Points of View

Market pricing continues to suggest the post-Global Financial Crisis regime remains in place — that bonds and equities will stay negatively correlated, acting as a natural hedge within portfolios.

Priced in
✓ A total of 75 bps cuts in 2019 and a further 25 bps cut in 2020
✓ Reimplementation of QE in Europe
✓ Trade stalemate
✓ 10% earnings growth in 2020
✓ GDP of approximately 2% as the consumer and service sector remain strong
✓ Inflation never again
✓ Absorbable impact from tariffs as the Dec. 15 “consumer tariffs” get delayed
✓ No European auto tariffs
✓ Ratification of USMCA
✓ A negotiated Brexit
✓ More China stimulus

Not priced in
✗ More rate cuts
✗ German fiscal spend
✗ A US–China trade deal by the election
✗ Earnings deterioration in 2020
✗ US GDP less than 2%
✗ An inflation spike
✗ A tariff-induced fundamental slowdown
✗ European auto tariffs
✗ No ratification of the USMCA in 2019
✗ Hard Brexit
✗ Ineffective China stimulus

What’s Priced In?

Equities
2019 earnings growth estimates for the S&P 500 have fallen to 1.4% and have held steady around 10.5% for 2020, which is likely too high. We think this is more in line with our “more of the same” scenario where slowing growth continues for the rest of 2019 but stabilizes in 2020. Expectations of greater central bank stimulus and lower rates have eased financial conditions and prevented risk-off sentiment from escalating, helping to keep measures of implied volatility at subdued levels.

Our View on Equities
While we do not see a recession by the end of 2020, risks to growth are skewed to the downside and currently not reflected in earnings estimates or expected volatility. In addition, unless trade uncertainty is substantially reduced, we see limited upside potential to earnings. Compared with our forecasts and similar to our last report, this suggests a market that has become too complacent and potentially overly reliant on central banks.

Government Bonds
Similar to rates, market pricing more reflective of our downside scenarios is also apparent in sovereign fixed income markets. The inversion of the 2s10s Treasury curve in August for the first time since 2007 and further inversion between other segments (2s5s, Fed Funds-2s) suggest that markets think the Fed is too tight given the outlook for growth and inflation. 10-year real yields in the US retreated further and turned negative to the lowest in over three years.

Our View on Bonds
Our forecasts for yields still imply a market that is too pessimistic and lowered its estimates too far. Hence, we see a higher probability of an upward drift in yields as growth stabilizes in 2020.

Inflation
The market continues to expect inflation to remain subdued and below central banks’ targets over the near and medium term. In the US, long-term inflation expectations fell to 1.87% in August, only 8 bp above the all-time low in early 2016. In the Eurozone, the downward trend has stabilized but estimates have remained near historically low levels.

Our View on Inflation
Similar to the moves in rates, the market’s perception of inflation is more reflective of our downside scenarios. Our base case estimate for inflation still remains more optimistic compared to the market and like growth, we see the slowing inflationary backdrop to moderate and improve modestly over the next 12 months.

Interest Rates
The decline in interest rate expectations accelerated in the third quarter as trade-related uncertainty increased and growth and inflation continued to slow. As of October 16th, the market expects one more cut in 2019 (total of three in 2019) and one in 2020.

Our View on Interest Rates
In our highest probability scenario, “more of the same,” we now expect one additional rate cut for the rest of 2019 and the Fed to remain neutral next year as growth improves. That said, if trade conditions were to deteriorate significantly, we would expect further easing. Given the market’s heightened sensitivity to end-of-cycle concerns, an unspecified and negative shock to market sentiment would also lead to additional easing.
Market Sentiment

The theme for investors continues to be the fear and promise of policy choices on both the trade and rate fronts. These tail risks contributed to a bifurcated third quarter where rates rallied dramatically as investors rushed to safety while the equity markets witnessed increased volatility and price action that can only be called churn, trading in a range with daily dramatic swings. Intensifying trade conflict with China has softened the US growth outlook, reduced capital expenditure expectations, and threatens to shave earnings further in 2020. The Federal Reserve notes that the intensification of trade policy uncertainty in the second quarter of 2019 would likely have adverse and “protracted effects” on investment and GDP through time. Further, inflation expectations plummeted, even with a Fed 25 bps cut in July and another in September.

With the macro data signaling a global manufacturing recession, global yields dove into negative territory creating a pool of $14 trillion of negative yielding debt. US yields also dropped to near historic lows in August as the global flight to safety buoyed the US debt market. The 2–10-year spread joined the 3mo–10y in inverting, prompting models to increase the probability of a US recession within the next 18 months. With sentiment so negative, investors now expect a total of 75 bps cuts in 2019 and 25 bps more in 2020.

Despite the fact that the US and China slapped further tariffs on each other’s goods on September 1, investors now believe that trade talks with China are likely to result in a near-term stalemate which has stabilized markets. With talk of a phase 1 “skinny deal,” markets stabilized and the yield curve steepened (both 3 mo–10y and 2–10 year spread are in the positive territory as of October 16th). The probability of a US recession in 2020 has increased owing to a decline in US manufacturing activity and some signs of softness in both the consumer and the labor markets.

Nevertheless, earnings forecasts suggest the market remains constructive on US growth, expecting GDP to come in around 2% as the hit from tariffs and slower growth is expected to be manageable. Investors, while cognizant of the obvious threat to fundamentals, also expect central banks to cushion the blow as the S&P 500, despite volatility, remains near its historic high. While investors anticipate global central banks to inoculate the economy from any further deterioration, there is a creeping suspicion that central bankers have run out of ammunition in a low-yield world.

“While investors anticipate that global central banks will inoculate the economy from any further deterioration, there is a creeping suspicion that central bankers have run out of ammunition in a low-yield world.”
Executive Summary

WHAT WE THINK — ECONOMIC SCENARIOS

More of the same
In this scenario, the world economy slows but does not shrink. Progress on trade talks helps stabilize the manufacturing slowdown and the sharp fall in bond yields seen to date helps ease financial conditions and stabilize demand in the major economies. Secular stagnation in the industrialized world means equilibrium real interest rates remain very low, possibly negative, and inflation remains subdued in all the major economies. The Federal Reserve cuts rates three times in 2019, but the stabilization of growth means it doesn’t have to do much more. The Euro Area, and Germany in particular, flakes with recession, but this is short-lived and modest growth returns as the global manufacturing cycle picks up in 2020. The European Central Bank re-launches Quantitative Easing and the Bank of Japan continues balance sheet expansion. The Chinese economy responds to stimulus, and stronger domestic demand spills over to the rest of Asia and commodity exporters in 2020. Equities are helped by low bond yields and a modest revival in earnings growth. The dollar holds steady.

US: leader of the pack
We retain this scenario, but its likelihood has fallen sharply in successive editions. In this world, growth surprises to the upside as trade tensions recede and monetary stimulus has marked effects. This is the only scenario in which secular stagnation is not at play; in fact, output is very near capacity and the US/Eurozone and UK economies are at full employment, so an upside growth surprise translates into higher inflationary pressure. It takes some time for central banks to realize this and they are initially cautious about raising rates, but as inflationary pressure builds they come to realize they are behind the curve not ahead of it. The Federal Reserve starts to raise rates in the second half of 2020 and re-tapers. Interest rate expectations are revised up sharply in a number of economies and bond yields rise sharply. Higher US rates and a stronger dollar trigger capital flight out of risky assets. The result is a sharp slowdown, possibly recession in the US around 6-9 months after the surprise tightening begins — maybe 2021.

Tail wags dog
In this scenario, disruption in the financial markets triggers and/or intensifies the downturn. With $16 trillion of public debt worldwide yielding negative rates, the search for yield has been intense, leaving risk premiums compressed and expected returns low. An unspecified shock leads to a sharp reversal in market sentiment and a flight from risky assets. Risk premiums normalize very quickly, raising the cost of capital and tightening financial conditions sharply. Corporate net worth suffers and credit yields, particularly in high-yield and other risky categories such as leveraged loans, rise rapidly. Given the much greater importance of non-bank credit these days, this scenario looks more like the dotcom crash of 2001 than the great financial crisis of 2008. This is largely because it is intermediated through nonbanks, whose leverage is much lower than that of banks, and equity holders bear the brunt of losses (as opposed to taxpayers).

Globalization is dead!
Arguably the bond market appears to attach a higher probability to this scenario than our 30%. Here, the US/China trade conflict is shorthand for something much bigger — full-scale de-globalization over the next decade. The belief is that this implies much lower growth, productivity growth and returns on capital for some years ahead. The tariffs announced to date aren’t large enough to account for the global manufacturing slowdown we’ve seen, and it appears to be fear of something more fundamental that is holding back investment. In this scenario, the situation gets worse not better over the next 18 months. Global trade and investment fall further, the international manufacturing slowdown intensifies and, by undermining household and industrial confidence, eventually spills over into real economies too. In other words, fear of a very different and much more autarkic world in a few years’ time has a real impact on investment and growth now.

IDIOSYNCRATIC RISKS

US China Trade
Higher tariffs between the US and China and continued uncertainty surrounding future negotiations continue to weigh on sentiment, capital expenditures, and manufacturing activity. This uncertainty is prolonged and the damage spills over into the US consumer. US businesses also begin to feel the pain from the trade war.

Brexit
The UK leaves the European Union without a deal and economic activity slows more than the consensus is pricing in. Uncertainty lingers longer than expected and both consumer and business sentiment suffer dramatically.

Oil
Geopolitical tensions escalate in the Middle East disrupting supply and leading to a sharp upwards spike in oil and risk aversion.

* Views expressed are those of the author and do not reflect views of other managers or the firm overall.
Investment Conclusions

US Equities: Domestic equities are faced with offsetting forces; on a positive note, strong US consumer data, a stable labor market and expectations of better earnings in 2020 are keeping cyclicals afloat. Questions about the enforceability of a trade deal and uncertainty around the efficacy of central bank support continues to drive near-term volatility. With this backdrop, we still see opportunities in equities as the Fed has indicated it will work in sync with market expectations. In particular, we favor large-cap, domestically focused, dividend paying stocks in the US. US small caps could outperform after notable underperformance YTD should there be some stabilization of the trade war and an inflection point in growth, even if slight.

European Equities: Stimulus from the European Central Bank in the form of rate cuts and quantitative easing could buoy prices, and we suspect the fundamental economic data are bottoming given the message from the markets. European yields are quietly off their lows perhaps in expectation that Christine Lagarde will support fiscal boosts. UK equities can be an interesting buying opportunity as we near the Brexit deadline since most of the bad news is likely priced in and regardless of the outcome, the removal of uncertainty would be an overall positive.

Emerging Markets (EM) Equities: We believe it is prudent to reduce risk exposures in EM equities, especially as we do not see a meaningful acceleration in world trade in the near term and more evidence that China has accepted lower GDP growth as their base case scenario for the next 6–12 months. Although an increasing number of EM countries are stimulating their economies via easy fiscal and monetary policy, we expect a transmission lag in EM growth stabilization into equities (especially as local currencies are under increasing pressure from the USD). However, as EM is not a homogeneous asset class, there is ample room for returns to good selection. We see more interesting investment opportunities in countries like India, Indonesia, and Brazil with strong macro fundamentals and reform agendas, less exposure to the US–China trade dispute, and resilient earnings growth.

US Dollar and Foreign Exchange (FX): The level of global uncertainty remains elevated, which supports demand for the US Dollar (USD). We expect this trend to continue through the end of 2019, and as a result, see the USD staying flat to slightly positive. Any rate cuts by the Fed are likely to have a minimal effect on the value of the USD as a gradually steepening yield curve and increasing yield differential should continue to point to the Dollar as the most attractive hard currency.

Alternatives: In this environment, alternatives that provide exposure to uncorrelated asset classes should be effective hedges should either of our two downside scenarios materialize. Positive sources of return in alternatives can selectively be found in private exposure to equity and debt, and diversified natural resources.

Sovereign Debt: Safe haven demand around the globe has provided steady demand for US Treasuries. If the Fed meets the market signal and cuts 75 bps in 2019, we expect a gradual steepening of the yield curve to persist through the end of the year, making longer duration US sovereigns more attractive than long. The negative stock/bond correlation still makes the case for traditional sovereign exposure as a hedge in volatile environments.

Global Investment Grade Credit (IG): We view US investment grade credit as attractive overall, and see it benefiting from persistently low rates and strong US consumer and labor market trends. The strength and flexibility of many large corporations allows them to remain fundamentally sound even in the face of tariff increases and we are confident that management teams are being prudent during the uncertainty. We favor US IG credit over European, but selective opportunities in Europe are attractive to long-term investors as the ECB restarts QE.

High Yield (HY) and Leveraged Loans: In a yield-starved world, high yield and leveraged loans continue to provide an income boost as a satellite asset class. Easy policy from the Fed and ECB should keep default rates stable and prevent sharp spikes in yield. Tighter supply in European HY has made for more attractive technicals, but investors should be cautious of additional risk. Generally, we would suggest a tilt toward US HY over European, but diversified exposure to the asset class can provide attractive real yields.

EM Hard Currency Debt: The search for yield and easy global central banks makes EM debt attractive, although discretion remains critical and we suggest focusing on countries less exposed to US–China trade. Our expectation of a continued stable-to-slightly strengthening USD makes valuations less attractive, but reduces investors’ need to hedge out more volatile currency risk. As such, we continue to favor USD-denominated EM debt as opposed to other hard currencies.

EM Local Currency Debt: We view EM local currency debt as an attractive investment for the long-term, but selective risk taking is advised. For investors entering into the space, we view countries such as Brazil, Mexico, India and Indonesia as attractive because of their high real yields and low exposure to trade tensions. Given the uncertain trajectory of trade negotiations and policy volatility, we believe hedging local currency risk can dampen volatility.
2020 earnings growth estimates have remained resilient but risks are skewed to the downside.

![Graph showing S&P and STOXX Europe 600 earnings growth estimates from 2019 to 2020.](image)

Data as of October 14, 2019. Source: Factset.

The market remains optimistic about a US–China trade deal being reached.

![Graph showing China Trade Deal Basket relative to S&P 500.](image)

100 = 12/31/2017. Data as of October 11, 2019. Top 30 S&P 500 companies with the most revenue exposure to China relative to the S&P 500 Index. Source: Strategas.
BNY Mellon Global Investment Strategy

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RISKS
Investing in foreign denominated and/or domiciled securities involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries. Bonds are subject to interest rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Small and midsized company stocks tend to be more volatile and less liquid than larger company stocks as these companies are less established and have more volatile earnings histories. Commodities contain heightened risk including market, political, regulatory, and natural conditions, and may not be suitable for all investors. Currencies can decline in value relative to a local currency, or, in the case of hedged positions, the local currency will decline relative to the currency being hedged. These risks may increase fund volatility. Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. High yield bonds involve increased credit and liquidity risk than higher-rated bonds and are considered speculative in terms of the issuer’s ability to pay interest and repay principal on a timely basis. Alternative strategies may involve a high degree of risk and prospective investors are advised that these strategies are suitable only for persons of adequate financial means who have no need for liquidity with respect to their investment and who can bear the economic risk, including the possible complete loss, of their investment. The strategies may not be subject to the same regulatory requirements as registered investment vehicles. The strategies may be leveraged and may engage in speculative investment practices that may increase the risk of investment loss. Investors should consult their investment professional prior to making an investment decision.

All investments involve risk including loss of principal. Certain investments involve greater or unique risks that should be considered along with the objectives, fees, and expenses before investing. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Charts are provided for illustrative purposes only and are not indicative of the past or future performance of any product. An investor cannot invest directly in any index. Past performance is not indicative of future results.

DEFINITIONS
S&P 500® Index is designed to track the performance of the largest 500 US companies. Europe STOXX 600 Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. Yield Curve refers to a line that depicts the yields of bonds of varying maturities, from short-term to long-term, showing the relationship between short- and long-term interest rates. The 10 Year U.S. Treasuries Average Yield is a range of Treasury Securities all adjusted to the equivalent of a ten-year maturity.

STATISTICAL TERMS
Duration is a measure of a bond’s interest-rate sensitivity, expressed in years. The higher the number, the greater the potential for volatility as interest rates change. Correlation is a statistic that measures the degree to which two variables move in relation to each other.

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