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GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

APRIL 2019

MARKET INSIGHTS

As of March 31, 2019

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Risk On!

On the back of the Fed's dovish pivot, risk assets are off to a banner start with the MSCI All-Country World Index (on a local currency basis) and the S&P 500 indexes returning 12.4% and 13.6%, respectively, over the first three months of the year. This is their strongest quarterly return since September 2009 and the best first quarter since 1998. Commodities were also up strongly as oil had its best quarter in almost a decade. Does this foreshadow significant upside for the remainder of the year, or will markets trade sideways from here? Unusually strong starts have historically led to further strength, but with the bond market signaling that the end of the cycle may be near, markets may need another catalyst to carry the torch from here.

Back to Lower for Longer?

Government bond yields around the world continued to slide as dovish signals for both the Fed and the European Central Bank (ECB) sent the yield on the 10-year U.S. Treasury note to its lowest level since December 2017. While the U.S. Fed sees solid underlying economic fundamentals, they have indicated that they are willing to be patient in the face of low inflation and slowing growth and the bond market is pricing in an outright cut in 2019. At the same time, the ECB has further delayed its timeline policy normalization and announced additional stimulus, highlighting concerns about slowing global growth. Is the recent rally in rates simply an extension of the cycle or a harbinger of recession?

Coming in for a (Soft) Landing

China's recent economic slump appears to be stabilizing as the effects of stimulus measures begin to filter through the economy. Chinese fixed asset investment and manufacturing Purchasing managers' Index (PMI) beat expectations last month, thanks to infrastructure spending, with the PMI posting the biggest increase in seven years and the first significant monthly improvement since mid-2018. Additionally, despite ongoing posturing from negotiators from the U.S. and China, both sides seem keen to broker a deal to head off an escalation of a trade war that has been weighing on global sentiment. While clearly positive, will these green shoots be enough to stabilize global growth?

FIG. 1: Asset Class Performance
Price Return in USD as of March 31, 2019

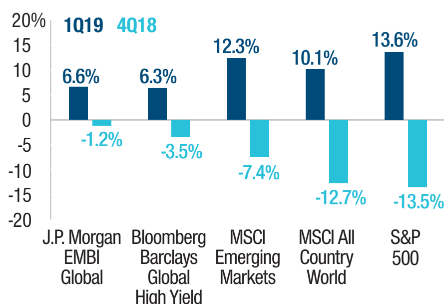


FIG. 2: 10-Year Government Bond Yields
March 31, 2009 to March 31, 2019

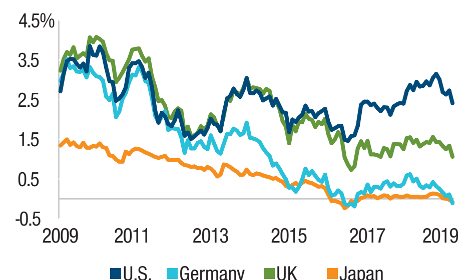
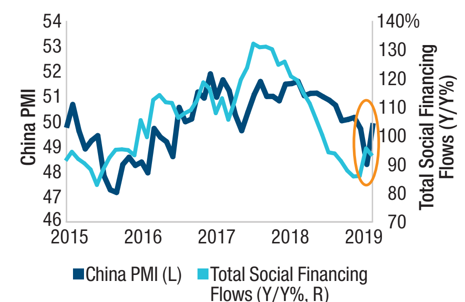


FIG. 3: China Credit Growth vs. China PMI
January 1, 2015, to March 1, 2019



Past performance is not a reliable indicator of future performance.

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Developed Europe	▪ Highly accommodative monetary policy ▪ Indirect beneficiary of China stimulus ▪ Political headwinds in Italy and France have eased	▪ Eurozone economy struggling, with limited scope for ECB to respond ▪ Export weakness, vulnerable to trade and China growth ▪ Political unity remains a concern with Brexit looming ▪ Banking sector remains challenged
United Kingdom	▪ The prospects of a no-deal Brexit seem to have diminished, avoiding “cliff-edge” scenario ▪ A delay to Article 50 increases the possibility of a soft Brexit or no Brexit	▪ Even if Brexit is delayed, political uncertainty will remain ▪ Weak economic outlook likely to weigh on sterling ▪ Firms have been stockpiling ahead of Brexit, potentially leading to a capex slowdown
United States	▪ More dovish Fed, stable inflation ▪ Healthy consumer spending, improving wages ▪ Trade deal with China appears likely ▪ Greater share of secularly advantaged companies than rest of world	▪ Moderating economic growth with fading fiscal stimulus ▪ Late-cycle concerns: tight labor market, rising wages, and elevated margins ▪ Political uncertainty and trade tensions ▪ Deteriorating near-term earnings expectations

Japan	▪ The fiscal stimulus will go into effect in April ▪ The Bank of Japan (BoJ) continues to reaffirm its accommodative policy ▪ Changes to company governance could put Japanese stocks in a better position to benefit from any global recovery	▪ Economic slowdown expected to continue in 2019 ▪ Earnings revisions are pricing in a gloomy outlook ▪ We remain negative on Japanese government bonds due to extended valuations
Asia ex Japan	▪ China stimulus could support regional trade ▪ Earnings revisions are stabilizing, and valuations remain slightly attractive. Recent price actions suggest that the rally may be behind us and further gains would turn more modest ▪ We still believe that a rebound in economic activity is likely in the second half of 2019 ▪ Micro opportunities in Chinese companies are better than the macro picture	▪ Continued policy easing puts pressure on the RMB ▪ Australia is facing a slowing economy with weakness in housing ▪ Australian earnings reports for this quarter are the weakest since the Global Financial Crisis
Emerging Markets	▪ Muted inflation, more dovish Fed give central banks flexibility to ease ▪ U.S.–China trade deal appears likely ▪ Global trade indicators appear to be stabilizing ▪ With growth in tech sector, less tied to commodity cycle	▪ Long term China growth trajectory remains a headwind ▪ Highly linked to global trade ▪ Currencies face renewed pressure ▪ Near-term earnings expectations deteriorating ▪ Instability in Turkey could persist

ASSET ALLOCATION COMMITTEE POSITIONING

As of March 31, 2019

Underweight — *Neutral* — *Overweight* | ▼ or ▲ Month Over Change

		Change	Underweight (strong)	Underweight	Neutral	Overweight	Overweight (strong)	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	Equities			■				Fundamentals and valuations are reasonable, but cycle is aging, earnings expectations are falling, and trade remains a risk.
ASSET CLASS	Bonds					■		Yields are range-bound with modest inflation, and Fed is on hold. Credit fundamentals are broadly supportive amid elevated leverage and moderating earnings.
ASSET CLASS	Cash				■			U.S. yields are most attractive among developed markets but may have peaked with Fed on hold.
	Regions							
EQUITIES	U.S.			■				Earnings growth is moderating with valuations fair. U.S. market is less vulnerable to slowing global growth.
EQUITIES	Europe				■			Growth outlook is weakening amid concerns over exports, banking system, and elevated political risks.
EQUITIES	UK				■			Valuations are attractive relative to the U.S., but uncertainty due to the binary outcome of Brexit needs to be resolved.
EQUITIES	Japan				■			Trends in corporate governance and monetary policy are supportive. Export dependency and stronger yen are potential headwinds.
EQUITIES	Asia ex Japan			■				Valuations are attractive after sell-off, but headwind is global trade as global growth momentum fades and trade war concerns linger.
EQUITIES	Emerging Markets					■		Emerging markets are supported by a more dovish Fed, softer U.S. dollar expectations, China stimulus measures, and easing trade tensions.
	Style							
EQUITIES	Global Equity Growth					■		A quality growth bias has made the asset class less exposed to the global growth slowdown. Valuations have moderated and are in line with history.
EQUITIES	Global Equity Value			■				Cyclical orientation and financials exposure challenged by persistently low-rate environment and fading growth outlook.
	Capitalization							
EQUITIES	Global Equity Large-Cap				■			The strength of global trade remains key. Upside dependent on impact of China stimulus.
EQUITIES	Global Equity Small-Cap				■			Domestic growth trends remain a strong influence. Political uncertainty weighing on corporate and consumer confidence in key markets.

ASSET ALLOCATION COMMITTEE POSITIONING

As of March 31, 2019

Underweight — *Neutral* — *Overweight*   ▼ or ▲ Month Over 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	
BONDS	U.S. Investment Grade					■		Yields remain low with limited concerns from growth and inflation upside. Investment-grade (IG) corporate spreads are wider yet still tight relative to history.
BONDS	European Investment Grade				■			Yields remain low amid slowing growth and modest inflation. IG corporate spreads are wider but still tight relative to history.
BONDS	UK Investment Grade					■		Yields are more attractive the year to date amid slowing growth and modest inflation. Bank of England is likely to stay put until the resolution of Brexit.
BONDS	Inflation-Linked					■		Inflation expectations remain low on slower growth and lower energy prices, making valuation more compelling but lacking catalysts.
BONDS	Global High Yield			■				Yield carry is attractive with near-term default expectations low, but late stage of credit cycle is a risk.
BONDS	Floating Rate Loans				■			Rate reset feature is less attractive with Fed on hold. Loan terms have weakened and liquidity is a risk.
BONDS	EM Dollar Sovereigns					■		Yields are attractive relative to fundamentals supported by slower Fed path and fading country-specific risks.
BONDS	EM Local Currency					■		Despite healthy rebound, emerging market (EM) currencies valuation remains attractive in select areas.
BONDS	EM Corporates					■		Yields are attractive relative to fundamentals. Rising country-specific risks are concerning but unlikely to become systemic.
CURRENCIES	U.S. Dollars				■			The USD continues to be relatively range-bound, defying high valuations and worsening fundamentals. However, the incentive to sell remains low.
CURRENCIES	Euros					■		Political uncertainties, largely related to Brexit, remain while weakening economic indicators continue to hold the currency in check. Valuations remain supportive.
CURRENCIES	UK Sterling				■			Despite an ongoing weak economic backdrop, sterling continues to be primarily driven by Brexit. Valuation is attractive but this matters little without political clarity.
CURRENCIES	Japanese Yen					■		The JPY has stayed relatively weak of late with dovish BoJ commentary and soft data. External balances and valuations remain supportive, however.

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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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