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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

AUGUST 2019

MARKET INSIGHTS

As of July 31, 2019

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The First Cut Is (Not) the Deepest

As expected, the Fed cut interest rates for the first time since 2008 to "insure against downside risks" and ended the balance sheet runoff two months early. The 25 basis point cut was less than some pundits had hoped and was widely viewed as hawkish following Powell's suggestion that this was a "midcycle adjustment" rather than the start of an easing cycle. However, history has shown that "insurance cuts" are often the first in a series to follow. President Trump's subsequent ratcheting up of the trade war by extending tariffs to nearly all Chinese imports could likely necessitate the need for further easing. With U.S. 10-year treasury yields falling to the lowest level since 2016 on the news, the next cut may be right around the corner.

Brexit—Will Europe Bend to Boris's Hard Line?

On 23 July, Boris Johnson sealed the Conservative Party leadership contest and was named UK Prime Minister. Since then, Johnson has been galvanizing Brexit support and increasing pressure on negotiators with his commitment to renegotiating May's Withdrawal Agreement, deleting the Irish backstop, and assuring exit will occur on October 31st, with or without a deal. With both sides entrenched and just three the months to go, the odds of a no-deal Brexit are perilously high. The uncertainty has sent the pound to a two-year low with further downside likely should a no-deal exit occur. Johnson's slim majority leaves him vulnerable to a no-confidence vote but, even if a general election was called, it is not clear that any single party would gain enough support to stop what is looking more like the inevitable.

Earnings—U.S. Consumer to the Rescue (For Now)

As the 2nd quarter U.S. earnings season winds down, earnings beats have lifted results modestly into positive territory for the quarter, allaying fears of a possible earnings recession. However, slower global growth, a strong dollar, and trade disruption are taking a toll on multi-national companies, especially those with more that 50% revenue exposure outside the U.S., which have posted double-digit earnings declines this quarter. In contrast, domestically-oriented businesses are reporting mid-single digit growth supported by a resilient U.S. consumer. With the ratcheting up of tariffs on goods such as toys, apparel, and smartphones, U.S. consumer spending could retrench, and domestic-oriented companies may start feeling the pain too.

FIG. 1: U.S. Treasury Yield Curves

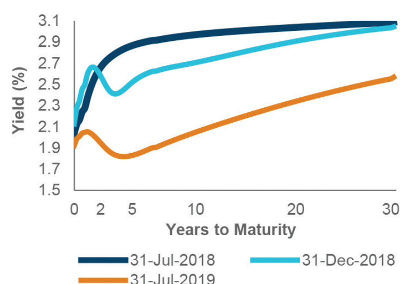


FIG. 2: British Pound Cross Rates
Five Years Ending July 31, 2019

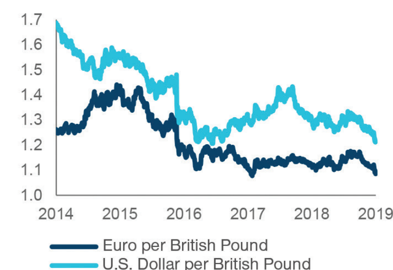
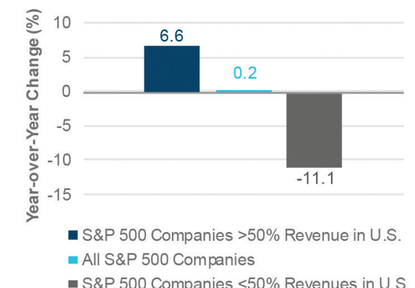


FIG. 3: S&P 500 Earnings Growth: Q2 2019
As of July 31, 2019



Past performance is not a reliable indicator of future performance.
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	Positives	Negatives
Developed Europe	▪ Monetary policy remains very accommodative ▪ Indirect beneficiary of China stimulus ▪ Economic growth showing signs of improvement ▪ Dividend yields remain strong	▪ Economic growth is muted ▪ Limited scope for ECB to stimulate further ▪ Geopolitical risks remain elevated (e.g., Brexit) ▪ Export weakness, vulnerable to trade and China growth ▪ Banking sector remains challenged
United Kingdom	▪ 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 it leaves little room for complacency ▪ Britain's fiscal position provides flexibility for government spending to be increased should the economy weaken	▪ The arrival of new PM 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 ▪ PMI data continue to suggest slowing business activity
United States	▪ 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	▪ 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 ▪ Recent economic data are mixed, but some green shoots are suggesting that slowdown might find a bottom soon ▪ Japanese stocks have rarely been cheaper. Meanwhile, improving governance seen through buybacks and ROE, 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 BoJ for ultra-loose monetary policies, there is not much room left for additional easing in case of an abrupt economic downturn ▪ 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 USD raises earnings concerns. ▪ Trade tensions with South Korea are creating new uncertainties
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 stress areas for small businesses and banks ▪ Economy seems resilient with business and consumer confidence stabilizing and housing-related downside risks diminishing ▪ RBA delivered on expected rate cuts, loosening credit conditions. Fiscal stimulus will also help	▪ Full impact of Chinese trade tensions with U.S. yet to be seen, especially regarding capex plans, supply chains, and trade activity ▪ China's firm political stance 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 set to roll over as specific supply disruptions are progressively resolved
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 ▪ 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

ASSET ALLOCATION COMMITTEE POSITIONING

As of July 31, 2019

▼ 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		Neutral	Overweight		
ASSET CLASSES	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, provide a buffer to equity volatility.
	Cash					■		U.S. yields most attractive among developed markets but may have peaked with Fed cut.
	Regions							
EQUITIES	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, the banking system, and elevated political risks.
	UK				■			Valuations attractive relative to the U.S., but uncertainty is elevated and likely to remain so until the October 31 deadline.
	Japan				■			Trends in corporate governance and monetary policy are supportive. Export dependency and stronger yen potential are headwinds.
	Asia ex Japan			■				Valuations are still attractive relative to 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					■		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 are extended versus history.
	Global Equity Value			■				Cyclical orientation and financials exposure are 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

As of July 31, 2019

Underweight — *Neutral* — *Overweight*

▼ or ▲ Month-Over-Month Change

	Asset Class	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 lower year-to-date driven by dovish ECB. IG corporate spreads tight relative to history, but technical backdrop is supportive.
BONDS	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.
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 the late stage of credit cycle is a risk.
BONDS	Floating Rate Loans				■			Yield level remains attractive, but step-ups are 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 (EM) 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 U.S. dollar continues to be relatively well supported on broad measures. Valuations remain a headwind to dollar strength as does likely upcoming easing monetary policy.
CURRENCIES	Euro					■		Political uncertainties, largely related to Brexit, remain and indeed have grown in recent weeks on the back of leadership changes in the UK. The currency remains in check.
CURRENCIES	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.
CURRENCIES	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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Emerging markets risk—emerging markets are less established than developed markets and therefore involve higher risks.

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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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