



OUTLOOK

2019 Global Market Outlook – Q4 update: The art of the no-deal

The uncertainties surrounding the China/U.S. trade talks, and to a lesser extent Brexit, dominate the outlook. While these unpredictable negotiations elevate the risks, we see reasons why a recession might be avoided, and the cycle extended for a couple more years.

The upcoming 2020 U.S. presidential election makes de-escalation of the China/U.S. trade war more likely. But unpredictability on both sides combined with the damage already done keeps us cautious.

Waiting for the election pivot

The risks surrounding the trade war are at an inflection point, with much depending on the next moves by U.S. President Donald Trump and China President Xi Jinping. A return to Trump's favorite maximum pressure tactics, or a refusal by Xi to make meaningful concessions, would reignite global recession fears. It may also be that Trump's pivot is coming too late. The damage to business confidence and global supply chains may already have been done, meaning the inverted yield curve is correctly forecasting an impending recession.

The alternative scenario is that a trade-war retreat, coordinated global central bank easing and significant China policy stimulus sets the scene for stronger global growth in early 2020 and an extension of the equity bull market.

We like the logic of the positive scenario, but the downside risks are evident in global manufacturing data and the sustained U.S. yield curve inversion. Caution is still warranted as we move into the fourth quarter.

Paul Eitelman is concerned that further trade-war escalation could tip the balance toward U.S. recession. He thinks the U.S. Federal Reserve (the Fed) is focused on re-verting the yield, which implies at least one more rate cut this year.

The European Central Bank (ECB) fired its last substantial bullets with the September return to quantitative easing (QE) and extension of negative interest rates, says Andrew Pease. German car production is yet to recover, but credit growth is picking up across the eurozone. Europe remains either a significant winner from a trade-war resolution or a loser from an escalation.

Alex Cousley sees slowing economic indicators across the Asia-Pacific region, led by trade weakness. There is plenty of talk about China stimulus, but it is yet to show up in data releases. Equity market valuations are generally OK across the region and many central banks have eased policy. Trade-war developments and China policy remain the key watchpoints.

Van Luu likes the value offered by the GBP/USD exchange rate and sees plenty of upside if a no-deal Brexit is avoided. However, his favored currency remains the Japanese yen, which is still cheap and offers defensive diversification qualities.

The recession probabilities from Kara Ng's U.S. business cycle index model have been hovering near the warning zone for a few months. Further Fed easing and improving macro and financial data could shift the model out of the danger zone in the next couple of months, but Kara's bias is toward caution.

"We like the logic of our positive scenario, but downside risks are evident in the global manufacturing data and sustained U.S. yield curve inversion."

Andrew Pease
GLOBAL HEAD OF INVESTMENT STRATEGY

INVESTMENT STRATEGY OUTLOOK

Recession risks are rising as trade tensions depress global manufacturing and the inverted U.S. yield curve signals danger. We're cautious for now, though the combination of central bank easing, a trade truce and China stimulus could brighten the outlook.



The art of the no-deal

Markets appear trapped in an episode of Deal or No Deal. The uncertainties surrounding the China/U.S. trade talks, and to a lesser extent Brexit, dominate the outlook. Manufacturing is contracting globally, trade is weakening and corporate profits are under pressure. The U.S. yield curve is signaling that recession risks are increasing, and Chinese economic indicators are weakening. There is a risk that global uncertainties generate a self-fulfilling cycle where rising pessimism leads to less private-sector spending and higher unemployment. This in turn would cause lower profits and equity markets—and ultimately, deeper pessimism.

The added concern is that central banks have limited ammunition to fight a downturn. Interest rates are already at zero or negative in Japan and Europe. The U.S. Fed has more scope to ease, but it also faces the zero-lower bound constraint. Previous recessions have seen the Fed cut rates by over five percentage points on average, something that would be impossible this time with the Fed funds rate in a target range of 1.75% to 2%.

Curb your pessimism

Although the risks are elevated, there are reasons that a recession might be avoided, and the market cycle extended for a couple more years.

First, in contrast to manufacturing, service sector activity is still robust in most economies as we move into the fourth quarter. Unemployment is low and consumer confidence is relatively high in the U.S. and Europe.

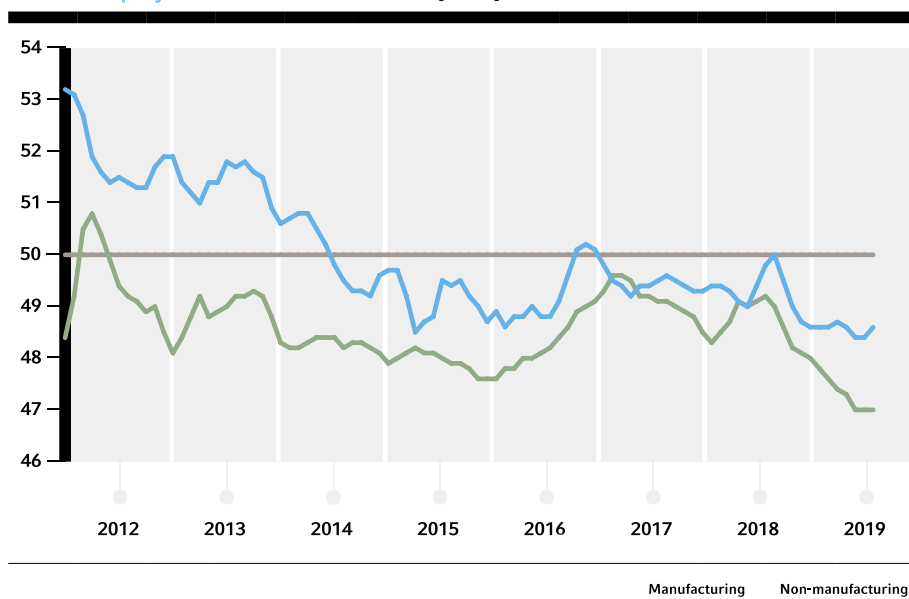
Second, policy stimulus is being ramped up with numerous central banks now cutting interest rates and indicating that more cuts are on the way; the Fed has started easing and the European Central Bank (ECB) has restarted quantitative easing. China is talking more aggressively about policy stimulus, while fiscal easing is being debated in Germany and U.S. Treasury Secretary Steven Mnuchin has discussed possible tax cuts in 2020.

This is a contrast to last year when the Fed was tightening, the ECB ended quantitative easing and Chinese officials were worried about high debt levels from previous episodes of stimulus. A timely policy response will go some way to offsetting limited central bank firepower.

Third, an easing of trade tensions seems likely, even if only temporarily. U.S. President Trump has shown a tendency this year to de-escalate trade tensions whenever the equity market falls. He has an incentive to limit the trade-war damage to the U.S. economy ahead of next year's election. To do this, he needs some form of trade deal before the end of the year.

China's stance is more complicated, but ultimately should favor a deal of sorts. Of course, China cannot be seen to reward Trump for aggressive and unilateral protectionist moves. However, China's economy is struggling from the combined impact of the 2017/18 deleveraging campaign and the tariff escalation. The purchasing managers' index (PMI) surveys highlight China's labor market weakness, something that the ruling Communist Party leadership is likely to take seriously.

China: Employment conditions / Purchasing Managers' Index: China (PMI level)



Source: China National Bureau of Statistics, Refinitiv Datastream. Last observation, August 2019; shown as a three-month moving average.

A PMI level above 50 on the 0 to 100 scale represents an expansion when compared with the previous month. A PMI reading under 50 represents a contraction, and a reading at 50 indicates no change. The further away from 50 the greater the level of change.

The bottom line is that President Trump has a clear motivation to avoid a recession before the November 2020 election. China's pain threshold is higher, but job losses and the threat of social instability provide an incentive to de-escalate the trade tensions and pursue domestic policy stimulus. However, it may take further equity market volatility to prod both sides into action.

We view the ongoing trade war as the most significant risk to the outlook. Although de-escalation makes sense for both sides, political uncertainties mean trade tensions have the potential to spiral out of control. Under that scenario, the yield curve will have correctly predicted a recession and equity bear market.

On balance, we think it is more likely that the combination of trade-war resolution and policy stimulus will see the global economy recover in 2020. The asymmetry of the different outcomes—bear market versus limited upside—keeps us cautious until there is more clarity on the trade and stimulus outlook.

Asset class preferences

Our cycle, value and sentiment investment decision-making process points to a slightly cautious view on global equities and a relatively neutral view on fixed income. Global equities and government bonds are expensive from our medium-term perspective. The trade war and China weakness have the global cycle under pressure. Our sentiment measures are broadly neutral to slightly oversold, but not yet close to the level of investor pessimism that would trigger a contrarian buy-signal.

- 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. UK equities offer good value as demonstrated by the 5% dividend yield. Valuation in Japan is slightly positive and neutral in Europe. Both should benefit from eventual China policy stimulus, which would help bolster export demand.
- We like the value offered by emerging markets (EM) equities. Regional central banks are easing policy and EM markets will benefit from China stimulus. EM markets are, 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 slightly expensive and at risk from slowing corporate profit growth.
- Investment grade credit is expensive, with a slightly below-average spread to government bonds and a decline in the average rating quality.
- Government bonds are universally expensive. As of mid-August, around 30% of global developed government bonds on issue were trading at a negative yield. U.S. Treasuries offer the most attractive relative value.
- The Japanese yen continues to be our preferred currency. It's still undervalued despite this year's rally and has safe-haven appeal if the trade war escalates. A resolution to the

trade war could see the U.S. dollar weaken, given its counter-cyclical tendency. British sterling is very undervalued, but likely to be volatile around Brexit uncertainty and a potential general election before year-end. Sterling should rebound if Prime Minister Boris Johnson can secure a deal with Europe, or if a second referendum is called.

“A trade-war retreat, coordinated global central bank easing and significant China policy stimulus could set the scene for stronger global growth in early 2020 and an extension of the equity bull market.”

Andrew Pease

GLOBAL HEAD OF INVESTMENT STRATEGY



UNITED STATES OUTLOOK

Bending or breaking?

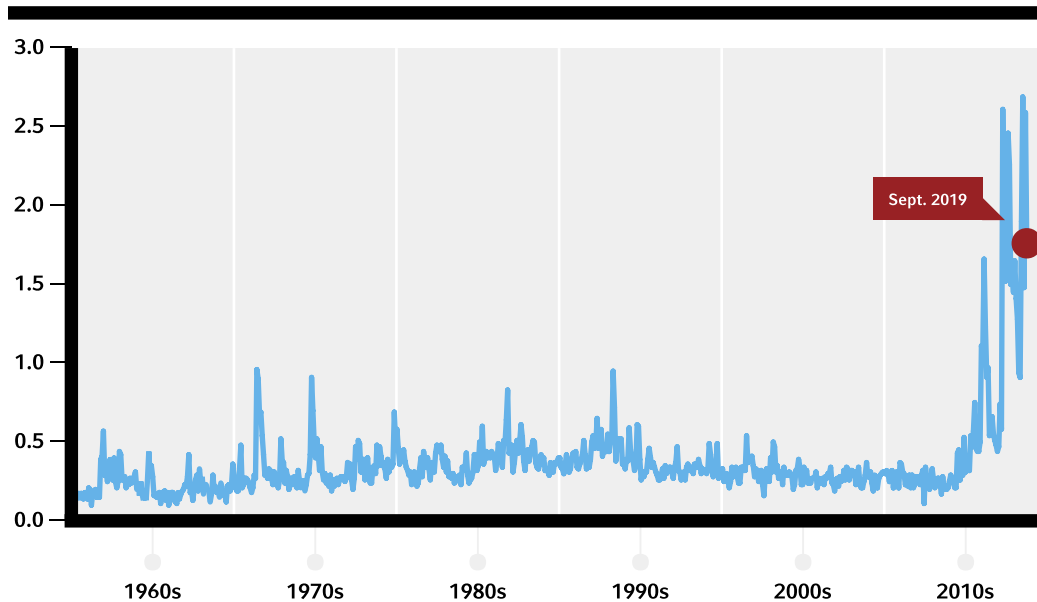
U.S. multinationals are facing a stiff headwind as the China/U.S. trade war exacts a toll on global growth and the earnings outlook. So far, the economy has followed the playbook from early 2016—the manufacturing sector is in recession, while the consumer continues to demonstrate strength and resilience. With the labor market beginning to show signs of slowing, however, a trade deal is necessary to reinvigorate the fundamentals underpinning asset prices.

Inflection point

Moving into the fourth quarter, markets face an inflection point. The trade war and associated uncertainty have rattled business confidence, capital expenditures have stalled, earnings growth is lackluster, the U.S. Treasury yield curve is inverted and we're left waiting to see what happens with the high-level China/U.S. negotiations that are slated for early October.

Trade policy is the key swing factor for the outlook /

Trade policy uncertainty index, % of news stories covering issue



Source: Dario Caldara, Matteo Iacoviello, Patrick Molligo, Andrea Prestipino and Andrea Raffo, "The Economic Effects of Trade Policy Uncertainty". Data as of September 11, 2019.

The tea leaves coming out of Washington, D.C., look rosier in September. President Trump's "good gesture" to postpone the scheduled October 1 tariff increase by a couple of weeks was met by favorable steps from China toward U.S. agricultural products. The market consensus seems to be extrapolating these positive vibes and is converging on the possibility of a "mini deal" in which the tariff tranches currently threatened for October 15 and December 15 get withdrawn. While that would clearly be a welcome development from the tit-for-tat roller coaster that we have been on during the third quarter, it may not be big enough to move the dial for the corporate sector. Management teams will need to feel confident in their respective five-year outlook to invest. For impacted industries, rebuilding that confidence will likely require the partial removal of existing tariffs and a clear, committed and believable de-escalation plan.

If the clouds of uncertainty are indeed removed by year-end, the global economy should reaccelerate. U.S. equities would likely rally in this period of fundamental strength but lag their international peers, which trade at more attractive valuation multiples.

A failure of trade talks and a further escalation of tariffs could easily tip the U.S. and global economy into recession. Some important leading indicators are already signaling that eventuality. The trusty Treasury yield curve has been inverted since May, while the Institute for Supply Management's manufacturing data for new orders in August showed a drop to a recessionary level of 47.

The Federal Reserve is playing second fiddle to these developments. They cut interest rates in July and September to push back against the downside risks from the trade war. Inflation expectations remain very low, which makes the Fed's calculus in favor of cuts much easier as well. Our baseline has one additional rate cut by year-end (most likely in October). But with this much policy-driven uncertainty, it is hard to say with conviction how many more rate

cuts the Fed will need to deliver. The range of answers is somewhere between one and eight. One useful benchmark for the Fed outlook that investors can consider is the yield curve. The inversion suggests that Fed policy may be restrictive into all of this trade-driven uncertainty. The Fed wants to be accommodative, which at current pricing would require two more cuts (our baseline). Our tactical preferred positioning on U.S. Treasury duration is neutral. We believe bonds still have a very important diversifying role to play in multi-asset portfolios if downside risks intensify.

Strategy outlook

- **Business cycle:** Slightly negative. We are late cycle and the further trade war escalation in August is likely to challenge U.S. manufacturing and global capital expenditure. The path forward will be determined by 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 the drawdown potential in U.S. equities. The warning signals from the yield curve and our Business Cycle Index model are instructive in this regard. We expect 2020 election-year politics in the U.S. make an eventual trade deal the more likely scenario. But given the risks, we would prefer to be more reactive to this positive cyclical wave than to step in front of a recession.
- **Valuation:** Expensive. The year-to-date rally has pushed U.S. equity market valuations significantly higher. Lower discount rates have been very supportive. But assuming a mean reversion (lower) in corporate profit margins over the next 10 years, our risk premium estimates for the S&P 500® Index are below historical norms.
- **Sentiment:** Neutral. Our momentum indicators are nothing to write home about at the beginning of the fourth quarter, with the U.S. equity market returning a paltry 2.6% over the past 12 months. Our proprietary aggregation of behavioral indicators did not flag a panic or euphoria in the zigzags of August, and it remains squarely in the neutral zone.
- **Conclusion:** Our underweight preference for U.S. equities in global portfolios rests solely on the back of their expensive valuations. We would expect this return driver to be rewarded over the medium- to longer-term. Our conviction levels on regional allocations tactically are low.

“If the clouds of uncertainty are removed by year-end, the global economy should reaccelerate. U.S. equities would likely rally in this period of fundamental strength but lag their international peers, which trade at more attractive valuation multiples.”

Paul Eitelman
SENIOR INVESTMENT STRATEGIST

EUROZONE OUTLOOK

Europe's outlook will improve if global trade tensions ease and China embarks on economic stimulus. Tentative signs of a pick-up in credit growth and a bottoming in car production provide some cause for optimism. ECB policy, however, has reached its effective limit.

Exit the Draghi

Mario Draghi expanded and then exhausted the monetary policy tool kit during his eight years as ECB president. The high point was his statement at the peak of the euro-crisis in mid-2012 that the ECB "is ready to do whatever it takes to preserve the euro, and believe me, it will be enough." It calmed markets and demonstrated the power of the central bank as the lender of last resort.

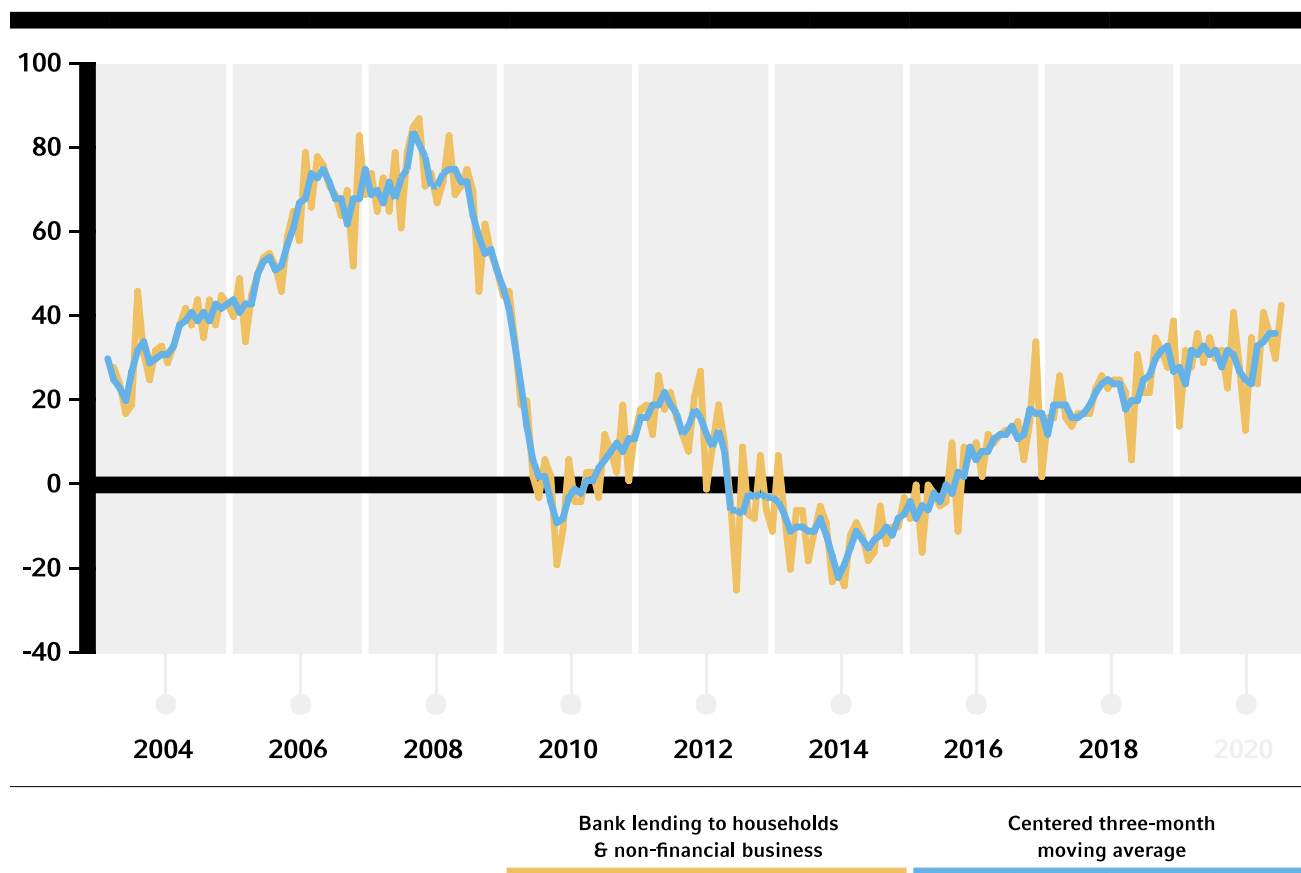
His last policy action in September 2019, however, illustrated the limits of central bank policy. Draghi cut the interest rate on overnight reserves by 10 basis points to -0.50% and restarted quantitative easing (QE) at a rate of €20 billion per month. The ECB ended its previous QE program last December after cumulative purchases of €2.9 trillion, mostly in government bonds.

Pushing the ECB's policy rate further negative and re-starting QE are unlikely to provide much economic stimulus, however. The latest addition to central banking jargon is the "reversal rate". This is the point where negative central bank interest rates start to depress rather than support economic activity. It operates mostly through bank profit margins, where the spread between the cost of funding (mainly bank deposits) and the average lending rate is compressed. This can discourage banks from lending.

We're not sure where the reversal rate lies, but -0.5% can't be far from it. The other monetary policy transmission channels, QE and currency depreciation, are also near their limits. Ten-year German bund yields at -0.45% have limited scope to decline further and the euro, at 1.1 to the USD, is already very undervalued.

Fortunately, there is evidence that eurozone credit conditions were improving before the ECB's latest move. Monthly lending by banks to households and non-financial corporations has been increasing since February and is now close to €40 billion per month. This is the highest pace of monthly bank lending since the 2008 financial crisis.

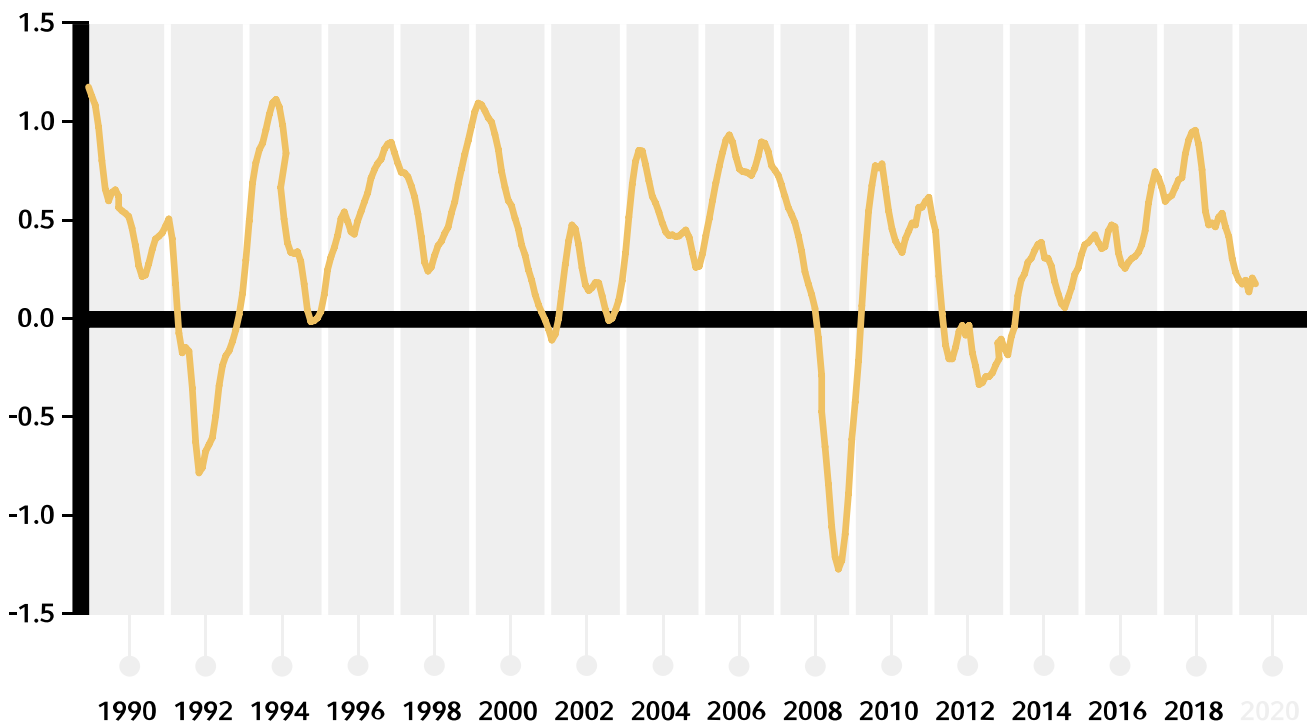
Eurozone: bank lending to households & non-financial business / € billion



Source: Refinitive Datastream, last observation July 2019.

The Bank of Italy's monthly Eurocoin indicator, which tracks underlying gross domestic product (GDP) growth in the eurozone, tentatively suggests that the growth slowdown since early 2018 may be starting to bottom.

Eurocoin activity indicator / Monthly %



Source: Refinitiv Datastream, Bank of Italy; last observation, August 2019.

The economic weakness has been focused in manufacturing, with Germany hit hardest. Automobile production is yet to recover from last year's declines following the European Union's new emissions testing regime. Car exports have been hurt by the global trade war. There is some evidence that global car demand is now running above production levels, opening the possibility of a recovery in the fourth quarter.

One of the risks we were concerned about last quarter has eased. Italy's political crisis has reached at least a temporary resolution with the left-wing Five-Star movement forming a new coalition government with the center-left Democratic Party. The departure from government of the right-wing populist Lega party, led by the combative Matteo Salvini, has eased fears of a stand-off with the European Commission over budget rules. Italian bond yields have declined significantly as a result. The new government may not be long-lived, but it has pushed the risk of new elections well into 2020.

There is less clarity on the other two risks for Europe—the trade war and Brexit. Tensions between the U.S. and China appear to be easing as President Trump starts to focus on his 2020 re-election. Europe's export dependence made it a casualty of the trade tensions and it will benefit from a truce. The U.S. decision on European car tariffs will likely be delayed beyond November 14 if China/U.S. trade talks are ongoing.

The Brexit end-game is difficult to forecast. A chaotic no-deal exit seems the least likely outcome, but nothing is certain ahead of the October 31 deadline.

Strategy outlook

- Business cycle: The cycle should marginally improve over the coming months as car production recovers, 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 should be one of the main beneficiaries of significant China policy stimulus.
- Valuation: Eurozone equities are close to fair value on our calculations, compared to U.S. equities, which are expensive. Core government bonds are long-term expensive, including 10-year German Bund yields at -0.45% in mid-September, and we see limited scope to fall further.
- Sentiment: Contrarian sentiment signals are broadly neutral as of mid-September. There are no signs that equities are either overbought or oversold. Price momentum in eurozone equities is slightly positive.

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Andrew Pease

GLOBAL HEAD OF INVESTMENT STRATEGY



ASIA PACIFIC OUTLOOK

Waiting to Xi the stimulus

So far in 2019, the evidence of China economic stimulus has been underwhelming. Exacerbating this, China/U.S. trade tensions have escalated and regional economic data has been disappointing. Central banks have become more supportive, with rate cuts in most economies. The key watchpoint remains trade developments and further policy announcements from the Chinese government.

China

In our mid-year report, we noted that the data in the region had been disappointing, particularly for China and South Korea. We are yet to see real signs of improvement in either country and have seen a deterioration in some other countries. The political unrest in Hong Kong has impacted activity there, and we are closely watching both the Chinese government's response as well as any spill-over into Taiwan. Trade tensions between South Korea and Japan have also risen, which is of second-order importance relative to the China/U.S. situation. As a result of the risks around trade and regional growth, central banks are responding by cutting rates, which should provide some support moving forward.

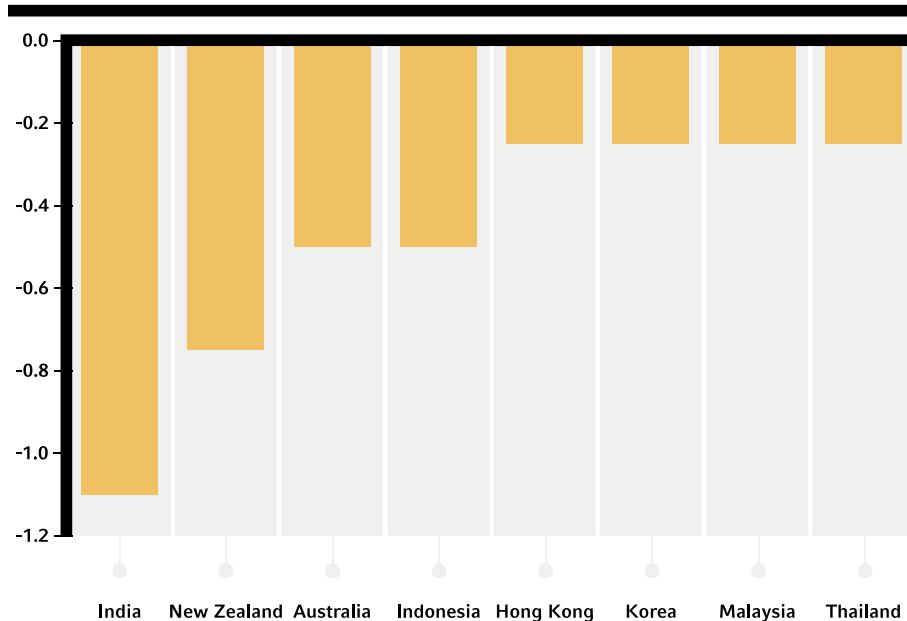
The Chinese economy has continued to slow, with the manufacturing sector feeling the most pain. The divergence between services and manufacturing that we're seeing globally is also apparent in China. Employment indicators are pointing to a slowdown in hiring across the economy, which increases the imperative of the Chinese government to either negotiate some form of trade deal or introduce new measures of stimulus.

On the stimulus front, there have been several announcements from the Chinese government regarding new measures. These have included further cuts to the Reserve Requirement Ratio and reform to the Loan Prime Rate. However, the issue now for credit creation isn't a lack of funds, but instead a lack of demand. The latter could encourage a pickup in demand, as this reform effectively acts as a reduction in interest rates. Nevertheless, it is concerning that we have not yet seen meaningful signs of stimulus in the data—and as a result, we have become slightly more cautious. We continue to think that the monthly credit numbers will be the first to show signs of stimulus and will be closely monitoring them.

South Korea and Taiwan have seen weak export demand, which has weighed on the economic picture there. This has been driven by the trade war, as well as slowing demand for smartphones, which are major exports for both countries. The South Korean economy is set to benefit from fiscal expansion in 2020, while focus in Taiwan will soon turn to the pending 2020 presidential election, where support for incumbent President Tsai Ing-Wen has picked up due to her tough stand on China in the wake of the Hong Kong protests.

Regarding India, we noted at mid-year the dual headwinds of pre-election uncertainty and some regulatory changes in the autos sector. Offsetting this, government spending has been a positive contributor to GDP. The Reserve Bank of India has cut rates by a full percentage point since the start of 2019, and we think it is likely to provide more accommodation before the end of the year.

Change in cash rates since the end of 2018 / %



Source: Refinitiv Datastream. Last observation: September 30, 2019.

The Australian housing market has started to stabilize, as we highlighted in our mid-year report. Despite this, we continue to categorize the outlook as lackluster given households are heavily indebted and there's a drag from falling housing construction. The Reserve Bank of Australia (RBA) has shown it is ready to act, and we now expect two more rate cuts by the middle of 2020. This easier monetary policy has provided a boost to the local equity market, however, we think any upside is limited, given the soft fundamentals.

A similar story is being seen in New Zealand, where the Reserve Bank of New Zealand (RBNZ) surprised the market by cutting interest rates by 50 basis points in July. The combination of falling interest rates and a depreciation in the New Zealand dollar propped up the equity market, given the high proportion of bond proxies and foreign earners.

It is increasingly likely that both the RBA and RBNZ will need to go down the path of unconventional monetary policy, either before or during the next global downturn. Here, we see an interesting divergence between the two. In New Zealand, where there is not a strong domestic banking sector, we think it is likely that the RBNZ will take the policy rate into negative territory. In Australia, where there is a strong domestic sector, we think the RBA is more likely to look at some form of quantitative easing.

Finally, the Japanese economy continues to stare down the barrel of the increase in the value-added tax (VAT) rate, which is scheduled for October. We have not seen the level of front-running of orders that were observed before the previous VAT increase in 2014. The Bank of Japan (BoJ) are likely to ease monetary policy, however with interest rates already in negative territory, the BoJ have limited room to significantly ease financial conditions. The Japanese equity market continues to look slightly cheap in our opinion.

Investment strategy

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

- **Business cycle:** We have become more cautious in the near-term on the region, given the risks around trade. However, there are still positive circuit breakers in the form of expected Chinese stimulus and more accommodative central banks.
- **Valuation:** Valuations in emerging Asian markets and Japanese equities continue to look reasonable to slightly attractive. Despite their strong performance year-to-date, mainland China equity prices also look fair. New Zealand equities stand out as being very expensive. Developed economy bonds also look expensive.
- **Sentiment:** While trade remains a risk, we think investor sentiment in the region will remain cautious. Positive developments in trade negotiations would spark renewed interest and optimism, which likely would see the region outperform.

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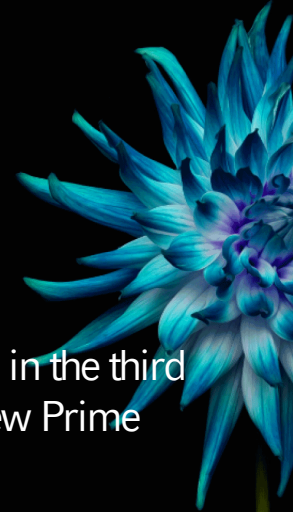
Alexander Cousley
INVESTMENT STRATEGY ANALYST



CURRENCIES OUTLOOK

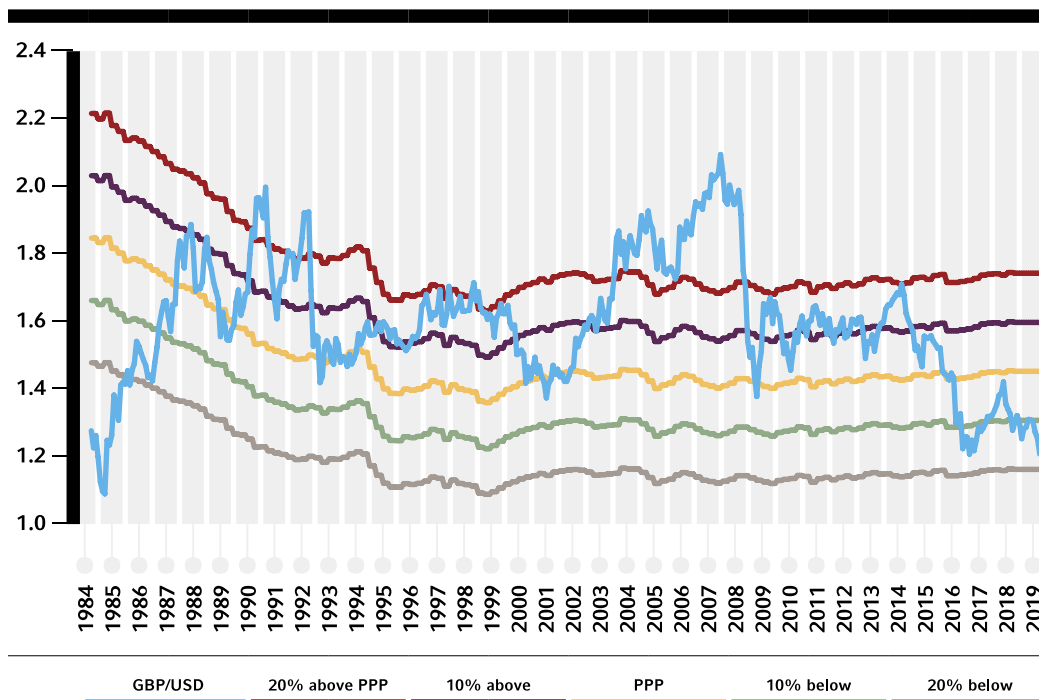
Sterling needs a hero

The British pound touched 35-year lows versus the U.S. dollar in the third quarter as concerns about a no-deal Brexit increased under new Prime Minister Boris Johnson.



The UK faces an October 31 deadline for the six-month extension of its membership in the European Union. Since the extension was agreed, Britain took part in the European Parliamentary elections, where the Eurosceptic Brexit Party led by Nigel Farage received the highest share of the vote and the most seats. Partly because of the Conservative Party's disappointing performance in those elections, UK Prime Minister Theresa May stepped down and was succeeded by Boris Johnson. His ostensible willingness to accept a possible no-deal Brexit pushed the GBP/USD exchange rate briefly below 1.20, a 35-year low.

GBP/USD exchange rate / (%)



Source: Refinitiv Datastream. Last observation September 11, 2019.

PPP refers to purchasing power parity, where the same amount of goods could be purchased in either currency.

However, a majority in the House of Commons, the elected chamber in Britain's parliament, want to prevent a disorderly exit. To stop them from making his life more difficult, Johnson suspended the legislative session for five weeks through October 14. Before this suspension took effect, a coalition of opposition party politicians and Conservative "rebels" successfully passed a law that compels the prime minister to seek another extension through January 31, 2020, if no deal can be agreed with the European Union. Neither side in the domestic Brexit battle has landed a knock-out punch. To unlock the value in sterling, i.e., for it to strengthen from the current depressed levels, a Brexit resolution is needed, in our view.

On the other side of the Atlantic, the U.S. Federal Reserve cut interest rates by 25 basis points at its July 31 meeting and again in September—outcomes that were in-line with the industry consensus of economists. The Fed leadership is trying to lean against policy uncertainty from the China/U.S. trade war, weak business investment and lackluster economic activity abroad. However, Fed chair Jerome Powell emphasised that a few rate cuts should be seen as an insurance policy rather than the start of a big easing cycle. The U.S. Dollar Index (DXY) rose to new highs for 2019 after this "hawkish" surprise, suggesting that markets had raced ahead of themselves in pricing more than four rate cuts in the next 12 months.

In addition, weakness in global data ensures that the Fed is not the only central bank in easing mode. At its September policy meeting, the European Central Bank cut its deposit rate to -0.5% and announced that it will resume asset purchases, keeping the euro subdued and the U.S. dollar strong. While the U.S. has much more room to ease than other central banks, a deep and sustained rate-cut cycle would require a full-blown recession scare. We believe such a scenario would ultimately be negative for the U.S. dollar, but the day of reckoning for the greenback has been postponed.

Of all developed-market currencies, we still believe the Japanese yen is the most attractive investment. While it is not as cheaply valued at the end of the third quarter as it was at the beginning of 2019, it remains the most “defensive” currency. In other words, it is likely to surge when risky assets such as equities decline. We believe this diversification benefit of the yen makes it valuable as a portfolio diversifier.

“The British pound is cheap but needs a Brexit resolution to unlock its value.”

Van Luu

HEAD OF CURRENCY & FIXED INCOME STRATEGY

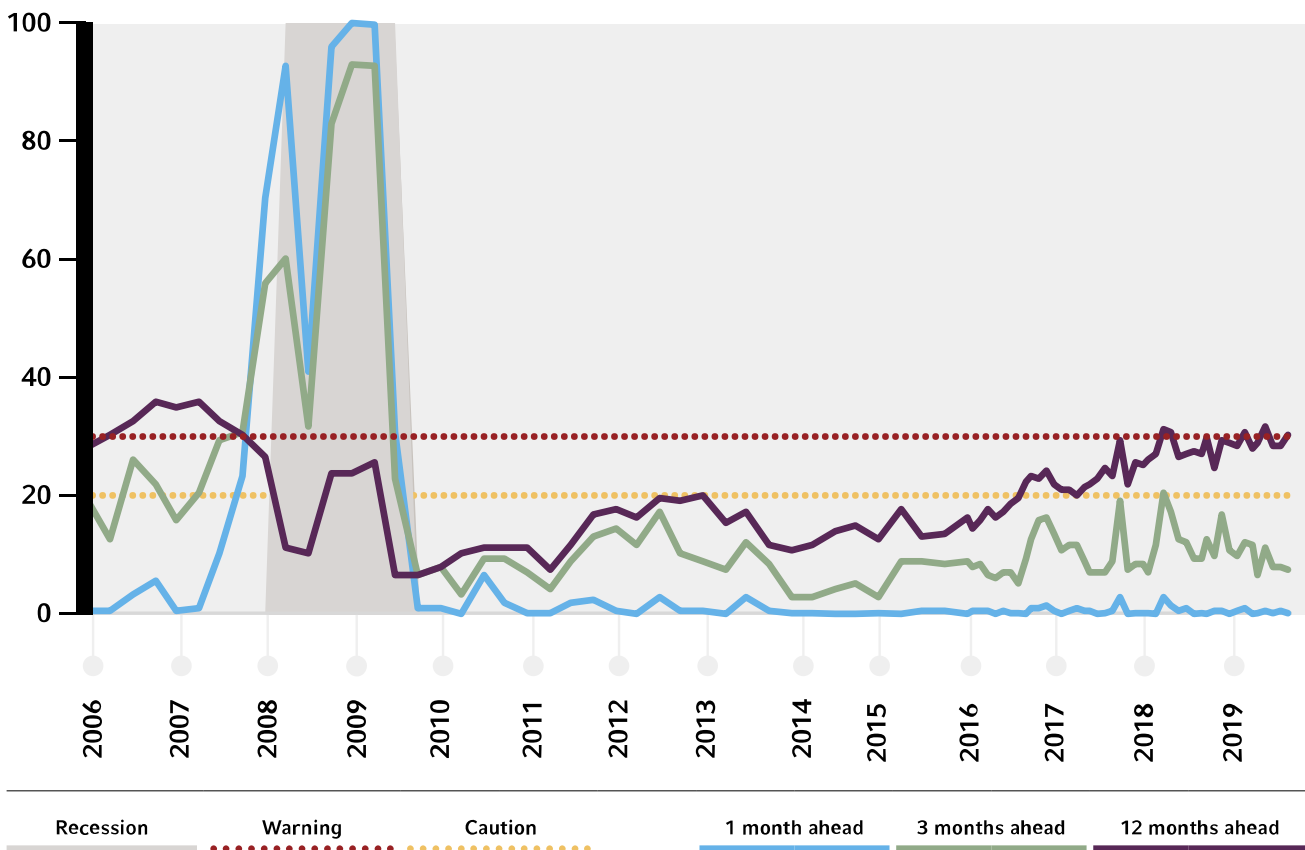


QUANTITATIVE MODELING INSIGHTS

Not out of the woods

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, is still in "risk-off" territory. Although short-term risks remain low, the BCI model estimates the probability of a U.S. recession in 12 months at 30%, which is the warning threshold for leaning out of risky assets. We had staged some initial cyclical downgrades on equities and risk-seeking fixed income last quarter, when the BCI recession probabilities first crossed the warning threshold. If the recession probabilities increase or stay above the warning threshold longer, we may downgrade cycle scores further.

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



Source: Russell Investments, as of September 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.

The path forward for the U.S. economy will depend on whether the Federal Reserve can cut rates enough to stabilize China/U.S. trade tremors.

Prolonged trade uncertainty damages global growth and corporate profits. A mild earnings recession, where we see consecutive quarters of negative earnings growth, looks increasingly likely. Historically, firms respond to poor profits by reducing capital expenditure (which they've already done) and hiring (which they might be starting to do). Consumer spending remains a pillar of strength for the U.S. economy as the fourth quarter begins, but that may quickly change if the labor market gets hit.

The bond market prices this increased risk through the inverted 10-year/3-month U.S. Treasury yield curve, an indicator which continues to distress the BCI model. An inverted yield curve—provided it's of sufficient¹ duration and magnitude—is historically one of the best predictors of recession. The yield curve has been inverted for more than 100 days and counting, with a maximum inversion of 50 basis points. These are duration and magnitudes consistent with previous pre-recession episodes. There is a chance that the damage is already done, but a path out of the woods involves accommodative monetary policy and a stable trade environment for businesses.

BCI recession probabilities may lower back under the warning threshold if 1) the Fed cuts interest rates enough to un-invert the yield curve over the next couple months, and 2) macroeconomic and financial data do not deteriorate in the meantime. Until then, our models continue to recommend defensiveness as we look toward the fourth quarter.

¹Historically, there have been false alarms with the 10-year/3-month U.S. 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 path forward for the U.S. economy will depend on whether the Federal Reserve can cut rates enough to stabilize China/U.S. trade tremors.”

Kara Ng
QUANTITATIVE INVESTMENT STRATEGIST

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The views in this Global Market Outlook report are subject to change at any time based upon market or other conditions and are current as of September 23, 2019. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed.

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 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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