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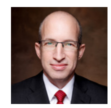
GLOBAL ASSET ALLOCATION: THE VIEW FROM EMEA

OCTOBER 2019

MARKET INSIGHTS

As of September 30, 2019



Yoram Lustig
Head of Multi-Asset Solutions, EMEA

Easy Money, Again

The dovish shift of monetary policy this year has been dramatic as negative trade headwinds and geopolitical uncertainty are weighing on growth. So far, 21 central banks have moved into outright easing mode, which should help stabilize global growth and allay fears of an impending recession. However, monetary policy is at an unusual starting point. After a decade of unprecedented monetary stimulus around the world, rates are already at historically low levels and inflation remains stubbornly low, raising questions on its effectiveness. While policymakers continue to stress that they are ready to do more, policy has been restrained and largely reactive to date, allowing trade negotiations to drive the macro outlook.

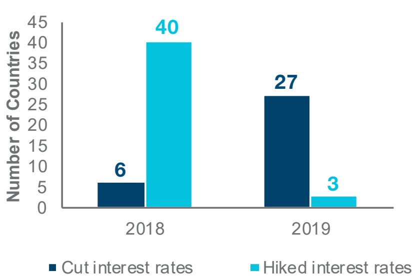
Head Fake?

In late August and early September, equity markets experienced a sharp rotation out of momentum-driven growth stocks into more cyclically oriented value names. This was a significant reversal in leadership, as cyclical companies had long been shunned by investors amid weak global growth while defensive growth stocks continued to lead. Bond markets similarly showed signs of inflection as interest rates bucked their downward trend, reversing a large part of August's steep decline. Was this an unwind of extended growth equity valuations and overly bearish sentiment that sent rates to record lows? Or does the market truly believe that economic growth will pick up enough to sustain earnings and price momentum of cyclical sectors?

Achtung!

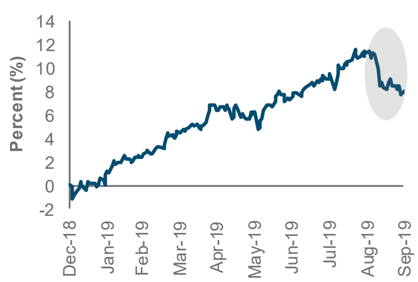
While sentiment within eurozone services has remained resilient, confidence within manufacturing dropped to its worst level in nearly seven years. The decline, largely driven by weakness in Germany (the region's largest economy), has raised fears that Europe may be headed for a recession. Uncertainty surrounding Brexit, trade disputes, and issues in the auto industry have all weighed on growth within the region. Monetary policymakers have already stepped back in to support growth, and after years of austerity, an increasing number of countries are expected to provide fiscal stimulus. The question remains whether policymakers can deliver enough support to avert a third euro-area recession in the past decade.

FIG. 1: Central Bank Action Comparison
As of September 30, 2019



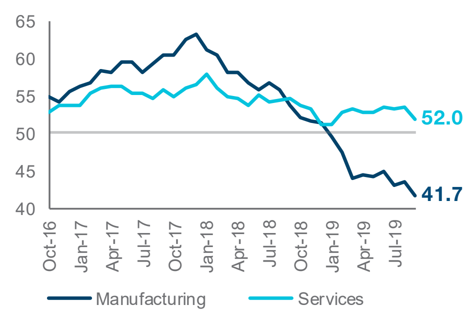
Source: International Monetary Fund (IMF). Analysis based on the 30 largest IMF countries based on gross domestic product (nominal).

FIG 2: MSCI ACWI Index Growth Less Value
December 31, 2018, to September 30, 2019



Shading represents inflection point on the chart. Source: Financial data and analytics provider FactSet. Copyright 2019 FactSet. All Rights Reserved. Based on daily returns.

FIG. 3: Germany PMI
September 30, 2016, to September 30, 2019



Source: Markit Economics Limited. Please see additional disclosures on the final page.

Past performance is not a reliable indicator of future performance.

Developed Europe

Positives

- Monetary policy increasingly accommodative
- Indirect beneficiary of China stimulus
- Services sector of the economy resilient
- Dividend yields remain strong

Negatives

- Economic growth is muted, with notable weakness in the manufacturing sector
- Limited scope for European Central Bank (ECB) to stimulate further
- Export weakness, vulnerable to trade and China growth
- Banking sector remains challenged
- Brexit uncertainty weighing on sentiment

United Kingdom

Positives

- Wage growth has risen despite Brexit fears
- Inflation has remained on target
- Abstracting from short-term volatility due to Brexit stocking, the UK's 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

Negatives

- The arrival of new Prime Minister 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
- Purchasing managers' index (PMI) data continues to suggest slowing business activity

United States

Positives

- Fed easing, stable inflation
- Healthy consumer spending, strong employment, and improving wages
- Lower rates driving a rebound in housing
- Pause in trade war escalation
- Greater share of secularly advantaged companies (e.g., cloud computing, internet retail) than the rest of the world

Negatives

- 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	▪ The domestic-driven economy is doing better than the export side. Retail sales, wage increases, and services PMI are all encouraging data points ▪ Expectations are building for the Bank of Japan to join the bandwagon of global monetary easing, even if its room to maneuver is limited ▪ Japanese stocks have rarely been cheaper. Meanwhile, improving governance seen through buybacks and return on equity, along with increasing number of start-ups, remains underappreciated	▪ Currency appreciation due to a sell-off in risk assets along with Japan's consumption tax hike remain the largest risks for equities ▪ The Japanese yen (JPY) could appreciate given weak valuation, uncertain risk sentiment, and lower interest rate differential with the U.S. A stronger JPY raises concerns for future earnings ▪ Economic momentum remains weak when looking at manufacturing and exports data
Asia ex Japan	▪ Chinese economic data give room for additional policy support, increasing the likelihood of more near-term stimulus even if it remains measured and targeted ▪ The renminbi is likely to remain range-bound, given that expectations should not be one-sided. At this level, the currency should give a breather to export-driven economy ▪ The Australian economy seems resilient, with business and consumer confidence stabilizing and housing data rebounding ▪ The Reserve Bank of Australia can continue with its easing cycle given low inflation, spare capacity in the job market, and the global monetary easing trend. Fiscal stimulus should also help	▪ Chinese credit impulse is losing momentum, while continuous deleveraging is lowering the intended stimulus effects ▪ Uncertainty around trade tensions creates volatile market sentiment and limits any rebound in Asian assets ▪ Weak global trade data continue to weigh on Australian company earnings, although tail risks are lower given policy support. Valuations are elevated based on earnings outlook ▪ The Australian dollar might rebound given attractive valuation and diminishing interest rate differential with the U.S.
Emerging Markets	▪ Muted (but rising) inflation and a more dovish Fed have given central banks flexibility to ease ▪ Equity valuations are 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

ASSET ALLOCATION COMMITTEE POSITIONING

As of September 30, 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	Underweight	Neutral	Overweight	Overweight	
ASSET CLASSES	Equities			■				Limited upside with above-average valuations and risks elevated; fragile global growth and vulnerable to further political uncertainty.
	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 with Fed easing.
Regions								
EQUITIES	U.S.			■				Earnings growth weak on margin pressure and valuations above average; U.S. market less sensitive to global growth concerns and potentially easier comparables in 2020.
	Europe				■			Growth outlook under pressure amid concerns over exports, banking system, and elevated political risks; potential tailwind from monetary and fiscal stimulus.
	UK				■			Valuations attractive relative to the U.S., but uncertainty due to Brexit is elevated and likely to remain so until the October 31 deadline.
	Japan				■			Monetary and fiscal policy supportive; export dependency and stronger yen potential headwinds.
	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 is a headwind.
	Emerging Markets					■		Beneficiary of China stimulus measures, Fed easing, and cheap currencies supportive; susceptible to trade concerns and earnings weakness.
Style								
	Global Equity Growth					■		Sector profile has defensive and quality growth bias; valuations extended versus history.
	Global Equity Value			■				Cyclical orientation and financials exposure challenged by macro environment; cheap valuations beginning to look extreme.
Capitalization								
	Global Equity Large-Cap				■			Central banks supportive, potential beneficiary of further China stimulus; susceptible to global trade weakness.
	Global Equity Small-Cap				■			Weak domestic growth trends and political uncertainty weighing on confidence in key markets.

ASSET ALLOCATION COMMITTEE POSITIONING

As of September 30, 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 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 credit fundamentals.
	UK Investment Grade				■			Yields are near all-time lows amid weakening growth and modest inflation. The weakness in UK data has increased the probability of near-term Bank of England cuts.
	Inflation Linked				■			Inflation expectations low but rising with coordinated central bank easing.
	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 with near-term recession risk low; but step-ups less likely with Fed easing, and liquidity remains a concern.
	EM Dollar Sovereigns					■		Yields are attractive and central banks supportive; idiosyncratic risks and potential contagion remain concerns.
	EM Local Currency					■		Emerging market currency valuation remains attractive; volatility likely to be driven by trade tensions and persistent U.S. dollar strength.
	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 perform well in spite of concerns about slowing growth and easier monetary policy from the Fed.
	Euro					■		With growth remaining weak, a dovish tilt to ECB policy actions, and still-simmering political risks, the euro remains under pressure.
	UK Sterling				■			The recent well-known trends for sterling have done little to dissipate of late. The Bank of England looks poised to ease monetary policy, which helps reinforce the weaker tone.
	Japanese Yen					■		As expected, the previous strength seen in the JPY has dissipated of late. We expect little from the Bank of Japan in terms of policy changes into year-end.

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Even if the asset allocation is exposed to different asset classes in order to diversify the risks, a part of these assets is exposed to specific key risks.

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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