

An owl is shown in profile, looking towards the left. It has a grey and white mottled pattern on its feathers. The background is dark.

OUTLOOK

2019 Global Market Outlook – Q3 update: China syndrome

China stimulus, global central bank easing and a U.S.-China trade-war ceasefire could set the scene for a rebound in the global economy later in the year. However, the inversion of the U.S. yield curve and the downtrend in business confidence indicators keep us cautious at mid-year.

The inverted yield curve, trade-war uncertainty and global data weakness argue for caution. On the other hand, U.S. Federal Reserve (Fed) easing, China stimulus and a U.S.-China trade deal could trigger another bull run. But it's late cycle, the downside equity market risks outweigh the upside and betting on a market friendly outcome at mid-year 2019 is risky.

Inversion aversion

Bond and equity markets are arguing with each other. Bond markets see trade-war escalation, weak global data and declining inflation expectations. Equity markets see Fed easing, China stimulus and a trade deal with China ahead of U.S. President Donald Trump's 2020 re-election campaign.

The bond market isn't always right, and the equity market story has some appeal, but there is one heavyweight indicator on the side of the bond market – the inverted yield curve. This has predicted every U.S. recession over the past 50 years. The inversion needs to be sustained for a couple of months to provide a strong signal, but it makes a persuasive case for caution.

Paul Eitelman thinks that the Fed is now on track for one or two precautionary rate cuts. U.S. inflation is below 2% and market inflation expectations are low, which biases the Fed towards taking out some insurance against a downturn. The U.S. equity market is expensive and there is pressure on the cycle, which adds to Paul's caution.

Europe is struggling to rebound from last year's growth setbacks, although Andrew Pease expects there will be some improvement. The trade-war dominates, however, and optimism on Europe requires an easing in global trade tensions.

Not surprisingly, the trade-war also dominates the Asia-Pacific outlook. Alex Cousley sees China stimulus and central bank easing across the region. Exports, however, are under pressure. Adding to concerns are that Japan seems likely to proceed with the October hike in the consumption tax rate. On the positive side, equity valuations in Japan and Emerging Asia are slightly cheap, but a positive view on the cycle requires confidence in a trade-war resolution.

Van Luu and Max Stainton think the shift in Fed action towards easing will signal the peak in the U.S. dollar. Emerging market currencies at near-decade lows are likely to be the main beneficiaries of the softer greenback. The Japanese yen stands out as the preferred currency on valuation grounds and because of its safe-haven properties during risk-off episodes.

The recession probabilities from Kara Ng's U.S. business cycle index model have moved into the warning zone following the yield curve inversion. The model's recession probabilities have not yet reached pre-2008 levels, but the readings are high enough to reinforce the note of caution that our qualitative assessment is providing at mid-year.

"Downside equity market risks outweigh the upside, and betting on a market friendly outcome at mid-year 2019 is risky."

Andrew Pease

GLOBAL HEAD OF INVESTMENT STRATEGY

INVESTMENT STRATEGY OUTLOOK

The China-U.S. trade war has re-ignited and the U.S. Treasury yield curve inverted in March. Offsetting this, global central banks have turned dovish and China's stimulus package is on the way. The cycle risks make us cautious until there is clarity on the trade-war fallout.



China syndrome

Global markets are tracking U.S. President Donald Trump's Twitter account. His May 5 tweet announcing a tariff increase on Chinese imports triggered the end of the equity market recovery from the late-2018 downturn. The S&P 500® index, which had rebounded 25% from its low on December 24 through May 3, fell 7% over the next month. Equity markets have since bounced back, but the lasting impact can be seen in falling long-term government bond yields, the inverted U.S. yield curve, the slowdown in global trade, and weak global manufacturing surveys.

The case for caution is that trade-war uncertainty is depressing business confidence and international trade. The added concern is that it is happening while global profit growth is slowing. JPMorgan's tracker of global business capital expenditure is signaling negative business investment spending for the second quarter of 2019 after healthy growth through most of 2018. The risk is businesses could cut back on hiring, which flows through to consumer spending and creates a self-reinforcing downturn.

The trade war's hard to measure risk is its impact on global supply chains. Modern trade is dominated by the exchange of intermediate goods, which account for around half of the global trade in goods¹. The ripple effects of a further trade-war escalation are unpredictable and potentially large.

On the other hand, China's economic stimulus, global central bank easing, and a trade-war cease-fire could set the scene for a rebound in the global economy later in the year. A number of central banks have either eased policy or made dovish announcements. It now

seems likely that the U.S. Federal Reserve (the Fed) will cut rates at least once over the next few months in an attempt to offset against a corporate confidence-led slowdown.

This key to a more positive outlook is for President Trump to back away from his trade threats and focus on his 2020 re-election campaign. That would be logical, given that his re-election may depend on support from Midwest states that will experience the most economic pain from rising tariffs.

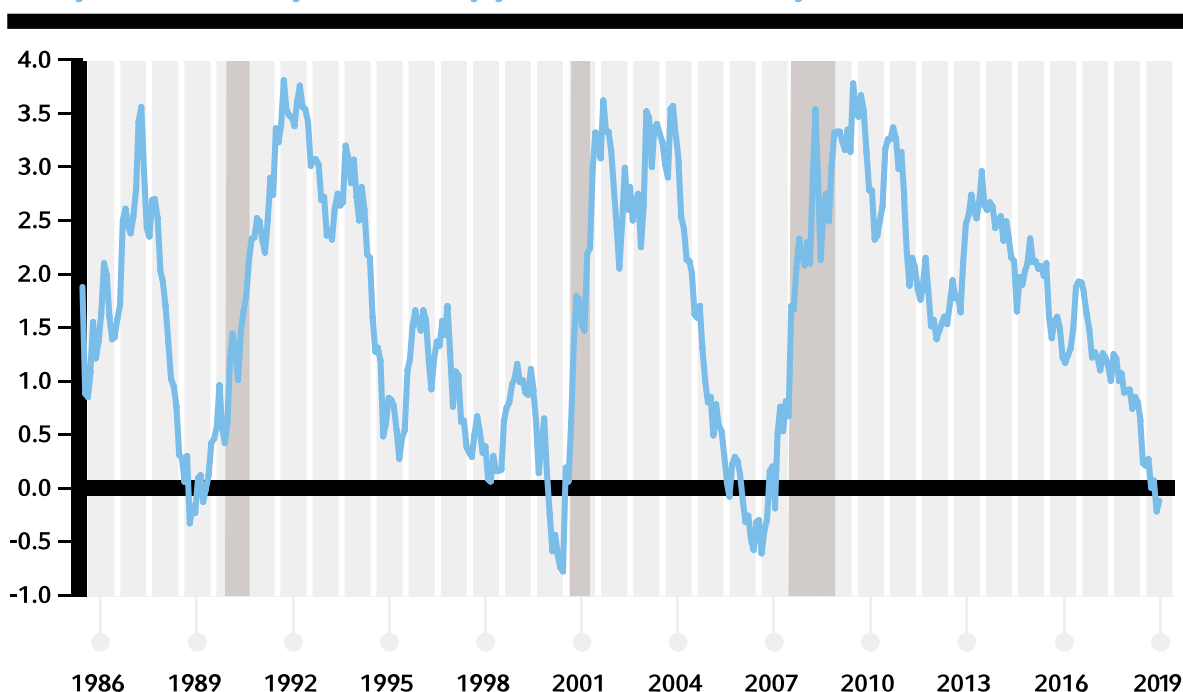
President Trump's actions so far, however, make it unwise to assume he will back down. The re-escalation of the China trade war since May, the additional threats against Mexico and the possibility of tariffs on automobiles (which would harm Japan and Germany) suggest the President intends to continue with his "maximum pressure" negotiating tactics. This uncertainty, along with the recession warning signal provided by the U.S. yield curve inversion and the downtrend in business confidence indicators, keep us cautious for now.

Yield curve inversion – is it different this time?

The most worrying indicator is the inversion of the U.S. yield curve. This has predicted every U.S. recession over the past 50 years, with just one false alarm – the inversion in 1998 amid the Asian economic crisis, the Russian bond default and the collapse of Long-Term Capital Management.

The yield curve inverts when the 10-year Treasury yield falls below the short-term yield. This is a powerful indicator because it implies that bond markets believe the economy will weaken enough to require lower Fed interest rates.

U.S. yield curve: 10-year Treasury yield minus 3-month yield / (%)



Source: Thomson Reuters Datastream. Gray columns are National Bureau of Economic Research-dated recessions.
Last observation: June 14, 2019.

It's possible the bond market has over-reacted to the trade-war fears and the weakness in global manufacturing and trade data. It may be like 1998 when the threats to the U.S. economy were exaggerated and a small amount of Fed easing set the stage for a further two and a half years of economic growth and market gains.

The combination of Fed easing, China stimulus and trade compromise could mean this inversion is a false signal. The yield curve has been inverted for a relatively short period of time so far. We will take the inversion much more seriously if it persists for a couple more months. For now, it's a worrying indicator that biases us toward caution.

HISTORICAL 10-YEAR/3-MONTH U.S. TREASURY YIELD CURVE INVERSIONS			
DATE	DURATION (DAYS)	MAGNITUDE (BASIS POINTS)	OUTCOME
1989	84	-14	Recession
1998	5	-6	False alarm
2000	196	-46	Recession
2007	314	-33	Recession
2019*	23	-14	?

*As of June 14, 2019, for the yield inversion which started on May 23, 2019.

Asset class preferences

Our cycle, value and sentiment investment decision-making process points at mid-year 2019 to a broadly neutral to slightly underweight view on global equities.

- We have an underweight preference for U.S. equities, driven by expensive valuation and cycle concerns around the trade-war escalation, fading fiscal stimulus and yield curve inversion. We're broadly neutral on non-U.S. developed equities. Valuation in Japan is slightly positive and neutral in Europe. Both should benefit from stimulus in China which will help bolster export demand.
- We like the value offered by emerging markets equities. Regional central banks are easing policy and emerging markets will benefit from China stimulus. It is, however, at near-term risk from the trade-war escalation and the disruption in global supply chains. Near-term caution is warranted.
- High yield credit is expensive and losing cycle support, which is typical late in the cycle, when profit growth slows and there are concerns about defaults.
- Government bonds are universally expensive although U.S. Treasuries are closer to fair value than German bunds, Japanese government bonds and UK gilts. The global trade-war escalation and manufacturing slowdown means cycle headwinds have eased slightly.
- Real assets: Real estate investment trusts (REITs) and global listed infrastructure (GLI) have posted high double-digit returns so far this year. We're moving back to neutral given that the support from falling Treasury yields is unlikely to be sustained, and earnings supports are at risk from a slowing global economy. Commodities are at risk from the trade war but will benefit from China stimulus. This keeps up neutral on commodities at mid-year.
- The Japanese yen is our preferred currency. It's undervalued and has safe-haven appeal if the trade war escalates. The U.S. dollar could weaken once the Fed eases. The main beneficiaries would be emerging markets currencies. The euro and British sterling are undervalued. Sterling, which has more upside potential than the euro, will be volatile around the Brexit uncertainty but should rebound if the UK's new Prime Minister can secure a deal with Europe, or if a second referendum is called.

¹Source: UNCTAD Key Statistics and Trends in International Trade 2018. Intermediate goods are goods or services used in the eventual production of a final good or finished product.

"We have an underweight preference for U.S. equities, driven by expensive valuation and cycle concerns around the trade-war escalation, fading fiscal stimulus and yield curve inversion."

Andrew Pease

GLOBAL HEAD OF INVESTMENT STRATEGY



UNITED STATES OUTLOOK

Fundamentals were supercharged over the first three quarters of 2018 on the back of corporate tax cuts, regulatory reform, and an accommodative Fed. The Trump administration's aggressive trade stance with China, however, is exacting a heavy toll on the U.S. and global economy.

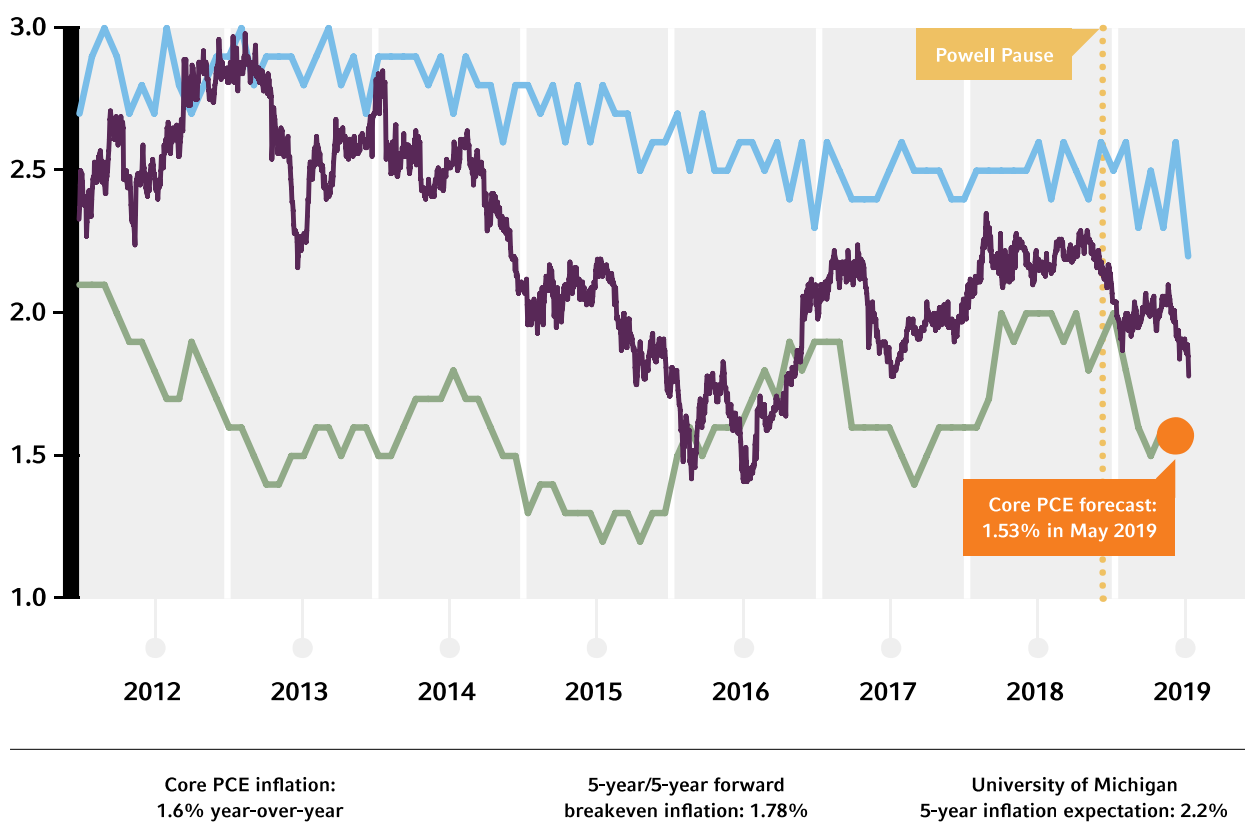
Trade wars and the Fed

The U.S. manufacturing cycle slowed abruptly at the end of 2018 and remains weak at mid-year 2019. Meanwhile the global manufacturing cycle continued to decelerate through May and is approaching recessionary levels. The 10-year U.S. Treasury yield has traded below the federal funds rate since May 22, and this inversion of the curve is a hallmark of the late cycle. And some of the economic data for the month of May suggested the labor market and the services sectors may now be decelerating, too.

To be clear, we are not in a recession. But the disconcerting dynamics above are causing our quantitative models to send a warning signal about the potential for an economic downturn in the next 12 months.

The Federal Reserve is likely to take these downside risks very seriously. At the end of the first quarter we forecasted the Fed to remain on hold for the bulk of 2019. But with downside risks re-intensifying and with inflationary dynamics weakening, it looks increasingly likely the Fed will now cut interest rates in both July and September. The crux of the argument is that the cost of a precautionary rate cut is now very low. Normally, late in the cycle central bankers are constrained by the prospect of an inflation overshoot. However, core personal consumption expenditures (PCE) inflation is running below 2% and market- and consumer-based inflation expectations have downshifted. Given the Fed wants higher inflation right now, we think it's more likely the Federal Open Market Committee will cut interest rates to buffer against downside risks.

The cost of a precautionary rate cut appears low



Source: Thomson Reuters Datastream; last observations: June 16, 2019. Powell Pause refers to Fed Chairman Jerome Powell's December 2019 remark that the Fed will remain patient regarding future rate hikes until inflation accelerates.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

It remains an open question whether the Fed's policies will be enough to save the economy and markets from the trade war. What is clear is that we are at a very important fork in the road for markets.

The road more traveled is one of rationalism, where President Trump wants and needs a strong economy in early 2020 to bolster his reelection odds, and he seeks out a trade deal with China to ensure that outcome. In this scenario, we see the Fed cutting rates twice to "un-invert" the curve, the removal of trade policy uncertainty providing a lift to capital expenditures (capex), and Chinese stimulus measures in effect. As a result, we'd expect a positive mini cycle to take hold and drive risk markets higher for the next few years. In addition, 10-year Treasury yields, while initially dampened on Fed cuts, would eventually rise from 2% in late June back up to 2.75 or 3%.

The other road, named "maximum pressure", is one where President Trump continues his risky strategy of tightening the screws on China through tariffs and other more targeted measures, where the Fed struggles to achieve an accommodative monetary policy stance against so much uncertainty, and global capex tumbles. In this scenario, if the policy mistake is big enough, we possibly could see an economic recession by year-end. With U.S. equity valuations still trading at the expensive range of history, we could be looking at a drawdown of 30% or more. The Fed normally cuts overnight rates by 400-500 basis points (bps) in a recession, and without that policy space, would likely cut these rates to zero, employ forward guidance, and kickstart quantitative easing (QE) again. In this

scenario, 10-year U.S. Treasury yields could fall to 1% (or lower).

The future path of trade policy is likely to be a key catalyst for markets, but it's nearly impossible to predict where it will head with any degree of conviction. This is the dilemma we're faced with at mid-year. A positive central scenario but with asymmetric risks to the downside.

Strategy outlook

- **Cycle:** Neutral to slightly negative. We are late cycle and fading fiscal stimulus is likely to slow the economy relative to its breakneck pace of 2018. The trade war re-escalated in May and this uncertainty is likely to challenge U.S. and global capex. The outlook crucially hinges on what happens with Sino-American trade policy. For now, we assume a downside risk bias given the asymmetry of what a negative outcome could mean for U.S. equities. The warning signals from the yield curve and the Business Cycle Index model are instructive in this regard.
- **Valuation:** Expensive. The year-to-date rally has pushed U.S. equity market valuations significantly higher. Assuming a mean reversion (lower) in corporate profit margins over the next 10 years, our risk premium estimates for the S&P 500 Index remain very unattractive.
- **Sentiment:** Slightly positive. Our momentum indicators have turned higher with the strong equity market rally thus far in 2019. Our more behavioral, contrarian, indicators suggest the market is neither panicked nor euphoric.
- **Conclusion:** We maintain a very small underweight preference for U.S. equities in global portfolios, solely on the back of their expensive valuations. Our conviction levels tactically are low.

"Disconcerting dynamics are causing our quantitative models to send a warning signal about the potential for an economic downturn in the next 12 months."

Paul Eitelman
SENIOR INVESTMENT STRATEGIST



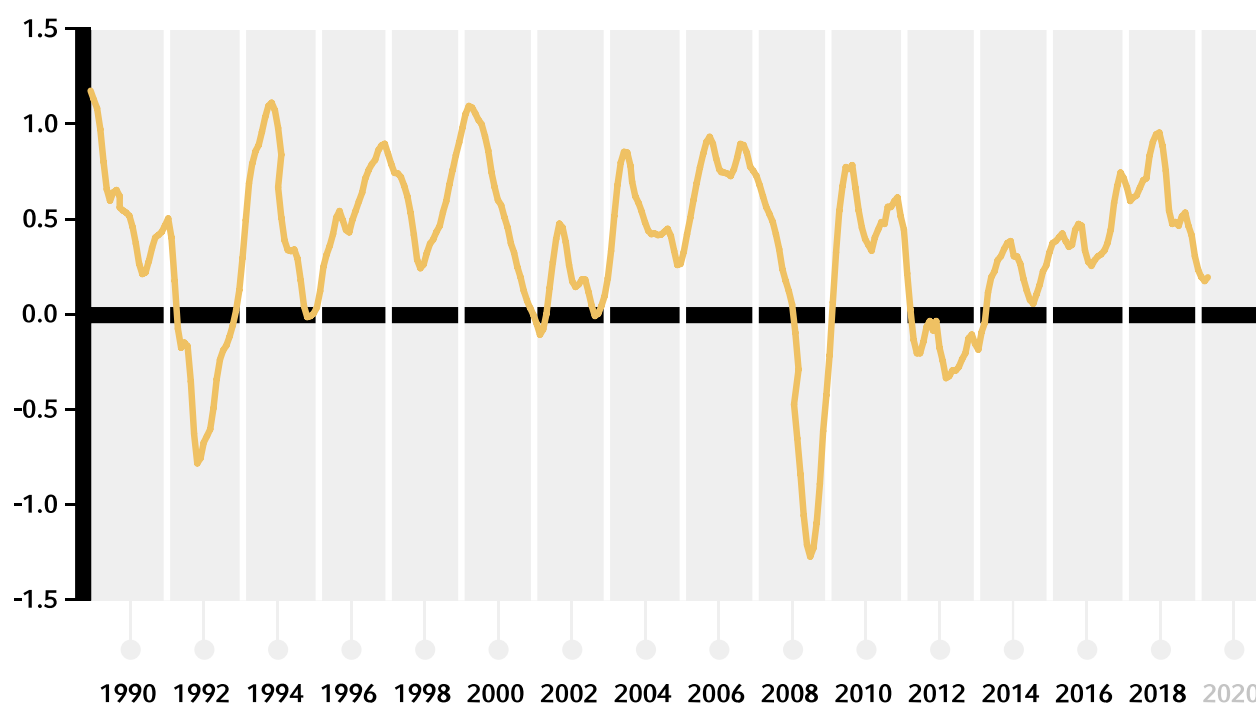
EUROZONE OUTLOOK

Europe's growth rebound is taking longer to materialize and is being threatened by the escalating global trade war. Italian risks are increasing in the background. The European Central Bank (ECB), however, has made a dovish shift and fiscal policy is still supportive. Optimism on Europe requires an easing in global trade tensions.

Failure to launch

Europe's long anticipated growth rebound remains just that, anticipated. Growth indicators are lackluster and persistent low inflation has the ECB pushing rate hikes further into the future. Bond market expectations for inflation in five years' time have fallen to a record low of 1.2% in mid-June.

Eurocoin activity indicator / Monthly (%)



Source: Thompson Reuters Datastream, Bank of Italy. Last observation: May 2019.

The Eurocoin (€-coin) activity indicator is a real-time estimate of GDP growth free from measurement errors, seasonal and other short-run fluctuations.

We're not bearish on Europe, but the one-off factors that depressed growth are taking longer to turn around than we had expected. These include the new emissions-testing regime that caused a collapse in German automobile production, the political turmoil in Italy, Brexit uncertainty, the U.S.-China trade dispute and the gilets jaunes political protest movement in France.

Industry-based data suggest the recovery in automobile production is underway. The widening of the trade dispute, however, is a drag on business confidence. The negotiations on a U.S.-European Union (EU) trade deal are making little progress, President Trump is keeping open the threat of tariffs on motor vehicles, and the U.S. has threatened additional tariffs on European exports in response to a long-running dispute over EU subsidies to the European aerospace corporation Airbus.

Adding to the list of concerns is the uncertainty around Italy. Opinion poll support for the right-wing populist Lega party, according to published local surveys as of mid-year, is running far ahead of its coalition partner, the left-wing populist Five-Star movement. An election before year-end looks increasingly likely. The spread between the yield on 10-year Italian bonds and 10-year German bunds has started widening. At 260 basis points at mid-year, the spread is still well below the peak of 330 basis points reached during last year's crisis. Further political uncertainty and a renewed fight by the Lega with the European Commission over fiscal easing could generate market nervousness.

Fiscal easing should provide a decent tailwind with the European Commission expecting fiscal thrust of 0.4% gross domestic product (GDP) this year. This combined with ECB dovishness and a rebound in German automobile output should put a floor under growth

in 2019. The risks, however, have increased and optimism on Europe requires an easing in global trade tensions.

Strategy outlook

- **Cycle:** We still expect the cycle to improve over coming months as the impact of one-off events subsides, although this is taking longer than expected. Exports to emerging markets are equal to nearly 10% of Eurozone GDP, which means a further escalation in the trade conflict is a significant risk. Equally, Europe will get a boost from a trade thaw and stands to be one of the main beneficiaries of significant Chinese policy stimulus.
- **Valuation:** Eurozone equities are close to fair value on our calculations. Core government bonds are long-term expensive. 10-year German bund yields at -0.25% as of mid-June, are essentially as low as they can realistically fall.
- **Sentiment:** Contrarian sentiment signals are broadly neutral as of mid-June. We see no signs that equities are either overbought or oversold. Price momentum in Eurozone equities is flat.

“We’re not bearish on Europe, but the one-off factors that depressed growth are taking longer to turn around than we had expected.”

Andrew Pease

GLOBAL HEAD OF INVESTMENT STRATEGY



ASIA PACIFIC OUTLOOK

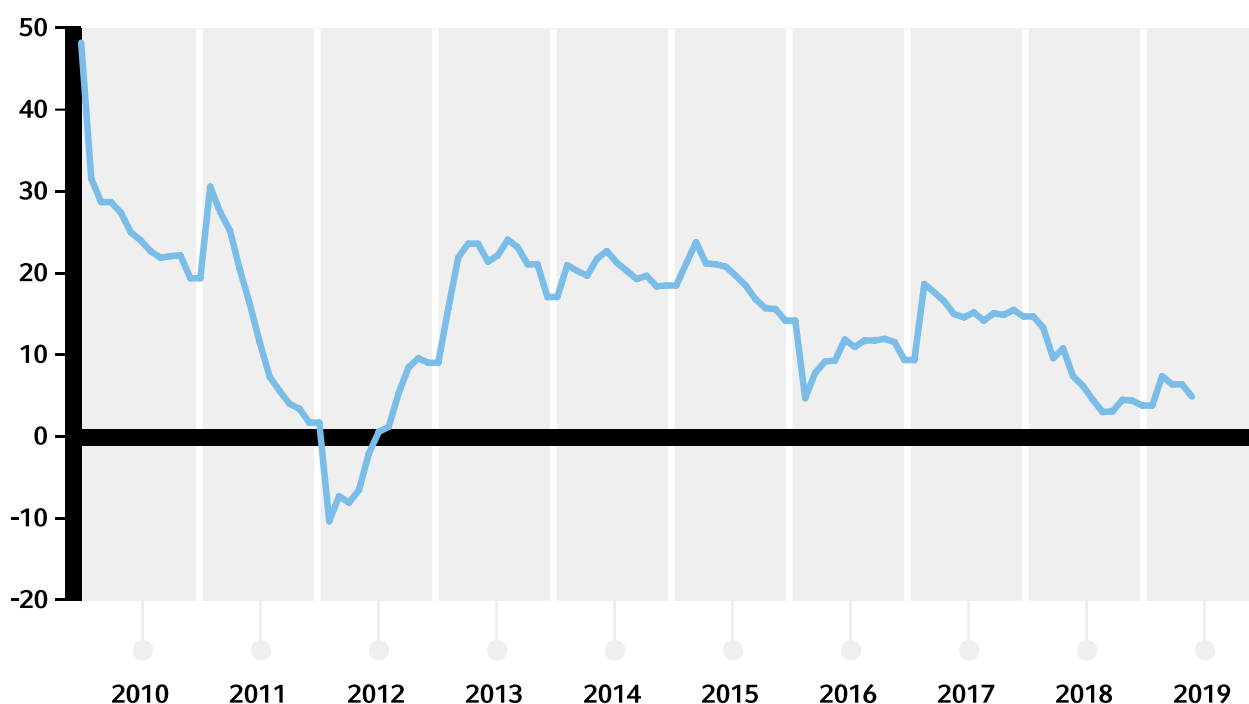
The China-U.S. trade war has escalated, which puts pressure on regional growth. The data coming out of China has been mixed to soft in the second quarter, which combined with trade risks, suggests we are going to see further Chinese government stimulus measures which should benefit the region. Meanwhile, central banks in the region have become more accommodative.

Expecting stimulus to ease the trade pain

The data out of Asia-Pacific has had a disappointing tone in the second quarter, led by China and South Korea. Exports from the region have slowed, while manufacturing activity growth (as reflected by recent Purchasing Managers' Indices) has slowed or in some countries, including South Korea and Taiwan, continued to contract. The Indian election saw the re-election of Prime Minister Narendra Modi, which should provide some support to the economy. Japan's economy continues to look lackluster, with the planned raising of the value-added tax remaining a risk watchpoint.

As always, let's start in China. In our previous quarterly outlook, we said we were becoming more constructive on growth, driven by stimulus measures that had been announced. Since then, the data has been mixed to soft and the trade war has escalated. However, it is not all bad news, with more stimulus measures likely to come. This will likely focus on infrastructure spending (which has disappointed). Comments from the People's Bank of China's governor suggest that monetary policy may also ease, and we will be watching the credit numbers for signs of credit impulse.

China's infrastructure spending dips in May / 12-month % growth



Source: Thomson Reuters Datastream. Last observation: May 31, 2019.

Activity in India has faced temporary headwinds of pre-election uncertainty and some regulatory changes in the autos sector. Both should dissipate in coming months, given the Modi government's retainment of a majority in India's recent general election. Additionally, the outlook for investment has been boosted by the accommodative stance that has been taken by the Reserve Bank of India, which has cut interest rates twice in the last three months. The key risk to the outlook is the tight financial conditions that are seen in the non-banking financial sector, which has a market share of close to 40% in housing and auto loans.

We remain cautious on the outlook for South Korea and Taiwan, given their exposure to trade. In South Korea, the outlook for the consumer has deteriorated (consumer confidence has fallen, and retail sales growth has decelerated) and the manufacturing sector is struggling (the PMIs are in contraction territory). We still expect that the Bank of Korea will shift to an accommodative stance and a rate cut may come later this year. Taiwan is also facing the headwinds of soft consumer spending and weaker external demand.

The Q1 GDP print from Japan was very strong, however, and most of the strength came from a fall in imports (which boosts GDP but suggests flagging domestic demand). Consumer spending has been reasonably solid, despite soft consumer sentiment, while business confidence has taken a hit due to the U.S.–China trade confrontations. Political developments have decreased the likelihood of a delay in a value-added tax (VAT) rate hike, which may also be hurting business confidence. It is worth noting, however, that there are a number of counter measures in place to assist with the hike.

The outlook for Australia remains lackluster, although there have been a number of positive developments that should help the housing market stabilize. First, the Liberal-

National Coalition government was re-elected in a surprise victory. This removes uncertainty around tax treatment of investment property. Second, there are some changes to macro-prudential regulation, which will provide borrowers with increased capacity to borrow. Finally, the Reserve Bank of Australia (RBA) cut rates and appears likely to cut again this year. The RBA remains focused on the labor market, however recent research has suggested that the natural rate of unemployment is lower than previous estimates, which gives the RBA scope to become more accommodative.

Finishing off in New Zealand, where the key development has been the dovish shift from the Reserve Bank of New Zealand (RBNZ). The outlook for the economy has softened, with business confidence remaining very soft and the labor market showing signs of slowing. The RBNZ have responded by cutting rates in May, and we are likely to see another cut sometime this year.

Strategy Outlook

For Asia-Pacific regional equities, we assess business cycle, value and sentiment considerations as follows:

- **Cycle:** Risks have risen for the region, given the escalation in trade-war threats. However, expected additional Chinese stimulus will be supportive. Central banks have been becoming more supportive. For Asia-Pacific regional equities, we assess business cycle, value and sentiment considerations as follows:
- **Valuation:** We see slightly attractive valuations in Japan and Emerging Asia, while the Australian equity market is fully valued. New Zealand equities continue to look expensive. Bond valuations in the developed economies look expensive. Overall, valuations on offer appear reasonable.
- **Sentiment:** The flows resulting from index provider Morgan Stanley Capital International's (MSCI) decision to increase the weight of mainland China in its global index are expected to continue with the announced incremental rise in August and November. Our contrarian sentiment signals are broadly neutral for Emerging Markets and Japan.

"The data coming out of China has been mixed to soft in the second quarter, which combined with trade risks, suggests we are going to see further Chinese stimulus measures which should benefit the region."

Alexander Cousley
INVESTMENT STRATEGY ANALYST

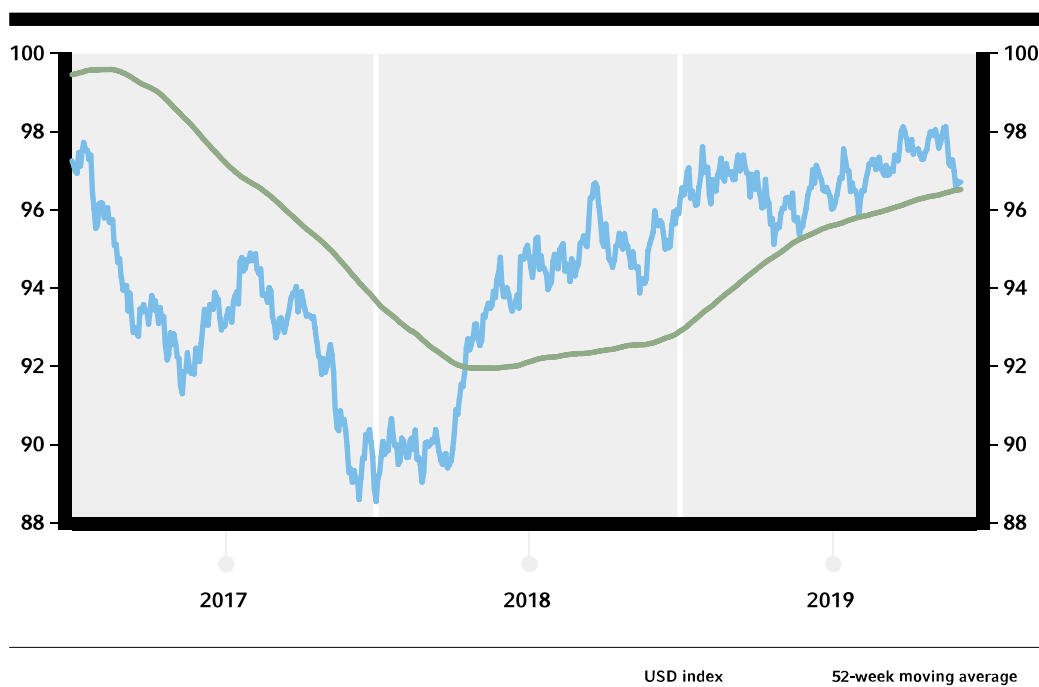
CURRENCIES OUTLOOK

As the Fed is considering whether below-target inflation and soft economic growth data could allow it to make “insurance” rate cuts, emerging markets (EM) currencies should be the main beneficiaries of easier monetary conditions.

EM currencies to benefit from U.S. dollar peak

In our previous quarterly outlook, we envisaged a final leg up in the U.S. dollar (USD) would take the USD index (DXY¹) to a level of 98 or higher. The chart below shows the DXY index reached our target level but failed to break above it three times between April and May. We think the greenback is peaking, i.e. that it will not set new highs in the remainder of 2019. The main rationale for our less positive dollar view is the shift in Fed policy. Whereas we previously expected the Fed to raise rates once in 2019, we now think that recent weakness in inflation and growth data will compel the Fed to take out some “insurance” and cut rates by 25 basis points twice.

U.S. Dollar Index (DXY¹)

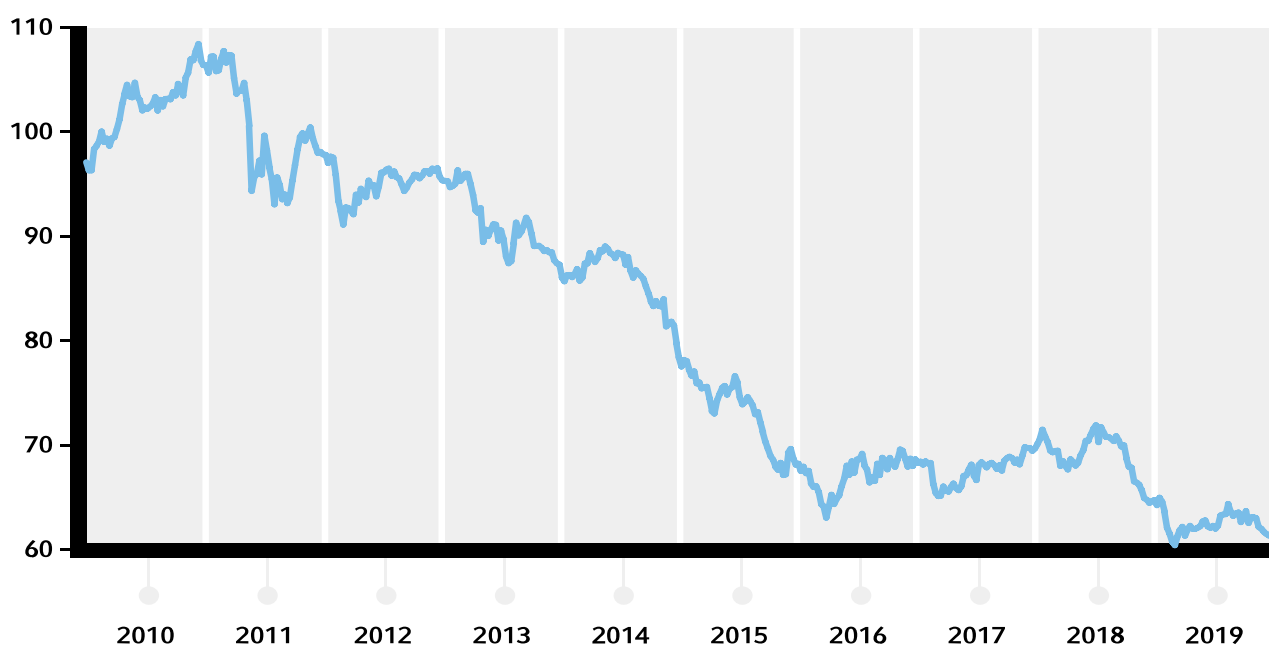


Source: Thompson Reuters Datastream, Jun 11, 2019.

The European Central Bank (ECB) and the Bank of Japan are also easing policy at the margin, but they have much less room to act on interest rates than the Fed. A declining interest rate gap between the U.S. and the Eurozone/Japan will weigh on the greenback, together with expensive valuation and worsening sentiment. To be sure, we do not forecast the start of a severe bear market for the U.S. dollar, which still enjoys a healthy, albeit diminishing, interest-rate advantage over the euro and the Japanese yen (JPY). In our view, the main beneficiaries of Fed rate cuts are likely to be higher-yielding emerging markets (EM) currencies.

Using the JP Morgan EM Currency Index² as a yardstick, EM currencies are still trading near their absolute lows over the last decade, as shown in the chart below. Our proprietary valuation models, which are based on several variants of purchasing power parity³, confirm that EM currencies are attractively valued vis-à-vis the U.S. dollar. An environment of easier monetary conditions, mostly driven by the predicted Fed rate cuts and other central banks dialing up their unconventional stimulus, is a benign cycle factor for EM currencies.

Emerging market currencies remain near this decade's lows



JP Morgan Emerging Markets FX Index – Trade Weighted

Source: Thompson Reuters Datastream, Jun 11, 2019.

The MSCI Emerging Markets (EM) Currency Index tracks the performance of emerging-market currencies relative to the U.S. Dollar.

Among developed-market currencies, we still like the Japanese yen best. During the escalation of the trade war between the U.S. and China in May, the yen acted as a safe-haven asset and strengthened considerably against other major currencies. This countercyclical characteristic of JPY makes it particularly valuable as a diversifier in portfolios that have sizeable allocations to equities and other risky assets.

¹ The U.S. Dollar Index (DXY) is a measure of the value of the United States dollar relative to a basket of foreign currencies, often referred to as a basket of U.S. trade partners' currencies. The index goes up when the U.S. dollar gains "strength" (value) when compared to other currencies.

² The constituents of this index are the Brazilian real, Mexican peso, Chilean peso, Chinese renminbi, Indian rupee, Singapore dollar, Turkish lira, Russian ruble, Hungarian forint, and South African rand.

³ The purchasing power parity exchange rate equalizes the cost of living in two different countries and is used by economists as a measure of the "fair value" of currencies.

"Our proprietary valuation models confirm that EM currencies are attractively valued vis-à-vis the U.S. dollar."

Van Luu

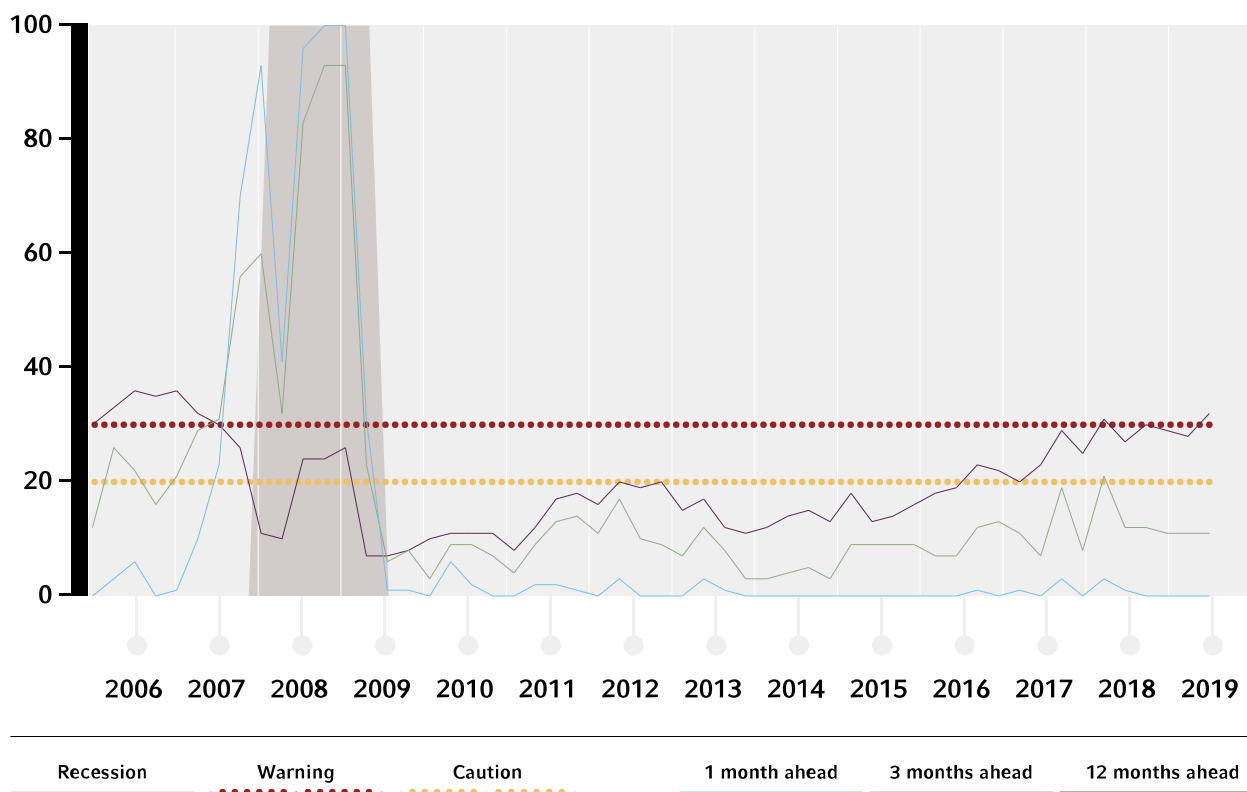
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QUANTITATIVE MODELING INSIGHTS

Countdown begins

The Business Cycle Index (BCI) model, which uses a range of economic and financial variables to estimate the strength of the U.S. economy and to forecast the probability of recession, has entered "risk-off" territory for the first time this expansion. Although short-term risks remain low, the BCI model at mid-year estimates the probability of a U.S. recession in 12 months at 32%, climbing above the warning threshold for leaning out of risky assets. As a result, we've staged some initial cyclical downgrades on equities and risk-seeking fixed income.

BCI model historical forecasted recession probabilities / Recession probability (%)



Source: Russell Investments, as of June 2019.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

Two key messages:

- We should take this 12-month recession warning seriously.
- However, the market's fate is not sealed.

The elevated 12-month recession probability reflects the inverted 10-year/3-month U.S. Treasury yield curve and some deterioration in the macroeconomic data. An inverted yield curve—provided it's of sufficient¹ duration and magnitude—is historically one of the best predictors of recession. In the previous five economic cycles, a 10-year/3-month yield inversion preceded a recession by one year on average. The other watchpoint is the labor market, previously a pillar of strength. There is tentative evidence of cracks in the labor market, with the broad-based weakness in May 2019 payrolls. A potential pathway to recession is via a negative confidence spiral, where trade uncertainty and global slowdown causes a fall in CEO confidence. Businesses halt capital expenditure, hiring slows, consumer income slows, consumer spending slows, and the spiral continues until recession is underway.

In the past few months, we've observed slower global growth, lower CEO confidence, and lower capital expenditure. If the labor market fails, this may be a path to total organ failure. The BCI 12-month recession probability is over the warning threshold and should be taken seriously.

Not all hope is lost. The 12-month recession probabilities suggest elevated risk, but it is not yet at the pre-2008 levels. Also, the short-term recession probabilities are still low, suggesting recession is not yet imminent. Under our central view, if the Fed cuts interest rates twice and macroeconomic conditions do not deteriorate, the BCI recession risk could be pushed back under the warning zone and the economic expansion may continue longer. In the meantime, our models recommend defensiveness.

¹Historically, there have been false alarms with the 10-year/3-month yield inversion, when the inversion was very brief. For example, in September 1998, the yield curve inverted shallowly and sporadically for five days over a 25-day period but did not precede a recession.

"The 12-month recession probabilities suggest elevated risk, but it is not yet at the pre-2008 levels."

Kara Ng

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. They do not typically grow at an even rate of return and may experience negative growth. As with any type of portfolio structuring, attempting to reduce risk and increase return could, at certain times, unintentionally reduce returns.

Keep in mind that, like all investing, multi-asset investing does not assure a profit or protect against loss.

No model or group of models can offer a precise estimate of future returns available from capital markets. We remain cautious that rational analytical techniques cannot predict extremes in financial behavior, such as periods of financial euphoria or investor panic. Our models rest on the assumptions of normal and rational financial behavior. Forecasting models are inherently uncertain, subject to change at any time based on a variety of factors and can be inaccurate. Russell believes that the utility of this information is highest in evaluating the relative relationships of various components of a globally diversified portfolio. As such, the models may offer insights into the prudence of over or under weighting those components from time to time or under periods of extreme dislocation. The models are explicitly not intended as market timing signals.

Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment.

The Business Cycle Index (BCI) forecasts the strength of economic expansion or recession in the coming months, along with forecasts for other prominent economic measures. Inputs to the model include non-farm payroll, core inflation (without food and energy), the slope of the yield curve, and the yield spreads between Aaa and Baa corporate bonds and between commercial paper and Treasury bills. A different choice of financial and macroeconomic data would affect the resulting business cycle index and forecasts.

Investment in global, international or emerging markets may be significantly affected by political or economic conditions and regulatory requirements in a particular country. Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation. Such securities may be less liquid and more volatile. Investments in emerging or developing markets involve exposure to economic structures that are generally less diverse and mature, and political systems with less stability than in more developed countries.

Currency investing involves risks including fluctuations in currency values, whether the home currency or the foreign currency. They can either enhance or reduce the returns associated with foreign investments.

Investments in non-U.S. markets can involve risks of currency fluctuation, political and economic instability, different accounting standards and foreign taxation.

Bond investors should carefully consider risks such as interest rate, credit, default and duration risks. Greater risk, such as increased volatility, limited liquidity, prepayment, non-payment and increased default risk, is inherent in portfolios that invest in high yield ("junk") bonds or mortgage-backed securities, especially mortgage-backed securities with exposure to sub-prime mortgages. Generally, when interest rates rise, prices of fixed income securities fall. Interest rates in the United States are at, or near, historic lows, which may increase a Fund's exposure to risks associated with rising rates. Investment in non-U.S. and emerging market securities is subject to the risk of currency fluctuations and to economic and political risks associated with such foreign countries.

The S&P 500, or the Standard & Poor's 500, is a stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.

Performance quoted represents past performance and should not be viewed as a guarantee of future results.

Indexes are unmanaged and cannot be invested in directly.

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The MSCI All Country World Index is a market capitalization weighted index designed to provide a broad measure of equity-market performance throughout the world. The MSCI ACWI is maintained by Morgan Stanley Capital International, and is comprised of stocks from both developed and emerging markets.

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises. A positive reading of the Economic Surprise Index suggests that economic releases have on balance been beating industry consensus. The indices are calculated daily in a rolling three-month window.

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