Q3 2019 OUTLOOK & REVIEW

QMA's Global Multi-Asset Solutions Group

KEY POINTS

July 2019

Economic Outlook

- Global growth conditions are currently among the weakest since the financial crisis, and growth risks have increased from further escalation of geopolitical tensions.
- Tariffs have not yet taken a big bite out of economic activity, but if trade hostilities intensify, the effects of higher tariffs and supply chain disruptions could snowball and push the global economy into a full-fledged recession.
- Gross Domestic Product (GDP) growth surprised on the upside in Q1 in the U.S., Eurozone, UK, Japan and China. However, Q2 growth in the major economies is now expected to be soft as a payback for the solid Q1 growth.
- Strains in trade relations and slowing global growth have increased uncertainty around the emerging markets growth outlook.
- With muted inflation, global central banks are embarking on a fresh round of reflation by cutting rates to cushion the growth slowdown. In fact, many of them have indicated a willingness to cut rates even further, if needed.
- The jury is still out as to whether central banks are ahead of the curve and will succeed in engineering the elusive soft landing or whether the current dovish shift will be viewed as too little too late in retrospect.
- In the U.S., the yield curve has inverted—an ominous sign of a looming recession. However, other reliable indicators, such as high yield credit spreads, initial unemployment claims, and the Conference Board Leading Economic Index® (LEI) do not paint the same alarming picture.

Investment Outlook

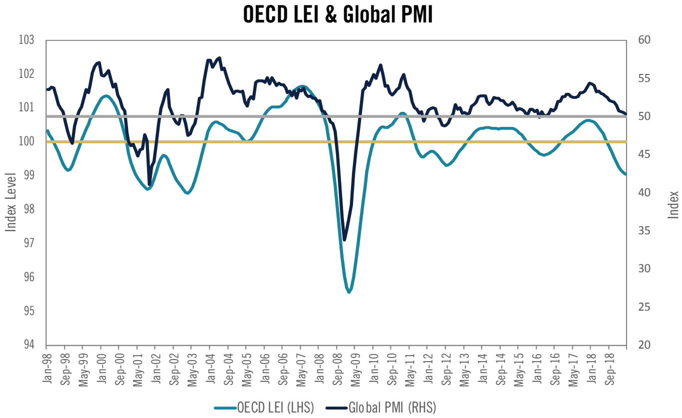
- Our view is that U.S.-China interests have permanently diverged and should be viewed in the context of a geopolitical competition that is unlikely to be resolved by a trade deal. Thus, the current tensions are likely to persist for some time.
- However, tensions are likely to ebb and flow, and a positive scenario for risky assets could involve a trade truce ahead of the presidential election year, along with continued central bank dovishness and more China stimulus.
- The strong bounce-back for risk assets, along with the reescalation of the U.S.-China trade tensions, convinced us to initiate de-risking trades in early May, including shifting back to neutral in global stocks, holding additional cash, and buying some Treasuries.
- We pulled back our emerging markets exposure toward neutral early in the second quarter (please see *Hitting the Pause Button on Emerging Markets Equities*) bringing exposure back to U.S. stocks. We currently maintain balanced exposure among U.S., international developed market and emerging market stocks.
- We also trimmed our exposure to fixed income risk assets in our multi-asset portfolios. We are overweight U.S. cash given the positive real yield and the lack of yield pickup available further out the maturity curve. Within fixed income, we have shifted exposure away from U.S. high yield bonds and emerging market debt (hard currency) to core bonds.
- We are underweight commodity futures as global growth conditions remain soft, inflation pressures stay muted, and the U.S. dollar's strong run continues.

Central Banks Counter Rising Geopolitical Risk with a Healthy Dose of Liquidity

Economic Outlook

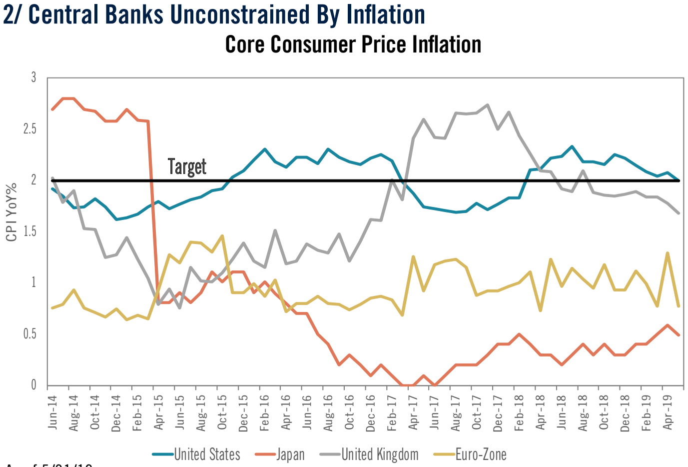
Global growth conditions are currently among the weakest since the financial crisis, and leading indicators show no signs of a turnaround yet (Chart 1). At the same time, we have seen a sharp rise in growth risks from further escalation of trade tensions. With inflation rates still running at or below their targets (Chart 2), global central banks are grabbing their liquidity fire hoses.

1/ Global Growth Still Slowing



As of 5/31/19.
Source: Datastream, JP Morgan.

2/ Central Banks Unconstrained By Inflation

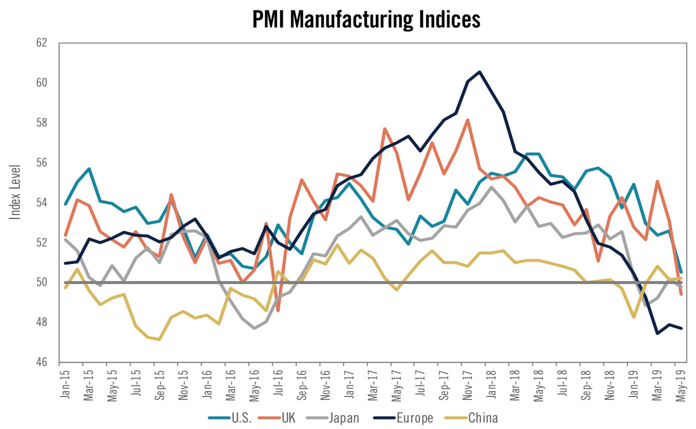


As of 5/31/19.
Source: Datastream.

Trade tensions ramped up in a major way during the quarter, prior to which it appeared the U.S. and China were on the verge of a deal. U.S.-China talks broke down in early May, however, and the Trump administration raised tariffs from 10% to 25% on $200 billion of Chinese exports. The U.S. threatened and then ultimately postponed auto tariffs on Europe, Japan, and Korea. Mexico also unexpectedly found itself targeted for U.S. tariffs as the Trump administration decided to weaponize trade to get the Mexican government to further stem the flow of illegal immigrants across the U.S. southern border. The U.S. and Mexico ultimately reached a deal and the tariffs were not implemented, but the threat of tariffs still hangs over the markets/economy like the sword of Damocles. Finally, Brexit claimed the head of another UK Prime Minister, and odds of a "No Deal" Brexit have increased, given the shape of the Tory leadership race. This raises risks for the UK's future trade relationship with the European Union.

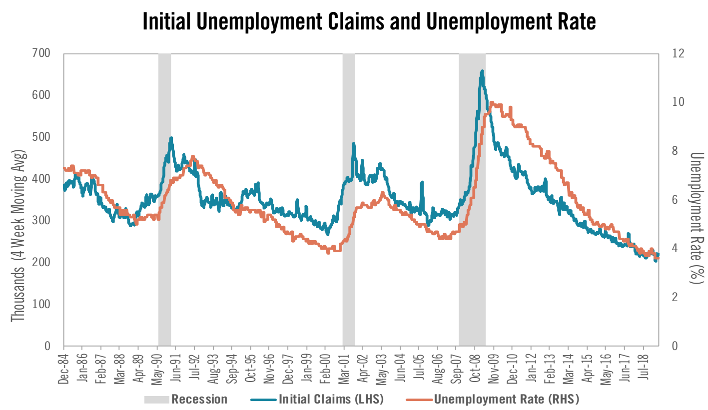
Tariffs have not yet taken a big bite out of economic activity, as their direct impact on growth has admittedly been small. However, the second-order effects could increase if business confidence (Chart 3) and risk appetite continue to decline. The U.S. yield curve is currently inverted, which historically has signaled a looming recession. However, other indicators, such as initial unemployment claims (Chart 4), The Conference Board's Leading Economic Index® and high-yield spreads, are not validating the ominous signal from the yield curve. Nevertheless, if trade hostilities intensify, the effects of higher tariffs and supply chain disruptions could snowball and push the global economy into a full-fledged recession.

3/ Trade Tensions Take Toll on Business Confidence



As of 5/31/19.
Source: Haver Analytics, Markit.

4/ U.S. Labor Market Remains Robust



As of 5/31/19.
Source: Datastream.

Responding to these risks, the global central bank cavalry—unconstrained by inflation pressures—is attempting to ride to the rescue. In fact, more than 16 central banks (including Australia, India, Russia, Indonesia and Chile) cut rates during the second quarter and have indicated a willingness to cut rates further, if needed. The European Central Bank (ECB) recently signaled that rate cuts and a resumption of asset purchases would be forthcoming if growth or inflation falls short of its expectations. The U.S. Federal Reserve did not cut rates at the June meeting but joined the ECB in signaling its readiness to cut rates going forward. Several emerging market central banks have either cut rates or shifted to a dovish stance, with the People's Bank of China cutting rates several times and undertaking other measures to inject liquidity.

The jury is still out as to whether central banks have gotten ahead of the curve and will succeed in engineering the elusive soft landing or whether the current dovish shift will be viewed as too little too late in retrospect.

Discussion of Major Regions

The **U.S. economy** posted an upside growth surprise with first-quarter Gross Domestic Product (GDP) growth of 3.1%, defying expectations of a slowdown due to the U.S. government shutdown, winter storms and trade uncertainty. Since the Q1 surprise was led by strong contributions from inventories and trade, there is likely to be payback in Q2 with growth downshifting to 2.0%. U.S. growth continues to be underpinned by still-healthy consumption spending due to a strong labor market that continues to create about 150,000 jobs per month and a 3.6% unemployment rate, the lowest in 50 years. On the other hand, investment spending is likely to remain soft with business confidence weakening as trade tensions mount.

In the **Eurozone**, the economy managed to halt its growth downtrend with better-than-expected Q1 GDP growth of 1.6% led by consumer spending. Growth was solid in Spain (+2.8%), steady in France (+1.2%), and recovering in Germany (+1.6%). Italy emerged from recession with a 0.8% increase in GDP growth. Looking ahead, Eurozone growth is likely to remain below trend, which is around 1.5%, as business confidence has fallen into contractionary territory in most Eurozone economies. The UK economy managed to post healthy 2.0% growth in Q1 despite ongoing Brexit uncertainty. However, continued uncertainty and increased odds of the UK crashing out of the EU without a deal is likely to depress confidence and activity.

The **Japanese** economy also surprised to the upside with stronger-than-expected Q1 GDP growth of 2.2% on the back of positive contributions from trade and inventories. However, risks to growth have increased as business confidence, especially in manufacturing, has moved into contraction territory and will likely depress businesses investment spending. Meanwhile, consumption spending remains solid as consumers front load purchases ahead of the consumption tax hike scheduled in October. While there is speculation the tax hike might be delayed due to external weakness, the hike remains on track for now with the government rolling out several stimulus measures to cushion the impact of the tax increase on consumer spending and the Japanese economy. Despite these measures, growth is still expected to turn negative in late 2019 before rebounding early next year.

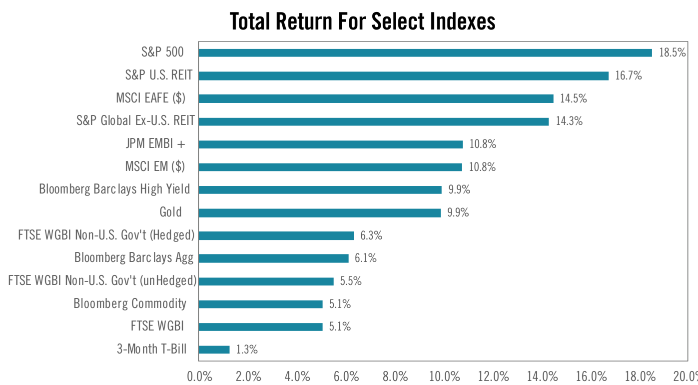
Emerging market economies benefited from the easing of global liquidity conditions in early 2019 as the Fed and other central banks stopped tightening and moved to an easing bias. Emerging market GDP growth stabilized in early 2019 and appeared on track to strengthen over the course of the year, driven by China stimulus, easing of trade tensions in Q1, lower oil prices and emerging market central banks moving to an easing bias after rate hikes in 2018. However, the reescalation of U.S.-China trade tensions and slowing global growth have increased the uncertainty around the emerging markets growth outlook. Business confidence, which had weakened over 2018, has since recovered. However, confidence levels are still barely positive and may deteriorate again if the trade uncertainty intensifies.

In **Asia**, the Chinese economy lost momentum in Q2 after a positive start in Q1 as trade tensions escalated. However, the Chinese government has been quick to announce additional stimulus measures to support the economy, and growth is expected to stabilize. In India, Q1 growth disappointed but is expected to rebound with Reserve Bank of India rate cuts and the removal of political uncertainty after a solid win for the incumbent government. In **Latin America**, growth expectations have been revised lower with already-soft growth in Brazil and Mexico slowing. In **Eastern Europe**, Russia is relatively insulated from the ongoing trade tensions but could suffer collateral damage as the decline in oil prices puts pressure on the economy.

Investment Outlook

After turning in a fantastic performance in the first quarter of 2019, global stocks delivered more modest but still solid, returns in the second quarter of 2019. The quarter proved volatile for equities with May's sharp declines bookended by solid returns in April and a buoyant rebound in June. The strong year-to-date bounce-back for risky assets (Chart 5), combined with the latest reescalation in U.S.-China trade tensions convinced us to initiate de-risking moves in early May, resulting in a pull back to neutral exposure to global stocks. We also trimmed our exposure to fixed income risk assets in our multi-asset portfolios.

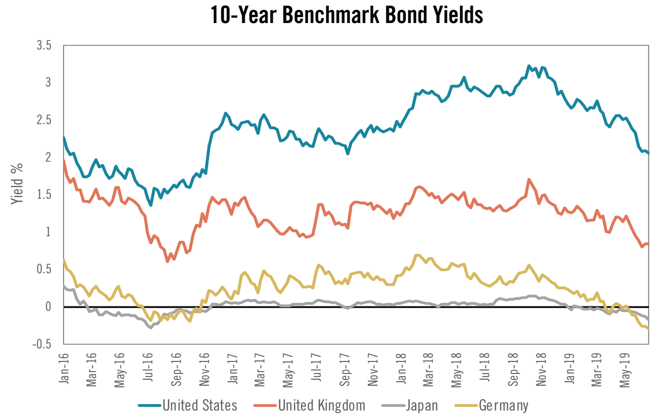
5/ A Great First Half for Financial Markets (2019 YTD)



As of: 6/28/19.
Source: Factset.

Looking forward, financial markets continue to be caught in the cross currents of the escalating trade war and the potential for more monetary stimulus. Responding to the prospect of weaker growth and monetary accommodation, global bond yields have dropped materially this year (Chart 6), providing some support for economic growth. Global economic conditions do not yet appear recessionary, but growth continues to slow, and the global economy would be vulnerable if the trade war escalates.

6/ A Sharp Decline in Bond Yields



As of: 6/21/19.
Source: FactSet.

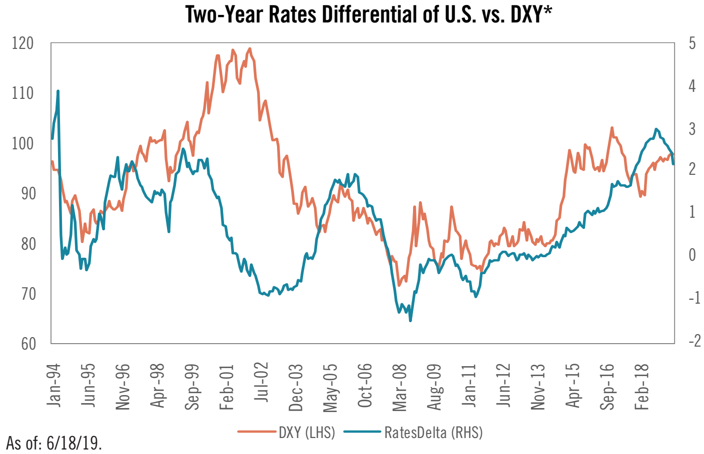
Monetary reflation can buy time and shore up confidence in the face of continued trade uncertainty; however, in an escalation scenario, we could reach a tipping point that would make an economic recession and equity bear market inevitable, rate cuts notwithstanding. This is why all eyes were on the Group of 20 meeting in Japan in late June when President Trump and his Chinese counterpart Xi Jinping had an "extended meeting" and agreed to a trade truce and to resume trade talks.

In general, we do not share the view that the current U.S.-China spat is simply about the economic interests of two parties seeking to negotiate the best deal for themselves. We believe U.S.-China relations have permanently diverged and should be viewed in the context of a geopolitical competition that is unlikely to be resolved by the Chinese buying more U.S. soybeans. Thus, the current tensions are likely to persist for some time. We also think it unlikely that a substantive deal addressing intellectual property, market access, and subsidies to state owned enterprises will be struck in the near future. That said, tensions are likely to ebb and flow around the structural trend of declining relations, and a positive scenario for risky assets could involve a trade truce ahead of the presidential election year, along with Fed/ECB reflation and more China stimulus.

We are underweight commodity futures as global growth conditions remain soft; inflation pressures stay muted; and the U.S. dollar's strong run continues. Dollar strength could persist given the U.S.'s relative economic strength; an attractive interest rate differential (Chart 7), and the dollar's safe-haven characteristics. While the U.S. economy is slowing, it remains the best house in a bad neighborhood in terms of global growth.

The Fed appears set to ease policy, but so are many other central banks. And unlike rates in Japan, Germany, Italy and other developed markets, U.S. real rates are still in positive territory. Meanwhile the trade war, the growing threat of a Hard Brexit with a strong pro-Brexit candidate likely to succeed Prime Minister May, and late-cycle jitters make the U.S. dollar a good place to hide from potential turmoil.

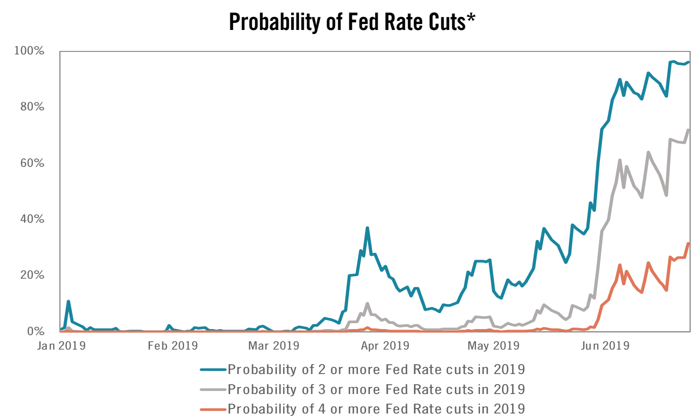
7/ Interest Rate Differential Supports U.S. Dollar



As of: 6/18/19.
Source: Bloomberg Barclays, QMA.
*The difference between two-year nominal U.S. Treasury rates and two-year sovereign bond rates for Canada, the Eurozone, Japan, the UK, Sweden and Switzerland weighted as their respective currencies in the U.S. dollar spot index (DXY).

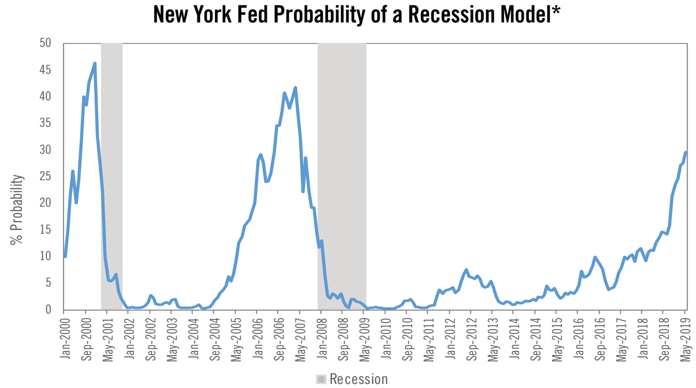
U.S. Treasury yields have melted and would be at risk of a backup if economic activity does not weaken further this summer. If that's the case, the Fed will probably not deliver rate cuts of the magnitude the market is expecting (Chart 8) Given the inverted yield curve, the U.S. bond markets appear to be pricing in a high risk of a U.S. recession (Chart 9). We are overweight U.S. cash given its positive real yield and the lack of yield pickup from moving further out the maturity curve. We are neutral on fixed income overall but have shifted exposure away from U.S. high yield bonds and emerging market debt (hard currency), to core bonds (Bloomberg Barclays Aggregate) because spreads are not especially attractive, and we are late in the credit cycle. Despite our overweight to cash, we view longer-duration Treasuries as a nice hedge in a multi-asset portfolio given the elevated probability of a recession.

8/ Markets Expecting Too Much?



As of: 6/24/19.
Source: Bloomberg.
*Implied by Fed Funds Futures

9/ Shape of Yield Curve Implies Elevated Risk of Recession



As of: 6/4/19.
Source: NY Fed, Haver Analytics.
*The New York Fed Model predicts the probability of recession using the 10-year/3-month Treasury yield spread

Regarding regional equity exposure, the performance of emerging market equities was disappointing in Q2 as the trade war intensified. Accordingly, we pulled back toward neutral early in the quarter (please see *Hitting the Pause Button on Emerging Markets Equities*). We currently maintain balanced exposure among U.S., international developed markets and emerging market stocks.

QMA's Tactical Asset Class Views

Asset Class	–		Neutral		+
Stocks			■		
Fixed Income			■		
Real Estate			■		
Commodities		■			
Cash				■	
Stocks[3]					
U.S.			■		
EAFE			■		
Emerging Markets			■		
Fixed Income[3]					
U.S. Core				■	
TIPS			■		
High Yield			■		
Non-U.S. Dev. Sov. Bonds		■			
EMD			■		

■ July 2019

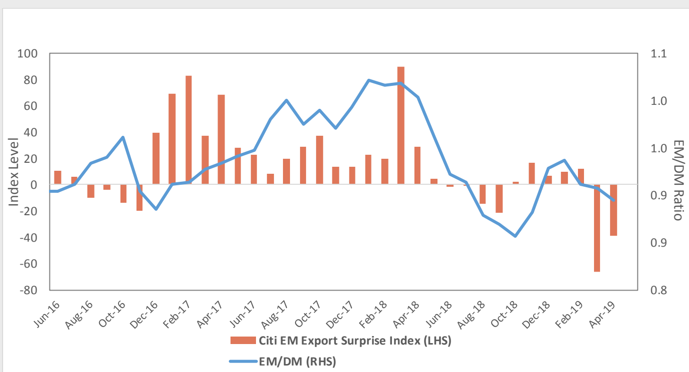
As of 7/01/2019.
Source: QMA.
There is no guarantee this will be achieved. For illustrative purposes only. Positioning subject to change.

Hitting the Pause Button on Emerging Market Equities

In March, we published a Market Pulse in which we argued that a tactical tilt towards emerging market (EM) equities was compelling for three reasons: 1) progress on a U.S. and China trade deal; 2) the Fed's dovish pivot; and 3) continued stimulus from China (the latter likely to help jump start global growth in the second half of the year). Unfortunately, the main risk we highlighted in that piece abruptly materialized in May when U.S.-China trade talks broke down, blindsiding investors, weighing on global growth and curtailing trade flows. (However, markets rebounded in June.) These headwinds caused the relative performance of EM to deteriorate anew (see Chart 10). We responded by pulling back to a neutral allocation to EM equities at the time by shifting exposure to the United States.

The trade conflict is likely to be a key factor influencing the relative performance of EM equities. However, there are also many other country-specific factors likely to drive EM stocks. In India, the ruling National Democratic Alliance secured a solid majority in recent elections, fueling hopes of a continuation of market-friendly policies. In Brazil, the odds of pension reform are rising, bolstering Brazilian stocks. In South Africa, the composition of President Cyril Ramaphosa's new cabinet increases the odds of economic reforms. On the negative side, Turkey's relations with the U.S. remain strained, with Turkey determined to take delivery of Russian S-400 missiles and the U.S. planning to exclude Turkey from the F-35 jet program (and possibly imposing sanctions.) In Mexico, the policy chaos of the Andres Manuel Lopez Obrador administration and the problems of PEMEX, the state oil company, are likely to weigh on the market.

10/ Emerging Markets Underperform



As of: 5/31/19.
Source: Bloomberg, Citi.

Because U.S.-China tensions extend beyond trade, they are likely to persist. Hence, a substantive deal will be difficult to achieve near term, prompting us to stay with our neutral position for now. That said, the trade truce emerging from the Group of 20 meeting, combined with global central bank dovishness and attractive valuation, could spark another round of EM outperformance. Given the fluid environment for EM, investors need to be both flexible and nimble.

QMA's Capital Market Assumption Framework

The process through which QMA builds an asset allocation portfolio generally consists of three components:

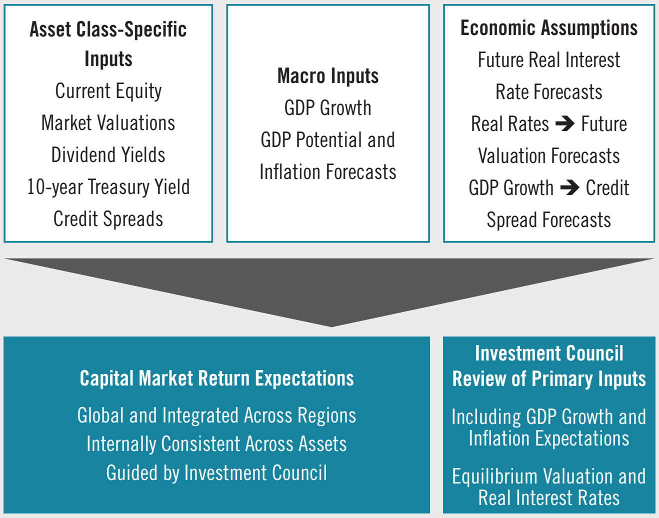
1) Strategic Allocations: sets acceptable risk parameters for investors and targets an efficient trade-off between return and risk.

2) Dynamic Asset Allocation: aims to enhance performance by overweighting/underweight asset classes and styles relative to the Strategic Allocations. (Our dynamic asset allocation views are presented in QMA's Quarterly Outlook & Review.)

3) Security Selection: seeks to capture alpha in underlying portfolios.

QMA's Capital Markets Assumptions (CMAs) underpin the long-term Strategic Allocations in our individual strategies and in our multi-asset portfolios. The CMAs provide 10-year forward-looking expectations for the most widely held equity, fixed income and non-traditional asset classes, measuring both return and risk. They are the product of a highly systematic process for generating consistent projections across the capital markets. For a more detailed discussion of our most recent CMAs see the [2019 Q2 Capital Market Assumptions.]

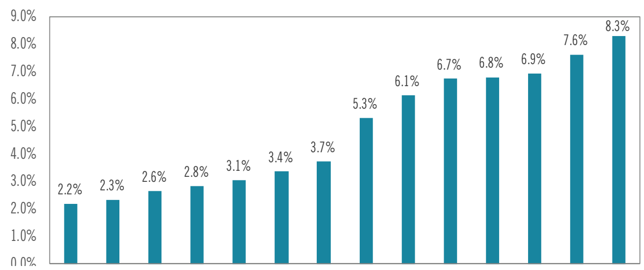
Capital Market Assumptions Framework



Shown for illustrative purposes only.
Source: QMA.

QMA Capital Market Assumptions

10-Year Return Projections-Select Asset Classes



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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 time-tested processes, based on academic, economic and behavioral foundations, serve a global client base with $121.8 billion in assets under management as of 3/31/2019.

NOTES TO DISCLOSURE

Sources: QMA, MSCI, FactSet, Bloomberg, OECD, Thomson Reuters Datastream, Federal Reserve Bank of Atlanta, Federal Reserve Bank of New York, FTSE Russell. **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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Foreign investments may be volatile and involve additional expenses and special risks, including currency fluctuations, foreign taxes and political and economic uncertainties. Emerging and developing market investments may be especially volatile. Investments in securities of growth companies may be especially volatile. Due to the recent global economic crisis that caused financial difficulties for many European Union countries, Eurozone investments may be subject to volatility and liquidity issues. Value investing involves the risk that undervalued securities may not appreciate as anticipated. Small and mid-sized company stock is typically more volatile than that of larger, more established businesses, as these stocks tend to be more sensitive to changes in earnings expectations and tend to have lower trading volumes than large-cap securities, creating potential for more erratic price movements. It may take a substantial period of time to realize a gain on an investment in a small or mid-sized company, if any gain is realized at all. Diversification does not guarantee profit or protect against loss.

Emerging markets are countries that are beginning to emerge with increased consumer potential driven by rapid industrial expansion and economic growth. Investing in emerging markets is very risky due to the additional political, economic and currency risks associated with these underdeveloped geographic areas. Fixed-income investments are subject to interest rate risk, and their value will decline as interest rates rise. Unlike other investment vehicles, U.S. government securities and U.S. Treasury bills are backed by the full faith and credit of the U.S. government, are less volatile than equity investments, and provide a guaranteed return of principal at maturity. Treasury Inflation-Protected Securities (TIPS) are inflation-index bonds that may experience greater losses than other fixed income securities with similar durations and are more likely to cause fluctuations in a Portfolio's income distribution. Investing in real estate poses risks related to an individual property, credit risk and interest rate fluctuations. High yield bonds, commonly known as junk bonds, are subject to a high level of credit and market risks. Investing involves risks. Some investments are riskier than others. The investment return and principal value will fluctuate and when sold may be worth more or less than the original cost.