QMA a PGIM company

2020 OUTLOOK & REVIEW

QMA's Global Multi-Asset Solutions Group

KEY POINTS

December 2019

Economic Outlook

- Global growth in 2019 was the weakest in a decade, weighed down by an escalation of the US-China trade war, which hit manufacturing and export sectors hard. Consumer sectors, propped up by strong labor markets and decent wage growth, remained a pillar of strength, preventing a more ominous tumble.
- The US economy slowed from 2018's above-trend pace, as the positive impact of the 2017 fiscal stimulus faded and the US Federal Reserve's 2018 rate hikes resulted in tighter financial conditions at year-end 2018.
- Eurozone growth suffered collateral damage from the US-China trade conflict, as its large manufacturing and external sectors took the biggest hit. Japanese growth held steady at around a trend pace of 1%, as policymakers cushioned the impact of the 2019 consumption tax hike with countervailing fiscal stimulus.
- Emerging markets growth weakened due to continued deceleration in some of the larger countries.
- With global growth weak and inflation running below targets in the major economies, nearly 50 central banks delivered over 100 interest rate cuts, the largest cumulative easing since the financial crisis.
- We expect a moderate improvement in global growth in 2020, rather than a strong rebound, fueled by monetary stimulus, potential fiscal stimulus, and reduced geopolitical uncertainty.
- Given the broad-based easing in 2019, the scope for further easing is limited, especially with rates already near, at, or below zero in many countries. Hence, further stimulus will likely come from the fiscal policy side.
- In the developed world, we see decent odds of fiscal stimulus in the UK, Europe and Japan. In China, fiscal stimulus is ongoing, and many other emerging markets seem likely to contribute.

Investment Outlook

- 2019 was a great year for financial markets, with solid gains across most asset classes. A key driver of stellar equity market performance was the shift from tightening to easing on the part of the Fed, which led to strong valuation expansion for stocks, while earnings were flat to down.
- Stocks also benefited from a reduction in trade tensions and other geopolitical risks at the end of 2019, as the US and China agreed on a phase-one trade deal and the Tory Party in Britain won a big victory in the December elections, which should lead to an orderly Brexit in 2020.
- The macroeconomic backdrop should continue to be supportive of risky assets in 2020. However, 2019 will be a tough act to follow, and we expect global equity markets to deliver returns closer to their long-term historical average.
- Within equity markets, we foresee better returns outside the US and expect non-US stocks to outperform the US after a decade of underperformance. We look for cyclical stocks to outperform defensive stocks and for value to outperform growth.
- Fixed income returns in 2020 are likely to be much lower than in 2019, given current low yields. We expect yields to rise, as growth picks up, but ongoing secular forces should cap yields.
- Within fixed income, we expect outperformance by spread sectors such as US high yield bonds and emerging markets debt relative to US core bonds and international developed sovereign bonds.
- We remain overweight stocks versus bonds in our multi-asset-class portfolios. We expect dollar weakness in 2020, as global growth picks up. Confirmation of that trend would cause us to add some exposure to commodity futures and to reduce cash.
- We see both upside and downside risks to our 2020 base case scenario. Uncertainties related to the US presidential election, renewed US-China trade tensions and fresh recession anxieties headline the potential downside risks. On the flip side, stronger-than-expected growth, combined with an abundance of liquidity, could spark further late-cycle exuberance in equity markets.

Modest Pickup in Global Growth and Continued Gains in Risky Assets

Global growth in 2019 was the weakest in a decade, as rising US-China trade tensions and other geopolitical concerns weighed heavily on manufacturing and export sectors. In contrast, the consumer sector remained a pillar of strength, propped up by strong labor markets with low unemployment and decent wage growth. This prompted a two-track global economy with service sector resilience juxtaposed against the struggling manufacturing sector. With global growth weak and inflation running below targets in many major economies, central banks shifted toward easing in a major way. In 2019, the global economy received over 100 interest rate cuts by nearly 50 global central banks, which represented the largest cumulative easing since the financial crisis.

With rates already at, near, or below zero in many countries, the effectiveness of monetary policy may be muted, but the lagged impact of central bank easing in 2019 is likely to provide a boost in 2020, as global manufacturing indexes are showing signs of bottoming and recovery. Fiscal policy would be more effective in stimulating growth, in our view, but it remains politically difficult, as many major economies are already running high public deficits and debt-to-GDP ratios. Still, the odds are high for meaningful fiscal stimulus in select spots, including China and other large emerging markets, the UK, Japan and the Eurozone.

We believe a global or US recession in 2020 is unlikely. Instead, we see prospects for a modest growth acceleration, driven by a continued supportive stance from monetary policy, potential fiscal stimulus, easier financial conditions and less drag from the trade war. We expect inflation to stay well-behaved in 2020 and inflation pressure to build very slowly.

Financial markets turned in a spectacular performance in 2019, and the macroeconomic environment in 2020 should continue to be supportive of risky assets. That said, 2019 will be a tough act to follow, and we expect global equity markets to deliver returns closer to their long-term historical averages. We expect interest rates to rise in 2020, as growth picks up, but the rise is likely to be contained as central banks stay dovish and secular forces remain disinflationary. Still, fixed income returns are likely to be much lower than we experienced in 2019 given an upward trajectory in rates and lower yields as a starting point.

More important than the overall level of market returns may be the shifts we see in the performance of different market segments. More specifically, improved economic and earnings growth could spark an inflection point leading to a shift in market leadership that includes the following:

- After a decade of underperformance, non-US stocks could outperform US stocks
- The US dollar should weaken, and commodity price performance should improve
- Value stocks should beat growth stocks
- Cyclical stocks should outperform defensive stocks

We see both upside and downside risks to our base case scenario. Risks related to the US presidential election, the US-China trade war and the potential for recession headline the downside risks.

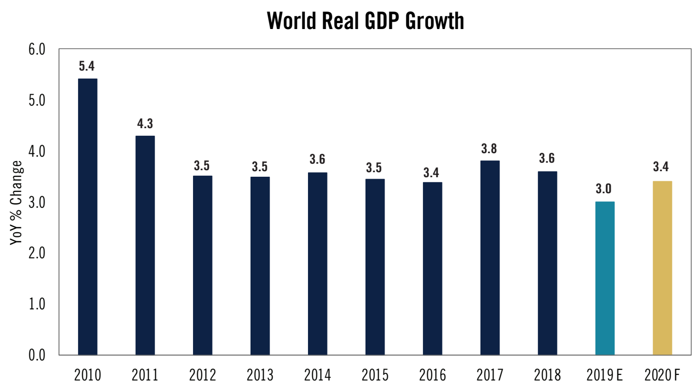
On the flip side, stronger-than-expected growth and an abundance of liquidity could fuel late-cycle exuberance and generate financial market excesses. That might feel great for a time and produce outsized returns again in 2020, but it also might set the stage for a bigger and more painful payback period down the road.

Economic Outlook

The slowdown in global growth that began in 2018 intensified in 2019, with a broad-based slowing in both developed and emerging markets. Disappointing growth resulted from the escalation of the US-China trade war, which weighed on global manufacturing confidence and industrial activity, and from the lagged impact of the US Federal Reserve's 2018 rate hikes and the tighter financial conditions they engendered. Eurozone growth took the biggest hit, as its former growth engine, Germany, sputtered and Italy stagnated. The US economy slowed to trend pace from 2018's above-trend growth due to prior Fed tightening and fading fiscal stimulus from the 2017 tax cuts. Japanese growth stayed steady at around 1% as policymakers cushioned the impact of the 2019 consumption tax hike with countervailing fiscal stimulus. Emerging markets growth weakened due to continued deceleration in some of the larger countries, including China, India, Brazil, Mexico, South Africa, Turkey and Russia.

We expect a moderate improvement in global growth in 2020 rather than a strong rebound (Chart 1). Multiple factors should boost growth, including 2019's broad-based monetary stimulus, fiscal stimulus in select regions, supportive financial conditions and reduced drag from the trade war and Brexit uncertainty. The result should be a bounce back in non-US growth, while US growth stays steady around its trend pace.

Chart 1: 2019 Growth Weakest in a Decade but Likely to Improve in 2020

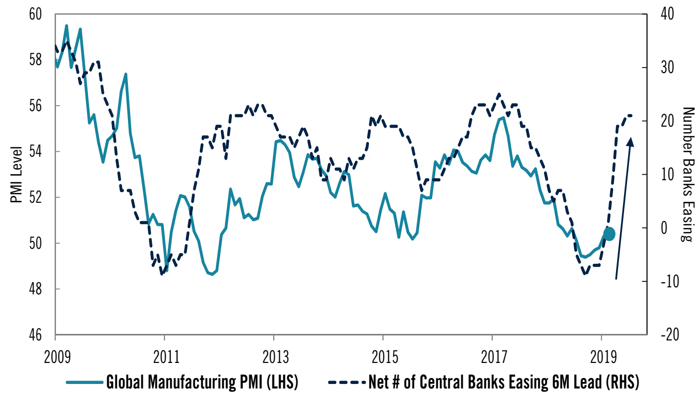


As of 10/31/19.
Source: IMF, World Economic Database.
2019 is an estimate. 2020 is a forecast.

Both the Fed and the European Central Bank (ECB) made sharp policy U turns in 2019. The Fed transitioned from rate hikes to cuts and from balance sheet reduction back to expansion, while the ECB shifted from phasing out quantitative easing (QE) to reinstating it. Chart 2 shows that last year's broad move toward global easing should fuel a continued recovery in the global manufacturing sector. However, the bulk of central bank easing is likely behind us, and there is limited room for additional cuts.

Chart 2: Recovery in Global Manufacturing Should Continue

Net Number of Central Bank Easings vs. Global Manufacturing PMI

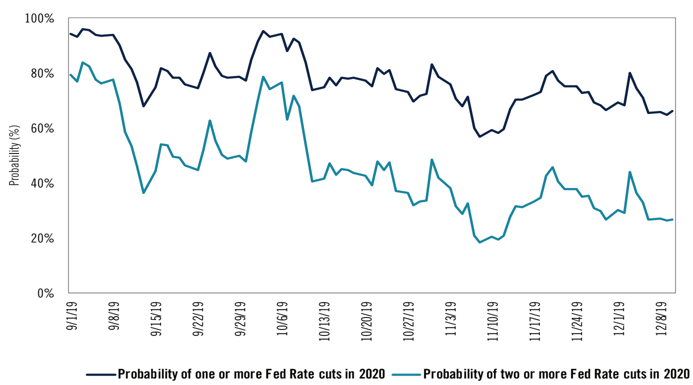


As of 11/12/19.
Source: JP Morgan.

The Fed is likely to keep rates steady, in our view, even though markets are still pricing in a high probability of a cut (Chart 3), but it should continue expanding its balance sheet, which will keep liquidity abundant. The ECB is likely to continue QE, but with rates already negative, further cuts are neither likely nor desirable. The Bank of England, in contrast, is likely to cut rates and undertake fresh QE once new Governor Andrew Bailey takes office in March.

Chart 3: Markets Still See High Odds of a Rate Cut in 2020

Market Implied Fed Expectations 2020



As of 12/10/19.
Source: Bloomberg.

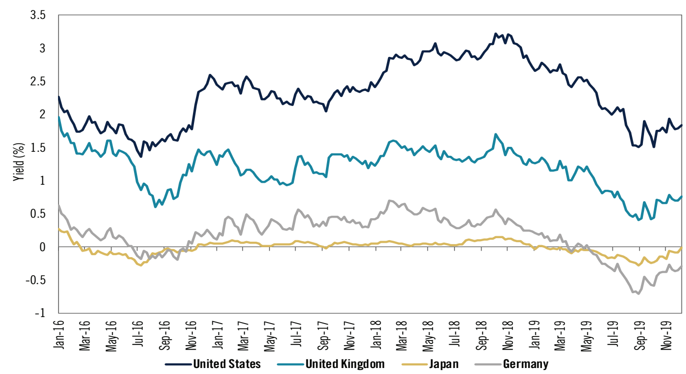
Given the broad-based easing in 2019, many central banks have used most or all of their policy rope and are calling for authorities to pursue fiscal stimulus. In the developed world, we see the UK turning to fiscal stimulus as it tries to deal with the consequences of Brexit. There is a growing consensus on the need for fiscal stimulus in Britain, and with the December election delivering a strong majority for the Tory party, the Johnson government is likely to launch a spending package. Japan and many European Union governments have already announced modest stimulus packages, and perhaps more are coming. With political uncertainty about the future of Chancellor Angela Merkel's coalition behind us, the odds of substantive German stimulus are rising. Fiscal stimulus in China is ongoing, as the country's general government deficit has risen from 3% of gross domestic product (GDP) to 6.5% since mid-2018 on the back of tax cuts for households and infrastructure spending.

Trade tensions, which cast a long shadow over the manufacturing sector, eased at the end of 2019, with a phase-one deal likely to mark a cease-fire in the trade war. This cease-fire should hold through the US elections in November, as President Trump's main rationale for reelection is the solid US economy, and we doubt he would put growth at risk with another escalation of the trade war in an election year. That said, tensions could ramp up again after Election Day regardless of the election's outcome.

We see benchmark interest rates rising in 2020 as growth picks up, but we don't foresee a dramatic move, as ongoing secular forces, including aging populations, high debt levels, slow trend growth and a muted appetite for private sector borrowing are likely to keep the upside in bond yields capped (Charts 4 & 5).

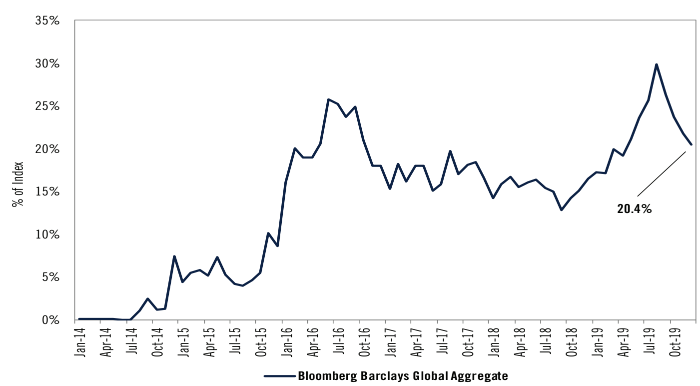
Charts 4 & 5: Some Upside From Here, but Ultra-Low Rates Are Likely to Persist

Global Bond Yields (10-Year)



As of 12/6/19.
Source: Datastream.

Percent of Global Debt with Negative Yield



As of 12/9/19.
Source: Bloomberg.

Summary of Major Regions

United States

The United States economy slowed from a robust pace of 2.8% growth in 2018 to around 2.2% in 2019 in response to the Fed's rate hikes in 2018, the fading impact of the 2017 fiscal stimulus and the global manufacturing slowdown, which spread to the US. Consumer spending was a pillar of strength, while business investment and residential investment spending were drags on growth.

We expect US growth to hold firm at around 2.0% in 2020, driven by continued solid consumer spending and a rebound in housing. We expect business investment will stay subdued, as policy uncertainty in the run-up to the US presidential election is likely to weigh on investment spending. Financial conditions eased substantially in 2019 and are likely to provide a tailwind for growth in 2020. We see the Fed remaining on hold, even as markets are pricing in a high probability of a cut. However, the Fed has resumed expansion of its balance sheet (mainly to ease liquidity strains in the repo markets) and is expected to grow it to $4.5 trillion after having shrunk its balance sheet to $3.8 trillion in 2019.

Eurozone

Eurozone growth slowed sharply to 1.1% in 2019, from 1.9% in 2018, after having grown by a robust rate of 2.5% in 2017. The region suffered collateral damage in the US-China trade war, as its large manufacturing and trade sectors took a hit. Germany, in particular, saw growth flag. Germany's manufacturing sector, at 21% of GDP, is roughly double that of the United States and focuses on the export and production of highly cyclical goods, such as cars, engineering products, machine tools and base chemicals. The Eurozone's largest economy was also weighed down by Brexit uncertainty because of the large percentage of German exports that go to the UK. Italy was another laggard, weighed down by political uncertainty and policy paralysis. However, growth in France and Spain remained healthy.

We expect a rebound in Eurozone growth in 2020, as Germany should benefit from stronger global growth, easing of trade tensions and reduction of Brexit uncertainty. Italy should also gain from an easing of financial conditions and receding political risk. Meanwhile, the ECB continues to provide monetary stimulus, and fiscal policy across the Eurozone is turning more stimulative. Mass strikes in France, political uncertainty in Spain, and structural headwinds for the German auto sector are likely to limit the GDP rebound in 2020, however.

UK

Economic activity in the UK continued to decelerate, with GDP slowing to 1.3% in 2019 due to extended Brexit uncertainty. With Prime Minister Boris Johnson's and the Conservative Party's decisive victory, Brexit uncertainty is on track to decline with an orderly Brexit on January 31, 2020. However, there is potential for fresh uncertainty as the UK and EU negotiate a new trade agreement before the December 31, 2020 deadline. The UK economy is likely to get a boost from the reduction of Brexit uncertainty, fiscal stimulus (spending on infrastructure and the National Health Service) and fresh rate cuts. Consequently, UK GDP growth is likely to strengthen in 2020.

Japan

Japanese economic growth slowed in 2019 to around 1%, as trade tensions took a toll on exports and manufacturing activity. Growth was above trend in the first three quarters, as the government undertook fiscal measures to help offset the impact of October's consumption tax hike, which still is likely to result in a GDP contraction in Q4. Growth should stay steady in 2020. The easing of trade tensions and a potential ¥25 trillion ($230 billion) spending package from the Abe government should boost growth and take pressure off the Bank of Japan to provide fresh stimulus.

Emerging Markets

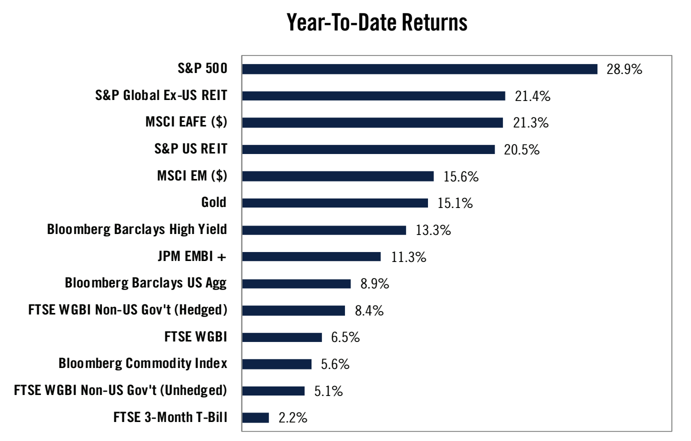
Emerging market (EM) growth slowed to 4.4% in 2019, from 5.1% in 2018, as US-China trade tensions resulted in weaker exports, depressed business confidence and declining investment spending in Asia's export-driven economies. China's growth slowed to 6.1%, from 6.6% in 2018, on the double whammy of the trade war and the effects of policy-induced deleveraging. In other large emerging markets, such as India, Brazil and South Africa, the positive impact of favorable election outcomes was offset by a slower pace of structural reforms. Meanwhile, sharp currency depreciations and policy uncertainty in Argentina and Turkey were a drag on growth in those economies. Emerging market central banks cut rates sharply in 2019 amidst a benign inflation backdrop and slowing growth.

EM growth is likely to improve in 2020 as emerging markets ex-China growth recovers. Multiple factors should provide growth tailwinds, including easing trade tensions (which should boost manufacturing confidence and investment spending), the positive impact of 2019's rate cuts, fiscal stimulus in many Emerging Markets, progress on much needed structural reforms in India and Brazil, lower oil prices and a reversal in US dollar strength. China's growth should at least stabilize with support from easing trade tensions, fiscal and monetary stimulus and the curtailment of the economy's deleveraging.

Market Outlook

2019 was a fantastic year for financial markets, as we experienced robust returns across most asset classes (Chart 6). A 60/40 balanced portfolio posted a 20% return for the first time since the late 1990s.[1] The year's stellar gains for global stocks were driven entirely by valuation expansion, as S&P 500 companies grew earnings by just 1%, while international developed market and emerging market equities saw declines of 3% and 8%,[2] respectively. The key driver of multiple expansion was the sharp pivot from tightening to easing on the part of the US Federal Reserve, the European Central Bank and other global central banks during the year.

Chart 6: 2019: A Tough Act to Follow



As of 12/13/19.
Source: FactSet.

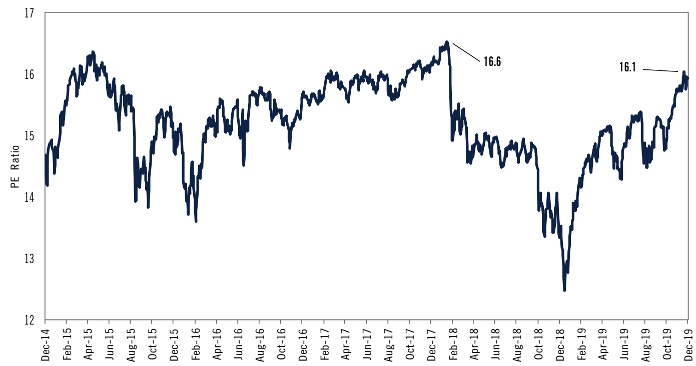
[1] 60% allocation to the S&P 500 and 40% to the Bloomberg Barclays Aggregate Bond Index.
[2] MSCI EAFE Index and MSCI Emerging Markets Index.

2019 will be a tough act to follow, but we expect risky assets to grind higher in 2020, as an improvement in global growth drives a recovery in corporate earnings growth. For US equities, we foresee total returns in the range of 6% to 10% on corporate earnings growth of between 3% and 7%. We see the potential for both higher returns and more robust earnings growth in overseas markets. Stocks usually outperform bonds when global growth is accelerating, provided central banks are not hiking rates to snuff out inflation. With growth on the upswing, interest rates are likely to rise, as investors price out odds of rate cuts, putting downward pressure on bond prices.

Relative valuation also favors stocks over bonds. Despite the big rise in the MSCI All Country World Index (ACWI) forward price/earnings ratio (Chart 7), this index still trades at a reasonable 16.1 times earnings. While that is in the 86th percentile relative to its 20-year history, it is still below the current cycle's previous highs. Meanwhile, the gap between the earnings yield on stocks and the yield on bonds remains wide relative to history, suggesting that stocks still offer an attractive forward-looking risk premium over bonds.

Chart 7: Expanding Valuation Drives 2019 Stock Market Performance

MSCI All Country World Index P/E (Next 12 Months)



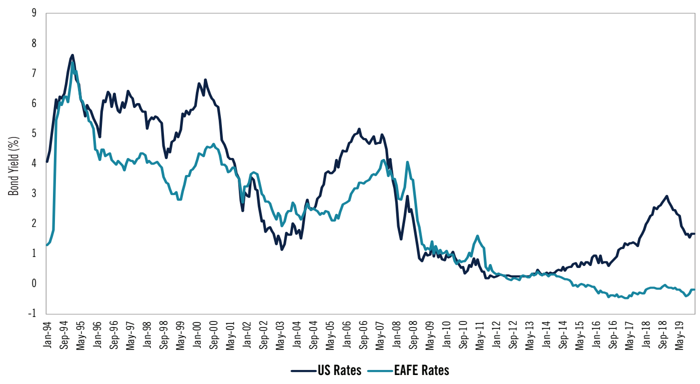
As of 12/9/19.
Source: FactSet.

The growth acceleration we foresee would be driven by a bounce back in growth outside the United States and the continuation of the US's current growth rate of about 2%. The past couple of years have been characterized by growth divergence, with the US significantly outpacing the rest of the developed world, which did not benefit from the fiscal stimulus and strong consumer spending that revved up the US economy. In contrast, 2020 should be a year of convergence, as fiscal policy turns more supportive in the Eurozone, Japan and the UK, and the fiscal support from the 2017 tax cuts fades in the United States.

With the growth differential between the US and the rest of the developed world expected to shrink, interest rate differentials have narrowed (Chart 8). This, combined with the trade war truce, large US fiscal and trade deficits, and a US dollar that is expensive on both a purchasing-power-parity and real-effective-exchange rate basis, means we have most likely seen a near-term peak in the US dollar. A stable-to-declining dollar, better global growth (especially in emerging market economies) and improved trade and manufacturing activity should underpin the demand for commodities and help fuel another year of commodity price gains, after a dismal decade for that asset class.

Chart 8: US Interest Rate Advantage Narrows

2-Year Sovereign Bond Rates



As of 12/2/19.
Source: Bloomberg.

Regional Equity

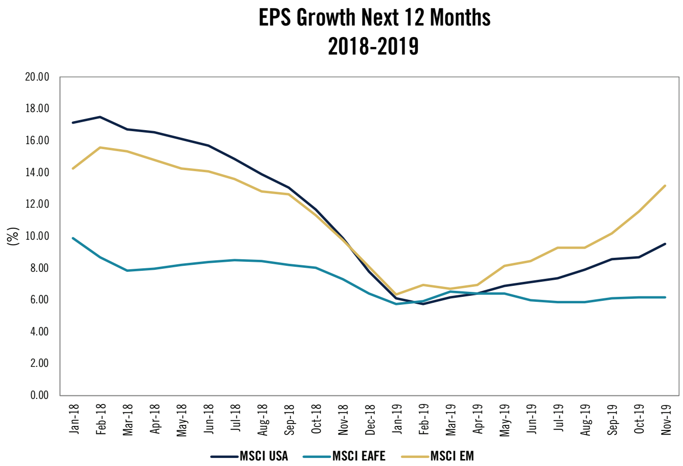
We have been overweight US stocks for most of 2019 but have slowly and steadily been shifting exposure toward foreign markets. US stocks have dominated not only in 2019, but also the past decade, outpacing the rest of the world's stocks by 8% in 2019, and by 180% cumulatively over the past 10 years.[3] We foresee a swing back toward non-US markets over the next decade, consistent with the views expressed in our capital market assumptions. During the decade that preceded the most recent one (2000 to 2009), non-US stocks outperformed US stocks by 40% on a cumulative basis.

US outperformance in 2019 was driven by an improvement in its relative economic and earnings growth advantage, its safe haven status in the face of rising trade tensions and slowing growth, and its heavy exposure to the tech sector, which was the best performing global sector (up 45%). We think many of these factors may reverse in 2020, to the benefit of international markets. Further, non-US equities are trading at much more attractive valuations than are US stocks.

Currently, our overweight in global equities reflects relatively balanced exposures among the major regions. We see many variables aligning for a catch-up in emerging markets performance, namely diminished trade uncertainty, improvement in global trade flows, improved growth and liquidity trends, and a weaker dollar. In EAFE markets, we're watching for more definitive signs of a pickup in industrial production and improving consumption in Europe, perhaps fueled by more aggressive fiscal stimulus out of Germany. We would also like to see the same kind of pickup in 12-month forward earnings growth expectations for EAFE markets that we are seeing in the United States and emerging markets (Chart 9). As the year progresses, risks related to the outcome of the US presidential election could weigh on sentiment toward US stocks.

[3] S&P 500 return vs. MSCI ACWI Ex US total return.

Chart 9: Earnings Growth Expectations Are Picking Up, but EAFE Markets Are Lagging



As of 11/30/19.
Source: FactSet.

Styles

Growth stocks crushed value stocks in 2019 and cumulatively over the past decade, with growth outperforming value by 9% and 101%, respectively.[4] This outperformance has generated a massive discrepancy in relative valuation, which QMA highlighted in a recent QMA paper called *Value/Growth: The New Bubble*. We expect a reversal toward value over the next decade and point out that value outperformed growth in the decade before the most recent one (2000 to 2009) by 65%.

What could spark a rotation toward value in 2020? In addition to extreme undervaluation (value has never been this cheap relative to growth on certain measures), we expect the profits cycle to turn up in 2020. When profits are scarce, investors are willing to pay a bigger premium for growth; when growth broadens out, investors tend to seek out cheaper opportunities.

Fixed Income

Fixed income returns in 2020 are likely to be far lower than they were in 2019 due to very different starting points for yields. For example, the 10-year US Treasury yield started 2019 at 2.72%, while it currently stands at 1.87% (as of December 17, 2019). The year-to-date return on the 10-year US Treasury is 9%. Assuming the 10-year yield will rise to 2.25% by the end of 2020 (a 38-basis-point increase), the approximate total return at the end of 2020 would be -1.6%. The returns on Eurozone bonds are likely to be even more negative, with yields likely to rise from current negative/low levels.

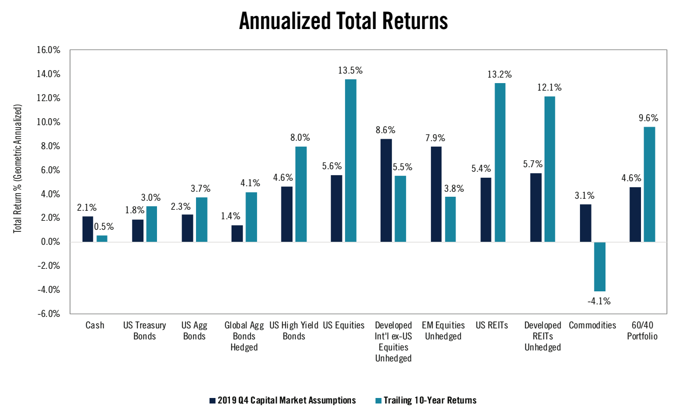
We plan to continue overweighting spread sectors, such as US high yield bonds and emerging markets debt relative to US core bonds and international developed sovereign bonds. While spreads are tight and the credit cycle is mature, the benign economic environment we foresee means that spreads should stay reasonably steady in 2020. Despite high levels of debt, interest coverage in the United States remains above levels that preceded previous recessions. To wipe out excess performance relative to comparable-duration Treasuries, we would need to see high yield spreads rise by about 110 basis points in 2020. A bounce back in EM growth and a weaker dollar in 2020 should support emerging market debt performance.

[4] Russell 3000® Growth and Russell 3000® Value.

The Next Decade Is Likely to Look Very Different from the Last One

The turn of the calendar this year represents not just the start of a new year, but also the dawn of a new decade. The past decade was a rewarding one for investors in US assets, as a 60/40 portfolio, comprised of the S&P 500 Index and Bloomberg Barclays Aggregate Index, realized a robust annualized return of 9.6%. Over the next decade, we believe that same portfolio is likely to generate a far lower return, based on our Capital Market Assumptions (CMAs). We project a much lower return for US equities over the next decade due to lower expected growth in corporate profits and valuation compression, as expensive US valuation reverts toward its longer-term equilibrium. Fixed income returns are likely to be lower, as well, mainly due to a lower yield starting point. In contrast, international and emerging market stocks had a very poor decade, underperforming US stocks by a wide margin. We expect average returns in these markets to improve over the next decade and beat US equities by a comfortable margin, mainly due to better valuation and, in the case of emerging markets, higher profit growth. For more details, please see the 2019 Q4 Capital Market Assumptions publication.

Figure 1: Last Decade Returns vs. Next Decade Expectations



As of 9/30/19.
Source: QMA, FactSet.

QMA's Tactical Asset Class Views (December 2019)

Asset Class	–		Neutral		+
Stocks				●	
Fixed Income		●			
Real Estate		●			
Commodities		●			
Cash				●	
Stocks					
US				●	
EAFE				●	
Emerging Markets				●	
Fixed Income					
US Core		●			
TIPS		●			
High Yield			●		
Non-US Dev. Sov. Bonds		●			
EMD			●		

Source: QMA.
For illustrative purposes only. Positioning subject to change.

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ABOUT QMA

QMA began managing multi-asset portfolios for institutional investors in 1975. Today, we manage systematic quantitative equity and global multi-asset strategies as part of PGIM, the global investment management businesses of Prudential Financial, Inc. Our investment processes, based on academic, economic and behavioral foundations, serve a global client base with $121.6 billion in assets under management as of 9/30/2019.

Notes to Disclosure

Sources: QMA, MSCI, FactSet, Bloomberg, Baker, Bloom & Davis, Thomson Reuters Datastream, JPMorgan, Markit, Oxford Economics. **This is intended for Professional Investors only. All investments involve risk, including the possible loss of capital. Past performance is not a guarantee or a reliable indicator of future results.**

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