Vantage Point

NEGATIVE CHARGE
Q4.2019
Welcome to the latest edition of Vantage Point. This is another interim update and our economic scenarios haven't changed significantly since we last published. The global slowdown has intensified since our last edition and downside risks are rising. That's reflected both in the probabilities we assign to the scenarios and the behavior of growth and interest rates within the scenarios. In short, we're more pessimistic about global growth and downside risks are rising further.

Since our last update, we’ve seen bond yields worldwide fall further – around $16 trillion of global debt now carries a negative yield. The world economy – the rich world at least – is characterized by three overarching phenomena: secular stagnation, financial repression and de-globalization. Secular stagnation because the desire to save exceeds the desire to invest globally, driving the world real interest rate down, probably into negative territory. This constrains the ability of central banks to raise interest rates significantly – as the Federal Reserve found out recently. In addition, the huge overhang of debt means interest rates will have to stay below the nominal growth rate of the economy for some time – this is what we mean by financial repression. But a side effect of this is the so-called ‘search for yield’ remains intense. On top of all that, international economic relationships are being re-shaped in a way we haven't seen in the past 40 years; the tariff war between the U.S. and China isn't large enough by itself to explain the global manufacturing slowdown we are witnessing. Instead, it must be the fear of something more fundamental – a future world that’s much less interconnected, with shorter international supply chains – that is causing manufacturing firms to cut back on investment right now. Finally, given rich valuations, markets remain vulnerable to exogenous geopolitical shocks.

The upshot is a difficult environment for investors. On the one hand, some safe assets yield zero or less; on the other, riskier assets suffer from compressed risk premiums and politically-driven volatility that is hard to predict. The answers aren’t straightforward, but this edition of Vantage Point examines all these issues, following our established logic – what we think, what the markets think and what the broad investment conclusions are. We hope you enjoy reading it.

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CHIEF ECONOMIST
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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, flirts with recession, but this is short-lived and modest growth returns as the global manufacturing cycle picks up in 2020. The ECB re-launches QE and the BoJ 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.

U.S.: 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 fears 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 U.S./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 U.S. rates and a stronger dollar trigger capital flight out of risky assets. The result is a sharp slowdown, possibly recession in the U.S. around 6-9 months after the surprise tightening begins – maybe 2021.

IDIOSYNCRATIC RISKS

U.S./China Trade

Higher tariffs between the U.S. and China and continued uncertainty surrounding future negotiations continue to weigh on sentiment, capex, and manufacturing activity. This uncertainty is prolonged and the damage spills over into the U.S. consumer. U.S. 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.
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<th>SCENARIO</th>
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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 non-banks, whose leverage is much lower than that of banks, and equity holders bear the brunt of losses (as opposed to taxpayers).

Arguably the bond market appears to attach a higher probability to this scenario than our 30%. Here, the U.S./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.

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.

This information contains projections or other forward-looking statements regarding future events, targets or expectations, and is only current as of the date indicated. There is no assurance that such events or expectations will be achieved, and actual results may be significantly different from that shown here.
Markets have priced in 75 bp of easing in 2019 and 50 bp in 2020. While our highest probability (35%) “more of the same scenario” sees three rate cuts in 2019 and then holds steady, our interest rate fan chart has shifted lower and is also skewed more to the downside compared to our last forecast. That said, the market’s pessimism is misaligned with our view of growth and inflation as we remain more optimistic and expect slowing fundamentals to stabilize.

Fixed income markets are pricing in an even worse economic outlook than they were three months ago. 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 expect growth, inflation and real interest rates to stay low for some time and potentially reach recessionary levels in the next 12-18 months. Given the sharp fall in yields vs. our more sanguine fundamental outlook, our bond yield fan chart is now skewed to the upside. This contrasts with our rates fan chart which is skewed to the downside and can be explained by the disconnect between the Fed and market’s outlook on rates. That said, a capital markets shock could easily send yields back to historical lows and possibly even lower.

Equities were volatile in August as the trade war escalated but recovered in the last week of the month and then rallied through September. Despite slowing growth, sentiment has been buffered by expectations of greater central bank stimulus and lower interest rates.

Overall, 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.
Equities
- We remain sanguine on U.S. equities and suggest staying fully invested as the Fed has a chance to support the economy.
- In European equities we are cautious due to the sharp manufacturing slowdown and stubborn growth and inflation data, but are watching for stimulus from the ECB and a resolution on Brexit as positive catalysts.
- We suggest reducing risk exposure in Emerging Market equities as we do not see a meaningful acceleration in world trade in the near term, and any stimulus efforts will take time to become effective.

Fixed Income
- Despite low yields and a possible steepening of the curve due to further Fed cuts in 2019, the negative stock/bond correlation still makes the case for traditional duration exposure (sovereign and high quality corporate) as a hedge in volatile environments.
- We favor U.S. investment grade credit over European, but selective opportunities are attractive in Europe as the ECB restarts QE.
- The search for yield and easy global central banks makes EM debt attractive, although discretion remains critical in focusing on countries less exposed to U.S.-China trade.
- We still recommend hedging some local currency risk in EM debt given trade and policy uncertainty.

U.S. Dollar
- Elevated global uncertainty continues to support demand for the USD; as a result, we expect the USD to remain flat to slightly positive.

Alternatives
- Alternatives that provide uncorrelated exposure to traditional asset classes should be effective hedges should either of our two downside scenarios materialize.
- Positive sources of return can be found in private debt and equity and diversified natural resources.
In this scenario global growth continues to slow in the major economies. The upshot is low inflation and slowing growth but no recession. 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.

As more leading indicators start to flash yellow, the Federal Reserve cuts rates once more in Q4 for a total of three in 2019, and is able to stabilize U.S. GDP growth at approximately 2%. The global easing cycle gains more momentum as the ECB cuts rates and re-launches QE; the BOJ continues its balance sheet expansion; major EMs respond to softer growth and inflation via easier monetary and fiscal policy.

Accommodative policy and positive trade headlines help stabilize the manufacturing slowdown before it hits U.S. consumers in a major way. Revival of the manufacturing sector in 2020 prevents Germany and the rest of the Eurozone from falling deeper into recession. A (skinny) U.S.-China trade deal is reached given the U.S. election campaign in Q2 2020; still, the longer-term realignment of foreign policy remains a concern for markets, as de-globalization of the world economy continues. The Chinese economy responds positively to both easing trade frictions and increased stimulus in 2020. Equity prices are buoyed by a revival in earnings growth and low bond yields, while the U.S. dollar remains stable against major currencies.


* Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product. *
Scenario #2
U.S. leader of the pack (5% Probability)

We have lowered the probability of our upside scenario to 5% from 20% at the beginning of this year and 10% in our last report. In this scenario, trade related uncertainty subsides, monetary easing boosts economic activity, China’s stimulus succeeds, and Eurozone’s struggles reverse. Growth surprises to the upside and resource constraints put upwards pressure on inflation. With already tight labor markets in developed markets and the U.S. producing above its potential, an upwards growth surprise finally leads to greater inflationary pressure. At first, the move is modest and inflation remains below target so central banks stay easy and let upwards inflationary momentum build as they remain cautious about raising rates.

The U.S. finally escapes the post-financial crisis regime; inflationary pressure and expectations continue to rise, eventually forcing the Fed to reassess its dovish guidance by mid-2020. By then, central banks realize they are behind the curve and the Fed pivots to rate hikes in the second half of 2020 and also re-tapers.

Given the shift in the Fed’s stance, rate expectations are revised up sharply and bond yields also rise significantly. Higher yields and expectations of monetary tightening drive the dollar higher and investors pull capital from risky assets and emerging markets. Growth notably slows with the U.S. reaching a potential recession in the 6-9 months after the tightening begins.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.
Inversion of the 2s10s in Q3 led to heightened recessionary fears.

Investors have become overly reliant and accustomed to dovish central banks and expectations of easy financial conditions.

Scenario #3
Tail wags dog (30% Probability)

Lower inflation and growth combined with greater political and trade uncertainty since our last report have handcuffed central banks and led to expectations of increased stimulus. In this scenario, monetary policy remains easy, prolonging and intensifying the search for yield and increasing risks to financial stability. The search for yield distorts market pricing even further relative to fundamentals and leaves risk premiums suppressed exposing investors to hidden and underpriced risks. Markets remain overly complacent and reliant on central banks.

With investors already sensitive to end-of-cycle concerns, a negative shock to sentiment triggers increased financial market volatility leading to heightened recession fears. Monetary policy is unable to stabilize deteriorating sentiment and investors pull capital from risky assets, financial conditions tighten, and previously unexposed vulnerabilities in corporate credit such as leveraged loans are revealed and exacerbate the downturn.

A credit crunch follows and the dramatic shift in sentiment and subsequent market decline becomes a self-fulfilling prophecy spilling over into the real economy with growth slowing sharply.

Given the greater role of non-bank credit since the 2007-2009 financial crisis, the bulk of losses is borne by equity holders on the buy side (i.e., private equity) as opposed to overleveraged banks. As a result, the extent and duration of the downturn is limited and a Global Financial Crisis (GFC) 2.0 is avoided.


Daily data as of September 12, 2019. A higher and increasing index indicates financial conditions that are tighter/tightening. Source: BNY Mellon Global Investment Strategy using data from Bloomberg.
In light of the recent escalation of the U.S.-China trade uncertainty and its impact on the global manufacturing sector (and market sentiment), we have increased the probability of our ‘Globalization is Dead!’ scenario from 20% to 30%.

We don’t think the U.S.-China tit-for-tat tariffs are large enough to explain the current global manufacturing slowdown and depressed market sentiment. Rather, businesses and investors seem to be worried about a fundamental shift in the global trade order: a protracted, full-scale de-globalization. They fear that the implication of this new world trade order would be a steady fall in global growth and productivity over the next decade, hitting the return on capital. As investors expect lower returns on investment, they reduce capex spending. Absent any major tariff de-escalation, a vicious cycle of self-fulfilling fears ensues. Fear of de-globalization leads to less investment and possible recession. The global manufacturing slowdown ultimately spills over to the services sector and hits corporate profits, consumer sentiment and spending.

Faced with worsening economic fundamentals and tightening financial conditions, central banks ease monetary policy significantly. China is at the eye of the storm, and its economy takes a substantial hit from the trade war while U.S. growth slows almost to 0%; the Euro Area moves into recession. As the Fed accommodates the market’s rate cut expectations, equities remain relatively insulated.

1 In this scenario, the investment response of an anticipated reduction in global trade (% GDP) of 15% over the course of a decade (which would bring world trade back to levels not seen since China joined the WTO), leads to a 9% fall in global growth. The real world corollary to this scenario in terms of the magnitude of global trade and slowdown would be the late 1920s-early 1930s when trade barriers were enacted, ultimately leading to radically lower global growth. Source: BNY Mellon Global Investment Strategy and Fathom Consulting.

De-globalization would lead to a steady fall in productivity over the next decade.

The U.S. is least exposed while the Eurozone and particularly Germany would suffer the greatest.
Confidence has weakened globally over the last three months, especially in the manufacturing industry. Part of that weakness is attributable to ongoing trade tensions, especially between the U.S. and China. But the damage to global trade arising from that and other sources, though visible in the data, is not yet sufficient to drive global GDP growth materially weaker. Instead, investors’ anxieties about future growth – perhaps in the form of a major downside risk arising from high debt ratios, or else from the potential for trade tensions to spread, developing into a global trade war – are weighing on firms’ investment decisions right now. As a result, we have increased the weight attached to our downside scenarios “Globalization is dead” and “Tail wags the dog.” In the U.S., we now judge there to be just over one chance in four that four-quarter growth will post a negative number by the end of next year, while in the Eurozone that risk is almost 50% – both substantially higher than they were a quarter ago. Germany has been particularly badly hit during the recent slowdown in global growth. It is highly sensitive to trade but the loss of confidence suggests that there are German-specific as well as global factors in play. Chinese growth retains its strong downside skew, reflecting its central role in the trade dispute and the importance of trade in China’s growth model to date. The Chinese authorities have the tools at their disposal to prevent an outright recession, but there remains a serious risk of a sharp slowdown in growth, while the upside potential is very limited.

Markets forced two cuts in the Fed funds rate and are now calling for more. In our most likely case, the Fed cuts to 1.625% (midpoint of the range) and stops there, encouraged to hold out against market pressure for more by low unemployment, reasonable growth and a relative immunity to vicissitudes in global trade. But the risks relative to that case are substantially skewed to the downside. Hopes that the ultra-low rate environment might become a thing of the past have been confounded, at least for now, and there is a non-zero chance of a negative Fed funds rate by the end of next year and beyond – with similar risks obtaining for other central banks.

Forecasts as of September 2019.

The two solid lines show the modal (central) and mean (probability-weighted average) forecasts. The darker bands towards the center of the fan chart show the more likely outcomes, while the lighter bands show progressively less likely.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.
In a couple of our scenarios bond yields fall dramatically – well below 1% and below what even the market is currently expecting. As a result, the modal or single-most-likely outcome is for yields to fall further from here. On the other hand, they can’t go below zero (or not much anyway) so, as a matter of arithmetic, the mean outcome is higher and the bond yield forecast is skewed upwards. Another way of saying this is our modal yield forecast is closer to market expectations than our modal rate forecast.

With the outlook for rates so weak, equity prices will be supported in the most likely case, and the mean also holds up through the forecast period, despite the substantially increased weight on the two bearish scenarios. Overall it is about 60:40 whether the S&P will end next year higher than it is now, with that ratio improving to nearly 70:30 by the end of 2021. The same pattern holds for equities globally, although some markets that are highly exposed to trade fluctuations, such as Germany, would see a distribution shifted more towards negative outcomes. In spite of this rather benign picture, it should be emphasized that downside risks do exist and are material, especially in the “Tail Wags Dog” scenario, where the S&P 500 ends next year below 2,500.
SECTION 2

Capital Markets
SECTION 2A

What is Priced In?

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. The market now expects three rate cuts in 2019 and two in 2020. These forecasts are more consistent with our downside scenarios—‘Tail Wags Dog’ and ‘Globalization is Dead!’ 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. 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. While we think the market has moved too far, on balance risks are skewed to the downside in our outlook.

GOVERNMENT BONDS
Similar to rates, market pricing more reflective of our downside scenarios is also apparent in sovereign fixed income markets. Forward curves in the U.S. shifted even lower since our last report, particularly on the longer end. In addition, 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 U.S. retreated further and turned negative to the lowest in over three years. We also expect real yields to remain suppressed as a result of the global savings glut. That said, our forecasts for yields imply a market that is too pessimistic and lowered its estimates too far. 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 U.S., 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. Similar to the moves in rates, the market’s perception of inflation is more reflective of a market closer to our downside scenarios. Our estimates still remain more optimistic and like growth, we see the slowing inflationary backdrop to moderate and improve modestly over the next 12-months.

EQUITIES

2019 earnings growth estimates for the S&P 500 have fallen to 1.9% and have held steady around 10.4% for 2020. We think this is more in line with our ‘More of the same’ scenario where slowing growth continues but stabilizes and improves in 2020. While we do not see a recession by the end of 2020, risks to growth are skewed to the downside as reflected in our fan chart which is currently not reflected in earnings estimates or expected volatility. In addition, unless trade uncertainty is substantially reduced, we see limited upside potential to earnings. 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. 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.
The theme for investors as we enter the fourth quarter 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 U.S. 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.² 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 $16 trillion of negative yielding debt. U.S. yields also dropped to near historic lows in August as the global flight to safety buoyed the U.S. debt market. The 2-10 year spread joined the 3mo-10y in inverting, prompting models to increase the probability of a U.S. recession within the next 18 months.

With sentiment so negative, investors now expect a total of 75 bps cuts in 2019 and 50bps more in 2020.

Despite the fact that U.S. 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. The probability of a U.S. recession in 2020 has increased owing to a decline in U.S. manufacturing activity, inverted yield curve, and some signs of softness in both the consumer and the labor markets. Nevertheless, earnings forecasts suggest the market remains constructive on U.S. 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.


The services sector has remained more resilient as manufacturing contracts.

Developed economies: increasing trade uncertainty is having a negative impact on GDP.

Data as of end-July 2019.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.
Emerging economies: increasing trade uncertainty is having a negative impact on GDP.

U.S.: increasing trade uncertainty is having a negative impact on GDP.

EFFECTS OF TRADE POLICY UNCERTAINTY ON THE LEVEL OF GDP SINCE 2018

Emerging economies – Total  Emerging economies – First wave only

0.0  -0.2  -0.4  -0.6  -0.8  -1.0  -1.2

U.S. – Total  U.S. – First wave only

0.0  -0.2  -0.4  -0.6  -0.8  -1.0  -1.2


Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.
2020 earnings growth estimates have remained resilient but risks are skewed to the downside.

The market remains optimistic about a U.S.-China trade deal being reached.
SECTION 3

Investment Conclusions
**EQUITIES**

**U.S. Equities:** Domestic equities are faced with offsetting forces: on a positive note, strong U.S. consumer data, a stable labor market and expectations of better earnings in 2020 are keeping cyclical aloft, but decreased expectations of a trade deal and uncertainty around Fed support continues to drive near-term volatility. With this backdrop, we suggest staying fully invested in equities as the Fed has a chance to support the economy and turn the growth trend around. In particular, we favor large-cap, domestically focused, dividend paying stocks in the U.S. U.S. small cap’s could play catch up after notable underperformance YTD should there be some stabilization of the trade war.

**European Equities:** We are cautious on European equities given the sharp manufacturing downturn and stubbornly low growth and inflation data even as the European bourse rallied over 20% YTD. Nevertheless, 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 is bottoming given the message from the markets. UK Equities, are 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 suggest reducing risk exposures in EM equities, especially those sectors/regions closely tied to the global manufacturing cycle downturn; 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 months. Although an increasing number of EM countries are stimulating their economies via 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 homogenous 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 U.S.-China trade dispute, and resilient earnings growth.

**FX**

**U.S. Dollar and Foreign Exchange (FX):** The level of global uncertainty remains elevated, which supports demand for the U.S. Dollar (USD). We expect this force to carry 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**

**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.

**FIXED INCOME**

**Sovereign Debt:** Further pressure on rates around the globe has provided steady demand for U.S. 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 shorter duration U.S. 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 U.S. investment grade credit as attractive overall, and see it benefitting from persistently low rates and strong U.S. 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 U.S. IG credit over European, but selective opportunities in Europe are attractive to long-term investors as in 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, particularly in European Financials. Generally, we would suggest a tilt toward U.S. 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 U.S.-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 (high nominal yields and low inflation) and low exposure to trade tensions. We still recommend hedging some local currency risk given the uncertain trajectory of trade negotiations and policy volatility.
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All investments involve risk, including the possible loss of principal. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Important Disclosures:

RISKS

Equities are subject to market, market sector, market liquidity, issuer, and investment style risks, to varying degrees. 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. Commodities contain heightened risk, including market, political, regulatory, and natural conditions, and may not be suitable for all investors. 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. 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. 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. Currencies are 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 volatility. 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.

INDEX DEFINITIONS

U.S. Consumer Prices (CPI) Index: measure of prices paid by consumers for a market basket of consumer goods and services. The yearly (or monthly) growth rate represents the inflation rate. The 10Y U.S. Treasuries Average Yield of a range of Treasury securities all adjusted to the equivalent of a ten-year maturity. The CBOE VIX Index (VIX) is an indicator of the implied volatility of S&P 500 Index as calculated by the Chicago Board Options Exchange (CBOE). The Majors Dollar Index (USD Index) measures the value of the U.S. dollar relative to a basket of currencies of the U.S.'s most significant trading partners including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc. The MSCI EM Index tracks the total return performance of emerging market equities. The S&P 500 Composite Index (S&P 500) is designed to track the performance of the largest 500 U.S. companies. Europe STOXX 600 Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. Conference Board Consumer Confidence: monthly survey of U.S. consumer confidence levels conducted by the Conference board. It is used to gather information on consumer expectations regarding the health of the overall economy. NFIB Small Business Optimism: compiled from a survey that is conducted each month by the National Federation of Independent Business (NFIB) of its members and is a general reflection of their sentiment towards their future business prospects. NFIB Job Openings Hard to Fill: compiled from a survey that is conducted each month by the NFIB of its members and is a general reflection of the tightness in the U.S. labor market. Global Economic Policy Uncertainty (EPU): A GDP-weighted average of national EPU indices for 20 countries: Australia, Brazil, Canada, Chile, China, France, Germany, Greece, India, Ireland, Italy, Japan, Mexico, the Netherlands, Russia, South Korea, Spain, Sweden, the United Kingdom, and the United States. Each national EPU index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy (E), policy (P) and uncertainty (U). Bloomberg Barclays U.S. Corporate High Yield: covers the universe of fixed-rate, non-investment grade corporate debt in the U.S. Bloomberg Barclays U.S. Corporate Investment Grade: designed to measure the performance of the investment grade corporate sector in the U.S. 1-mth. 1-year forward swap: the avg. interest rate for 1-mth. in 1-year forward. GDP: gross domestic product is the total monetary or market value of all the finished goods and services produced within a country's borders over a given time period. Fed funds Rate: the target interest rate for overnight lending and borrowing between banks. H2: second half.

STATISTICAL TERMS

Alpha is a measure of risk-adjusted performance that compares an investment's return to that of its benchmark. Skewness in statistics represents an imbalance and an asymmetry from the mean of a data distribution. In a normal data distribution with a symmetrical bell curve, the mean and median are the same. Probability-weighted mean is similar to an ordinary arithmetic mean, except that instead of each of the data points contributing equally to the final average, data points are weighted by the statistical probability for a particular scenario outcome. 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. Z-score: number of standard deviations from the mean a data point is.