Q4 2019 OUTLOOK & REVIEW

QMA's Global Multi-Asset Solutions Group

KEY POINTS

September 2019

Economic Outlook

- Global growth continues to be weak with the global economy buffeted by the powerful cross-currents of the US-China trade war, on the one hand, and global monetary easing on the other.
- The trade standoff has taken a toll on business confidence, industrial production and trade flows. It has weighed heavily on global manufacturing and hit export-oriented economies, including China, Europe and Japan, the hardest.
- Fortunately weakness in manufacturing has not yet dragged down the services sector, which remains resilient. The trade war also has less impact on more domestic-oriented economies, like the US. As a result, there is a pronounced growth divergence among sectors and regions within the global economy.
- Given the weak growth backdrop and elevated geopolitical risks, global central banks have embarked on a fresh round of easing, aiming to stimulate growth and counter the negative effects of the trade war.
- However, with interest rates already at, near or below zero in many countries, the power of monetary policy may be muted. Thus, the focus has shifted to the use of fiscal policy as a means of stimulating growth, especially in Europe.
- Powered by a healthy consumer, US growth remains resilient, while Eurozone growth is anemic, with Germany and Italy teetering on the edge of recession. Brexit uncertainty is finally catching up with the UK economy, which contracted in the second quarter of 2019. Japanese growth is decent, but risks are tilted to the downside given weak global growth, yen appreciation and a pending consumer tax hike.
- Emerging market growth remains held hostage to trade tensions, especially for such export-dependent economies as China, Taiwan and Korea. Emerging market economies less levered to the global export cycle, such as India and Brazil, have also succumbed to a slowdown in growth amidst weaker consumer spending and slow progress on much needed reforms.

Investment Outlook

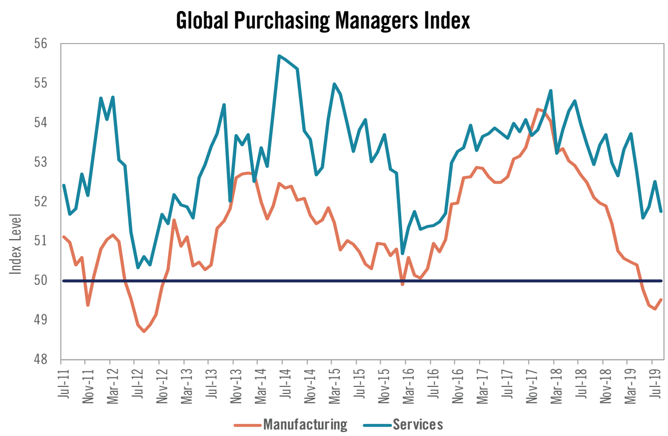
- Escalating geopolitical risks and increased monetary easing have elevated both the upside and downside risks for the global economy. As such, it is currently very difficult to determine which force will gain the upper hand.
- The greatest threat to the global economy is an escalation of the trade war, which would lead to an even deeper downturn in global manufacturing, which, in turn, could progressively weaken the more healthy components of the global economy, namely the services sector and the US consumer.
- A more constructive scenario for risky assets involves a tamping down of geopolitical risks and signs that monetary stimulus has reaccelerated global growth.
- Given this backdrop, we see the potential for significant market swings between now and year end. Accordingly, we are staying close to our policy benchmarks and maintaining a shorter-than-normal investment horizon, so we have the flexibility to quickly reposition our portfolios.
- For now, we are maintaining only a slight overweight to global equities relative to fixed income. Within equities we are tilting portfolios toward the US and away from international developed markets, given the clear relative growth advantage of the US.
- We have added some exposure to emerging markets on stabilizing growth forecasts and improvement in investor sentiment. We have also shifted some exposure to value stocks from growth stocks due to the increasingly extreme cheapness of the former and signs of improvement in US economic sentiment, which could act as a catalyst for outperformance.

Will Easy Money Trump Trade Tensions?

Economic Outlook

The global economy continues to be buffeted by the cross-currents of US-China trade tensions and global central banks launching a fresh round of easing. Trade tensions have taken a toll on manufacturing confidence, industrial production and trade flows. On the other hand, the services sector remains relatively resilient as manufacturing weakness has not dragged down the services component of the global economy (Chart 1). With trade tensions hitting certain regions (Europe, Japan and China) and sectors (manufacturing and exports-oriented) particularly hard, there is pronounced geographic and sector divergence within the global economy, raising downside risks to growth.

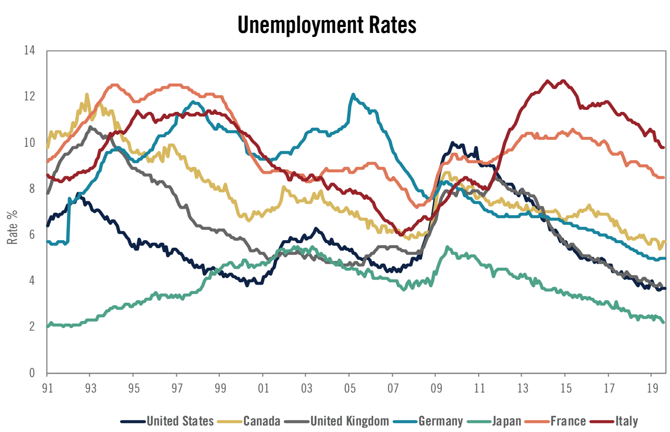
Chart 1: Growth Divergence Among Manufacturing and Services Sectors.



As of 8/31/19.
Source: J.P.Morgan, Markit.

On a positive note, the US economy appears to be growing at an above-trend pace, driven mainly by a robust consumer sector, which continues to be supported by healthy household balance sheets, steady employment growth, solid wage increases and low interest rates. In fact, the consumption sector appears to be healthy in most economies, as unemployment rates remain in a downtrend (Chart 2). This is true even in Germany, whose economy is likely already in recession due to its large manufacturing and export sectors, which have contracted due to the trade conflict and Brexit uncertainty. Nevertheless, consumer spending there remains buoyed by record low unemployment and solid wage growth.

Chart 2: Labor Markets Remain Strong.

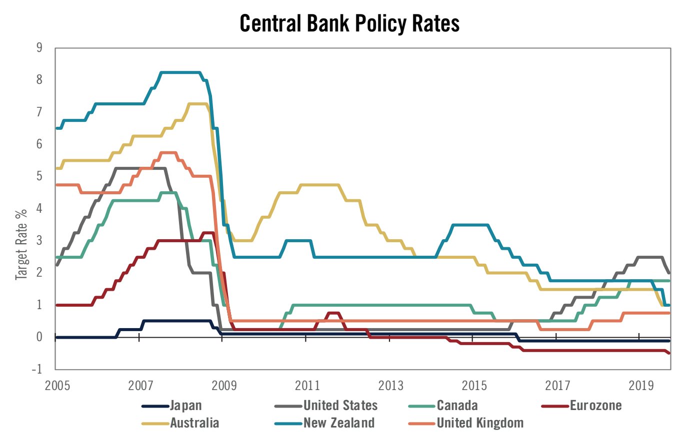


As of 8/31/19.
Source: Thomson Reuters Datastream.

Given the weak growth backdrop and elevated geopolitical risks, global central banks have embarked on a fresh round of easing through rate cuts and other stimulus measures. The US Federal Reserve cut rates twice in Q3, including the September rate cut. While markets are expecting more rate cuts, the outlook for additional easing is uncertain with Fed officials disagreeing about the impact of trade tensions and weaker global growth versus the strength of US domestic demand. At its September meeting, the European Central Bank (ECB) announced a comprehensive stimulus package that included a rate cut, a restart of quantitative easing and more dovish forward guidance. The Bank of Japan will likely seek to cushion the impact of a consumption tax hike scheduled in October with additional easing measures. Beyond the Big Three, 48 developed and emerging market central banks have cut rates and maintained an easing bias this year.

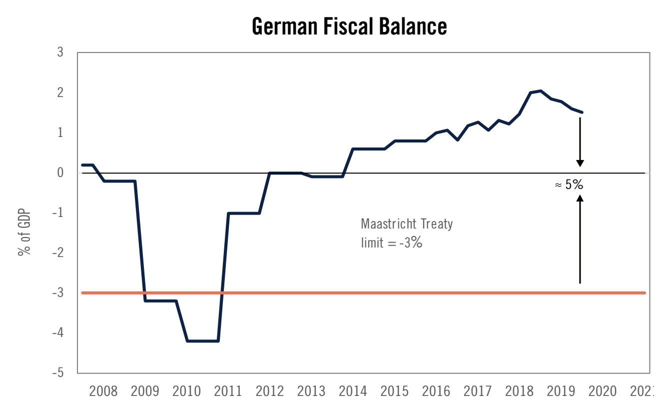
With policy rates already at, near or below zero in many countries (Chart 3) and negative interest rates having adverse unintended consequences for bank balance sheets, there are plenty of doubts about the ability of central bankers to ward off a downturn. Thus, talk has shifted to the use of fiscal policy as a means of stimulating growth, especially in Europe, where both outgoing ECB President Mario Draghi and incoming President Christine Lagarde have called on Eurozone governments with low budget deficits or surpluses to launch fiscal stimulus. With a budget surplus of 1.5% of gross domestic product (GDP), Germany would be a prime candidate to do this (Chart 4).

Chart 3: The Big Ease Runs Into the Zero Bound.



As of 8/31/19.
Source: Thomson Reuters Datastream.

Chart 4: Germany Has Fiscal Space, but Does It Have the Will to Stimulate?



As of 6/30/19.
Source: Thomson Reuters Datastream, Oxford Economics.

However, German policy makers appear reluctant to pull the trigger in the face of still strong domestic demand. In late September, the German government announced a "green policy" package to help reduce CO_2 emissions. Financed by extra spending and tax subsidies totalling €54 billion between 2020 and 2023, the package amounts to a tiny fiscal stimulus of less than 0.4% of GDP per year, just a drop in the bucket. While this is a step in the right direction, more fiscal stimulus is clearly needed, and Germany can easily afford it. The Netherlands also announced its budget for 2020, which included a modest fiscal stimulus of 1% of GDP. Even Italy may get a green light from the European Union to run fiscal deficit of greater than 2% of GDP to stimulate economic growth.

Discussion of Major Regions

US growth remains resilient with forecasts for Q3 economic growth recently revised higher to around 2%. Second-quarter GDP grew by 2% annualized with a solid contribution from consumer spending, which rose 4.7% during the same period. The outlook for consumer spending remains solid, with the labor market continuing to create jobs, the unemployment rate remaining at a 50-year low of 3.7% and strong wage growth in excess of 3%. Further, while job growth has been on a downward trend, the economy continues to generate around 170,000 non-farm jobs per month on average. A strong rise in retail sales (up 0.7% month-over-month in August), with broad-based gains, reflects solid consumer fundamentals. At its September meeting, the Fed noted that the "labor market remains strong and economic activity has been rising at a moderate rate," adding that "household spending has been rising at a strong pace." However, it also noted weakness in business investment and exports.

The Eurozone economy remains anemic, with Q2 growth remaining below trend at a 0.8% annualized rate. Gross domestic product growth has contracted in Germany; is stagnant in Italy; and is slowing in France and Spain. Trade and reduced consumption spending were drags on Eurozone growth, while investment spending held up despite manufacturing confidence being in contraction territory. Eurozone GDP growth is likely to remain under 1% in Q3, with falling retail sales and contraction in industrial production, especially in Germany. The ECB downgraded its forecast for Eurozone growth and inflation in September.

Brexit uncertainty appears to be finally catching up with the UK economy with Q2 GDP contracting -0.8% annualized, the slowest annual pace since Q1 2018. Looking ahead, UK GDP growth is expected to post a modest rebound in Q3. However, Brexit uncertainty continues to weigh on trade and business confidence generally and manufacturing confidence in particular. This suggests investment spending is likely to contract in Q3. Prime Minister Boris Johnson is struggling to push through a "no-deal Brexit" in Parliament, which has voted against this and against holding a snap general election. At this point, the most likely near-term scenario is a delay beyond the October 31, 2019 deadline, but the possibility of a no-deal Brexit, fresh election or a second referendum remains elevated.

Japanese GDP growth remains moderate for now with Q2 growth at 1.2%, but risks appear tilted to the downside, given slower global growth and yen appreciation. Further, increased uncertainty from the US-China trade dispute is weighing on Japan's export outlook, with exports to China and the US remaining stagnant. Another negative is the consumption tax hike scheduled for October 2019. The Abe administration is planning several stimulus measures to help soften a downturn in consumer spending and Japanese growth. However, consumer confidence has trended lower, raising concerns about domestic demand.

The outlook for emerging markets growth remains hostage to trade tensions. Growth has continued to slow in export-dependent economies, such as China, Taiwan and South Korea, due to both the ongoing US-China trade war and tensions between Japan and South Korea. China's growth slowed to 6.2% year-over-year in Q2 from 6.4% in Q1 as the escalating US-China trade tensions weakened business confidence and export growth. Growth is likely to fall to the lower end of the Chinese government's target of 6.0% to 6.5% in 2019. Growth forecasts for 2020 were revised down following the recent round of tariff increases and fears that the government's stimulus efforts will be insufficient.

Even emerging market economies that are less levered to the global export cycle, such as India and Brazil, have seen a slowdown in growth amidst weaker consumer spending and slow progress on much needed reforms. India's Q2 growth slumped to a five-year low of 5% year-over-year, for example, but the recent corporate tax cut is likely to boost growth. In Latin America, Brazil is growing at just around 1%.

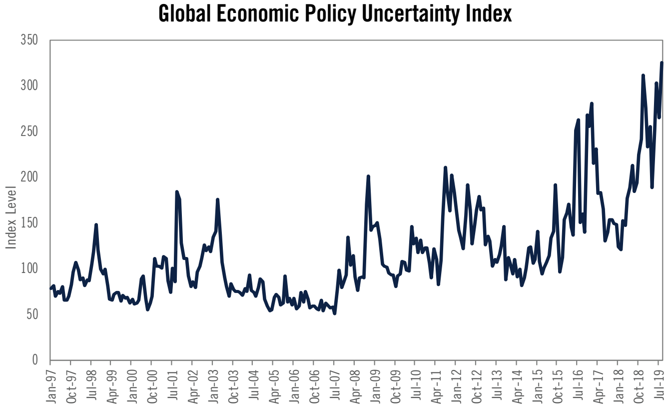
Investment Outlook

We are not straying far from the policy benchmarks in our multi-asset portfolios because cross-currents abound, and we see the potential for significant market swings between now and year-end. The clash between escalating geopolitical risks and additional monetary easing has fattened both the upside and downside risks for the global economy, and it is currently very difficult to determine which force will gain the upper hand.

The key downside risk is a continued escalation of the trade war, which would lead to an even deeper downturn in global manufacturing. This, in turn, could progressively weaken the healthier components of the global economy, namely the services sector and the US consumer, potentially triggering a broader global downturn.

Beyond US-China trade tensions, other global risks are flaring (Chart 5 on the following page). Brexit uncertainty has risen given Prime Minister Boris Johnson's penchant for risk and brinksmanship. Violent protests continue in Hong Kong despite a significant concession from the territory's government in officially pulling the controversial extradition law. Growing tension in the Middle East, underscored by attacks on the Saudi oil fields, create another headwind.

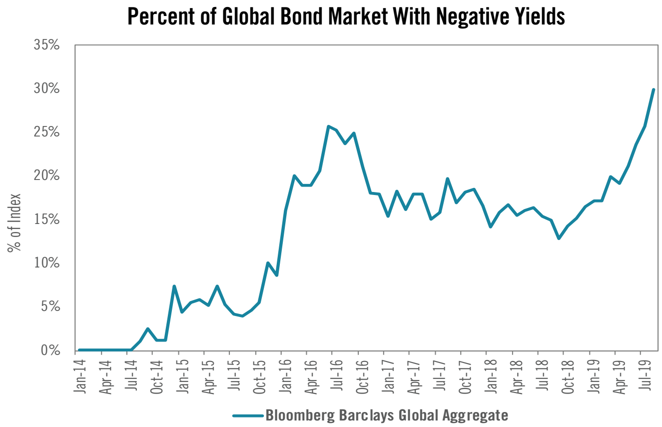
Chart 5: A Bull Market in Policy Uncertainty.



As of 7/31/19.
Source: Bloomberg, Baker, Bloom & Davis.

A more constructive scenario for risky assets involves a tamping down of geopolitical risks, while global central banks remain accommodative and G7 bond yields stay depressed. Global bond yields plunged during the summer on signs of economic weakness, increased trade tensions, and central bank dovishness. The US 30-year benchmark Treasury rate dipped below 2% for the first time ever in August, and now more than $17 trillion in debt—or approximately 30% of the global bond market—trades at negative interest rates (Chart 6).

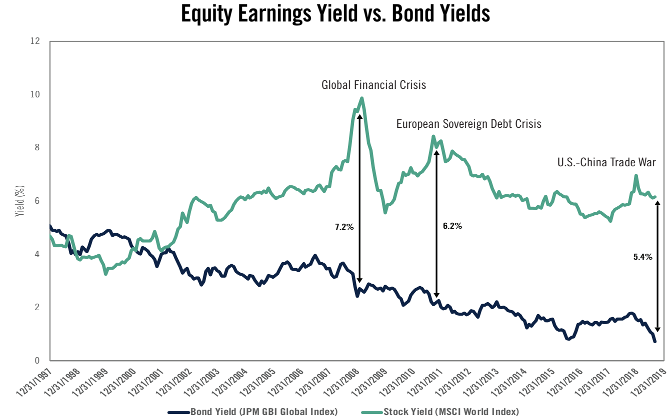
Chart 6: Rising Share of Global Bond Market Exhibits Negative Rates.



As of 8/31/19.
Source: Bloomberg.

Government bonds offer a safe haven and great diversification benefits but appear overbought and overvalued, assuming a global economic recession is not in the cards. Meanwhile, equity valuations are somewhat elevated relative to those of the past two decades with the forward price/earnings ratio at 15.2 for the MSCI All Country World Index and 16.9 for the S&P 500. Given today's valuations, equities could experience significant drawdowns if already elevated cyclical risks increase.

Chart 7: Valuation of Stocks vs. Bonds: Mind the Gap.



As of 8/30/19.
Source: MSCI, J.P.Morgan.

Nevertheless, the very depressed level of bond yields makes the relative valuation for equities quite attractive. The earnings yield on global and US equities is currently about 6.8% and 6.0%, respectively. Thus, the yield gap of stocks relative to current bond yields is very wide (Chart 7) and could fuel a TINA ("There Is No Alternative") trade in the event cyclical risks lighten.

Ultimately, the performance of the markets over the remainder of 2019 will depend on the answers we get to some critical questions. Will President Trump seek a détente with China as a way to protect the economic expansion ahead of the 2020 Presidential election, or will he double down on his current path of periodic escalation? Are the Chinese even willing to make substantive concessions if Trump changes his tune? Recently both parties have made minor concessions, involving pushing back timetables and exempting certain goods from tariffs as a way of generating good will ahead of high-level meetings set for October 2019. However, we still do not have high-conviction answers to these important questions.

Other key questions highlight the environment of elevated geopolitical risks. Could a hard Brexit occur, sinking an already vulnerable European economy? How will the Chinese government respond to continued violence in Hong Kong? Will the attacks on the Saudi oil fields spark a broader Middle East conflict?

The persistent economic and policy uncertainty described above argues against taking aggressive cyclical bets. Hence, we are generally plotting a broadly neutral course for the most part and maintaining a shorter-than-normal investment horizon, so we have the flexibility to reposition our portfolios when it appears one of the aforementioned tail risks is gaining dominance.

However, we do have some modest pro-risk tilts in our portfolios, including a small overweight to global equities relative to fixed income. This stance is based on the relative valuation discrepancies outlined above and our base-case view that a recession is still not the most probable outcome, given the strength of the US consumer and signs, albeit tentative ones, that some leading economic indicators are bottoming.

Within global equities, we are tilting portfolios toward the US and away from international developed markets (MSCI EAFE), as we have for most of the year, given the clear relative growth advantage of the US. However, we have added some exposure to emerging market equities lately, as our quantitative work shows GDP growth forecasts no longer deteriorating and investor fund flows improving. In the United States, we cut exposure to growth stocks and added to value stocks, given the increasingly extreme cheapness of the latter without a commensurate deterioration in their relative fundamentals. The shift to positive economic surprise in September from negative economic surprise (since February), as measured by the Citi Economic Surprise Index, could be a catalyst for value stock outperformance.

While we have dipped our toes into emerging market equities, we have stayed underweight commodities, as the global growth environment remains weak and US dollar strength remains a headwind. We think the downward lurch in bond yields in August was overdone (it has partially unwound through mid-September), so we are underweight bonds and overweight cash.

What would convince us to adopt a more bullish stance besides a reduction in policy uncertainty? The short answer is more definitive signs that global economic growth has bottomed and is starting to reaccelerate. A weaker trend in the dollar would also be encouraging. This would likely occur if the gap between US and non-US growth were narrowing, and it might show up before a decisive turn in the non-US economic data. German fiscal stimulus would also be a potential game changer depending on its size, but German policymakers still appear reluctant to act as they wait for evidence that the current downturn is more than just a technical recession.

QMA's Tactical Asset Class Views (September 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			■		

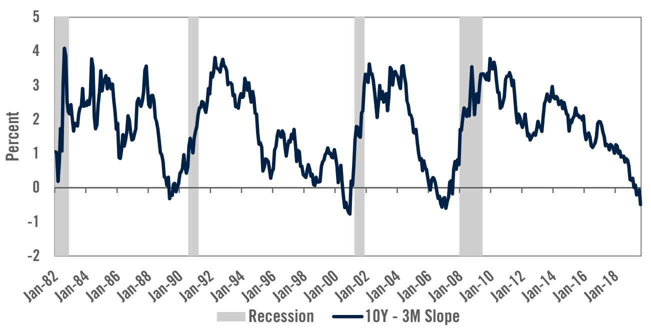
Source: QMA.
For illustrative purposes only. Positioning subject to change.

As the US Goes, So Goes the Global Economy

Global growth has been anemic, but the US economy has remained resilient. If the US were to falter and slide into recession, it would likely seal the deal on a global downturn, which is why the health of the US expansion is of critical interest to investors worldwide.

With the inversion of the yield curve and the Institute of Supply Management's manufacturing index dropping below 50 in August, indicating contraction, recession fears have been amplified in the media. Hence, we thought it a good time to step back and assess the state of the US business cycle using a tool we have used in the past: **our US recession dashboard**. Here we consider four distinct indicators we think are particularly useful for gauging the risk of a downturn: the slope of the yield curve, initial jobless claims, high-yield spreads and the Conference Board Leading Economic Index®.

Chart 1: Slope of Treasury Yield Curve (10Y-3M)



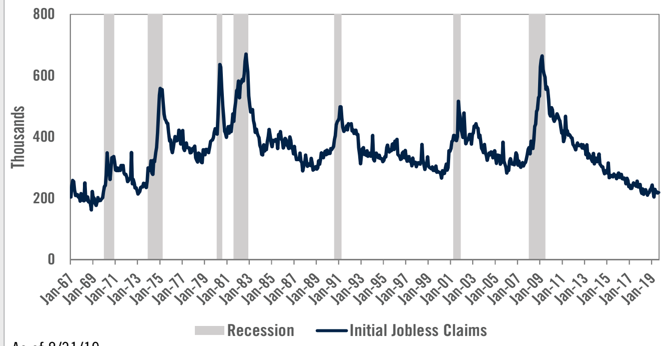
As of 8/31/19.
Source: Thomson Reuters Datastream.

The recent inversion of the yield curve (Chart 1) is admittedly a concern as yield curve inversions have preceded most recessions. Inversion suggests the current Fed policy rate is too tight, and growth is too slow. However, historically, inversions have been caused by overzealous Fed tightening, choking off growth in response to an inflation threat. Furthermore, the current inversion is happening in the context of widespread negative-yielding bonds abroad; the unwinding of the Fed's balance sheet; and strong demand for long Treasuries as pristine collateral for repurchase agreement (repo) trades.

Finally, unlike in the past, the Fed is proactively easing in response to anticipated weakness from global risks (i.e., the Fed is looking to get ahead of the curve). Therefore, we do not believe the inverted curve necessarily preordains recession. Even if the signal proves accurate in retrospect, the timing is usually tricky, as yield curve inversions precede recessions by at least a year on average. Typically, equities rise in the early stages of a yield curve inversion.

Importantly, the other indicators on our dashboard are not confirming the alarming signal from the yield curve. Initial jobless claims (Chart 2) are the lowest on record at 0.12% of the labor force. It may appear that the job market is cooling, with monthly payroll growth slowing to 130,000 a month, down from the more than 170,000 a month we've seen the prior 12 months. That said, the number of job openings still exceeds the number of job seekers, which has pushed up wages in excess of 3% year over year. The buoyant job market translates into a strong and confident US consumer, whose spending powers 70% of the US economy.

Chart 2: Initial Jobless Claims



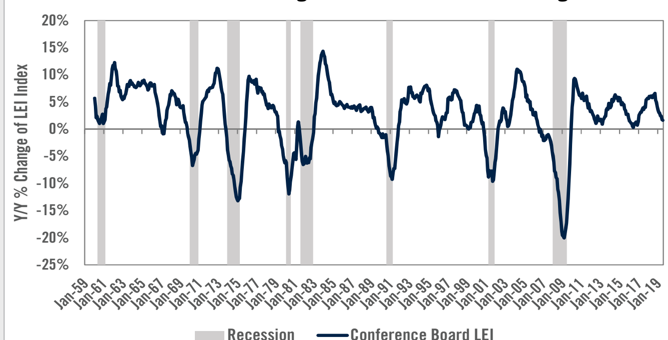
As of 8/31/19.
Source: Thomson Reuters Datastream.

High-yield spreads, (Chart 3) another component of the dashboard, remain historically low, suggesting the market is pricing a low probability of corporate defaults. While corporate debt in the US is at very elevated levels, interest coverage, a measure of corporations' ability to meet their interest payments, is in line with its norm, thanks to low rates. Moreover, as long as the Fed maintains easy monetary policy, debt repayment is likely to remain manageable.

Chart 3: High-Yield Spreads

As of 8/31/19.
Source: FactSet.

Chart 4: Conference Board Leading Economic Index (Y/Y % Change)



As of 7/31/19.
Source: Thomson Reuters Datastream.

Lastly, many measures of the business cycle have been signaling a slowdown, and the Conference Board Leading Economic Index® (Chart 4) is no exception. However, we have seen two other mid-cycle slowdowns during this long expansion, and this could simply be the third. The rebound in the US Citi Economic Surprise Index, which turned decisively positive in September after languishing in negative territory since February, argues in favor of this more benign view.

All in all, the recession dashboard indicates that this record long expansion still has legs, assuming, of course, that global risks don't escalate such that they push the US past the point of no return.

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ABOUT QMA

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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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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.