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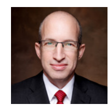
GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

JUNE 2019

MARKET INSIGHTS

As of May 31, 2019



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Fed Put Affirmed, For Now

Equity markets experienced one of the largest Fed relief rallies in history as global central banks policies have pivoted to a more dovish stance in the face of low inflation and moderating growth. However, equity markets reversed course in May as it became evident that a trade deal was not imminent and quickly priced in nearly three rate cuts by the end of 2020. While the Fed has historically cut rates after a sustained pause, such an aggressive retrenchment in policy seems unlikely outside of an outright recession. Recent reassuring comments by Chairman Jerome Powell reinforced the markets' expectation that the Fed put is alive and well. While tough to handicap the outcome of trade, markets think the Fed will provide a backstop if things worsen.

Technology In The Crosshairs

Technology companies have found themselves in the crosshairs of the U.S.-China trade dispute. Not only are provisions on intellectual property, forced technology transfer, and critical technologies at the center of the dispute, the escalation in tensions has had an immediate impact on business sentiment and technology supply chains. With a shaky global growth outlook and waning business confidence, actual capital expenditures could disappoint, particularly in cloud computing, which had been a bright spot in 2018. Additionally, non-tariff barriers, such as blacklisting Huawei, and questions surrounding the supply of rare earth metals represent yet another risk to investors in the technology space. The question remains: Is this simply a temporary setback for business models fueled by secular change, or are the long-term industry dynamics truly in question?

EU Rebuke Of The Establishment

The European parliamentary elections confirmed that the populist surge continues with established parties suffering substantial losses, often at the hands of euroskeptics. The backlash has been increasing as social policies have failed to keep up with the inequalities caused by the liberalization of trade and outsourced manufacturing. Election results in Italy will likely strengthen the ruling anti-EU Lega party's push for fiscal loosening—whereas results in France show a lack of popular support for President Emmanuel Macron's reformist economic agenda. Results in the UK were particularly concerning, as the newly formed Brexit party won the most votes with the governing Conservative party coming in a distant fourth. Unfortunately, investors seeking a safe haven from the political uncertainty prevalent in the U.S. and China are unlikely to find it in Europe.

FIG. 1: Futures Market Expectations for Fed to Cut In 2019
May 2018 to May 2019

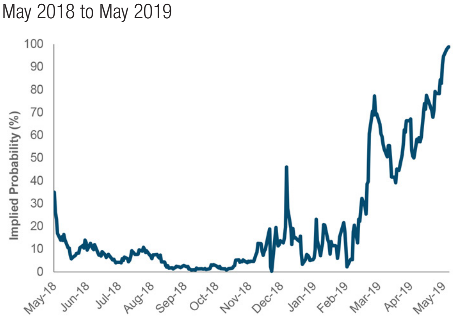


FIG. 2: S&P 500 Industries With Highest Revenue Exposure to Mainland China

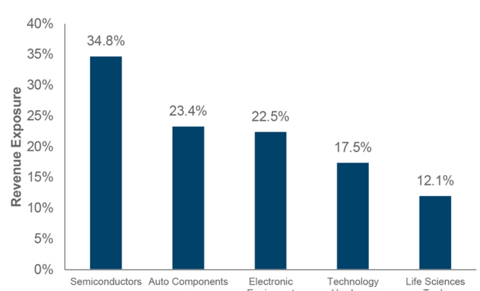
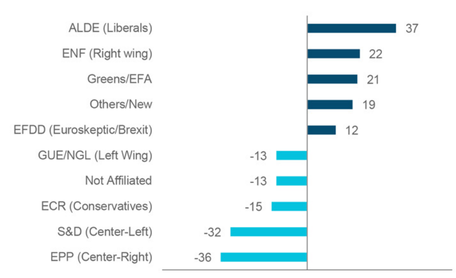


FIG. 3: European Parliament Change in Seats



Past performance is not a reliable indicator of future performance.
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REGIONAL BACKDROP

As of May 31, 2019

	Positives	Negatives
Developed Europe	▪ Monetary policy remains very accommodative ▪ Indirect beneficiary of China stimulus ▪ Economic growth showing signs of stabilization	▪ Eurozone economic growth is muted, with limited scope for the European Central Bank (ECB) to respond ▪ Export weakness, vulnerable to trade and China growth ▪ Banking sector remains challenged ▪ The composition of the new EU Parliament could lead to difficulties
United Kingdom	▪ Unemployment recently fell to 3.8%—its lowest level for 40 years ▪ The extension of Article 50 to October 31 has deferred the prospect of a disorderly Brexit ▪ The delay to Article 50 increases the possibility of a soft Brexit or no Brexit	▪ Political uncertainty remains very high, which could lead to a range of different macroeconomic outcomes ▪ Weak economic outlook likely to continue weighing on sterling ▪ Companies' stockpiling ahead of Brexit will end soon, potentially leading to a capex slowdown
United States	▪ Dovish Fed, 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	▪ Political uncertainty and trade tensions ▪ Moderating economic growth with fading fiscal stimulus ▪ Faltering capex spending and corporate confidence ▪ Late-cycle concerns: tight labor market, rising wages, and elevated margins ▪ Muted near-term earnings expectations ▪ Elevated corporate and government debt levels

	Positives	Negatives
Japan	▪ Given the poor economic momentum, expectations have been marked down significantly, creating upside surprise risk ▪ Expect fiscal stimulus measures to provide some support later in the year, while monetary policy from the Bank of Japan (BoJ) remains committed to easing ▪ Japanese stocks have rarely been cheaper. Improving governance is seen in buybacks and return on equity. This is still underappreciated	▪ Economic activity remains weak, particularly in manufacturing, waiting for external catalysts to form a bottom ▪ Despite the ongoing commitment from the BoJ for ultra-loose monetary policies, there is not much room left for additional easing in case of an abrupt economic downturn ▪ A spike in global risk aversion could trigger an appreciation of the yen
Asia ex Japan	▪ The benefits from Chinese stimulus measures are yet to be seen, with the potential for more measures being announced to support the economy ▪ Chinese corporate earnings are improving while valuations remain attractive. Investor flows have corrected since May ▪ The surprising Australian election results cleared some uncertainties on future economic policies: Tax rebates and looser macro prudential restrictions are expected ▪ The Reserve Bank of Australia seems ready to cut rates. One or more rate cuts this year is progressively becoming market consensus	▪ Uncertainties on U.S.-China trade talks present the major risk. The market is still expecting a trade deal in the near future, which could prove to be too optimistic ▪ Business and consumer confidence in China are likely to be impacted by the trade uncertainties ▪ Recent buoyant price movements in Australia seem disconnected with fundamentals. Risk of a positioning unwind in stocks ▪ The fallout of the housing market contraction is yet to be seen on consumer confidence
Emerging Markets	▪ Muted (but rising) inflation, more dovish Fed gives 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 ▪ 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 ▪ Currencies facing renewed pressure

ASSET ALLOCATION COMMITTEE POSITIONING

As of May 31, 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.

		Change	Underweight	Underweight	Neutral	Overweight	Overweight	
ASSET CLASS	Equities	▼		■				Above-average valuations with risks rising. Equities vulnerable to further political uncertainty and economic weakness.
	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 may have peaked with Fed on hold.
EQUITIES	*Regions*							
	U.S.	▲		■				Earnings growth weakening with valuations elevated. U.S. market less vulnerable to slowing global growth.
	Europe				■			Growth outlook pressured amid concerns over exports, banking system, and elevated political risks.
	UK				■			Valuations attractive relative to the U.S., but uncertainty due to Brexit has been prolonged by the EU's decision to grant a six-month extension.
	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. China stimulus measures are likely to flow through to the broader region, and improving economic activity is expected in the second half of 2019.
	Emerging Markets					■		Valuations attractive amid growing trade concerns and earnings weakness. China stimulus measures and more dovish Fed should be supportive.
	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				■			Exposed to strength of global trade. Upside dependent on 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

As of May 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				■			Yields lower year-to-date amid slowing growth and modest inflation, IG corporate spreads tight relative to history.
	UK Investment Grade					■		Yields are lower year-to-date amid slowing growth and modest inflation. The Bank of England is likely to stay put until the 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 late stage of credit cycle a risk.
	Floating Rate Loans				■			Yield level remains attractive but step-ups 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.
CURRENCIES	U.S. Dollars				■			The U.S. dollar continues to be relatively well supported. Valuations remain a headwind, as does easing growth and fiscal support. However, the incentive to sell remains low.
	Euros					■		Political uncertainties, largely Brexit-related, remain. Weak economic indicators and a dovish tilt to ECB policy continue to hold the currency in check.
	UK Sterling				■			Despite a weak economic backdrop, short-term price action in sterling continues to be primarily Brexit-driven. Valuations remain attractive but are unlikely to matter without political clarity.
	Japanese Yen					■		The Japanese yen has recently been buoyed by risk aversion, despite still-soft economic data.

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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.

Small and mid-cap risk—stocks of small and mid-size companies can be more volatile than stocks of larger companies.

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

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