue to be underpinned by a dovish ECB. Credit remains trapped in a tug of war between tight valuations and weakening fundamentals and looser monetary policy.
	UK Investment Grade				■			Yields are near all-time lows amid weakening growth and modest inflation. Constructively, no-deal Brexit tail risk has receded and the base case is for an orderly withdrawal.
	Inflation Linked				■			Inflation expectations remain low despite growth stabilization and central bank easing.
	Global High Yield					■		Yield carry attractive with near-term default expectations low. Vigilant on late-stage risks of credit cycle and weakness within lowest-quality segment.
	Floating Rate Loans					■		Yield level remains attractive, especially relative to high yield. Fed pause after mid-cycle adjustment is supportive.
	EM Dollar Sovereigns					■		Yields remain attractive and central banks supportive; turmoil in Latin America and potential contagion remain concerns.
	EM Local Currency					■		Yields attractive with currency valuations near extreme low levels; remain susceptible to political volatility and rising inflation expectations.
	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 has tracked largely sideways of late. December brings likely crystallization of the outlook of near-term U.S. trade policy, particularly with respect to China.
	Euro					■		While overall growth remains weak in Europe, it appears to us to have found a floor. Market participants seem more willing to see a more benign assessment of the recent data trends.
	UK Sterling				■			Sterling has tread water in recent weeks, as a Conservative victory in the forthcoming December election was largely priced in. However, volatility will remain pronounced.
	Japanese Yen				■			The yen has moved sideways during recent months. We expect it to drift weaker over time as global growth improves but the BoJ retains a dovish monetary policy stance.

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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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