Through the Global Looking Glass: Markets in 2020

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Vantage Point – our approach

What we think
- Economic scenarios
- Fan chart forecasts

What the markets think
- What’s priced in?
- Market sentiment

Where are the big differences?
- What do they mean for investments?

Broad investment conclusions
### Economic scenarios

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<th>Economic scenario</th>
<th>Probability</th>
<th>Description</th>
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| **More of the same**              | (35%)       | - Global growth slows but does not shrink.  
- Progress on trade talks helps stabilize the manufacturing slowdown.  
- Equity prices are helped by low bond yields, easy financial conditions, and steady growth with no recession.  
- The Fed cuts rates three times in 2019, but the stabilization of growth means it doesn’t have to do much more.  
- ECB re-launches QE and the BoJ continues balance sheet expansion.  
- The Eurozone and China respond positively to increased stimulus.  
- US Dollar finishes broadly flat. |
| **US: Leader of the Pack**        | (5%)        | - 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; i.e. growth fears are overdone and US economy is close to capacity.  
- An upside growth surprise finally translates into higher inflationary pressure.  
- At first, the Fed lets inflation move higher but eventually starts to raise rates and re-taper.  
- Growth slows sharply in late 2020 into 2021 — possibly recession.  
- Higher US rates and a stronger dollar trigger capital flight out of risky assets, exacerbating the global economic downturn. |
| **Tail wags dog**                 | (30%)       | - Complacent markets and expectations of easy central bank policy and low yields prolongs and intensifies the search for yield increasing risks to financial stability.  
- A disruption in financial markets, or a small shock, leads to a sharp reversal in market sentiment ultimately triggering and/or intensifying the downturn.  
- Flight from risky assets raises cost of capital, tightens financial conditions and hits confidence, causing real economies worldwide to slow sharply — a self-fulfilling prophecy.  
- Credit channel exacerbates real effects — “Dotcom 2.0 ensues.” |
| **Globalization is dead!**        | (30%)       | - The US-China tit-for-tat tariffs are not large enough to explain the current global manufacturing slowdown.  
- The fear is the implication of a new world trade order — a steady fall in global growth and productivity over the next decade, hitting expected return on capital and depressing capex.  
- A vicious cycle of self-fulfilling fears ensues. Fear of de-globalization leads to less investment and possible recession.  
- China is at the eye of the storm, and its economy takes a substantial hit from the trade war while US 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. |

### Idiosyncratic risks

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<th>Idiosyncratic risk</th>
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<td>US/China Trade</td>
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<td>Brexit</td>
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<td>Oil</td>
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What we think: Global economic activity is weakening

OECD leading economic indicators are softening

The services sector has remained more resilient as manufacturing contracts

World trade volumes

Vulnerability to a global trade slowdown:
Impact on GDP of a 1% fall in world trade

What we think: Our forecasts

World economy faces slower growth with risks shifted to the downside

Data and 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 outcomes covering 90% of the forecast distribution. The width of the fan chart shows the level of uncertainty, while the fact the bands below the central forecast are wider than those above shows the balance of risks lies to the downside. Source: BNY Mellon Global Investment Strategy and Fathom Consulting.
What we think: Our forecasts

Interest rate estimates have moved lower

Data and 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 outcomes covering 90% of the forecast distribution. The width of the fan chart shows the level of uncertainty, while the fact the bands below the central forecast are wider than those above shows the balance of risks lies to the downside. Source: BNY Mellon Global Investment Strategy and Fathom Consulting.
Fed to the rescue?

S&P 500 performance 12 mos prior and 12 mos after Fed cut (indexed to 100 at date of first cut)

Source: BNY Mellon Investment Management using data from FRED and Morningstar. We classify 1995 & 1998 as “insurance” cuts, while 2001 & 2007 were in response to recessionary environments.
What markets think

Capital markets pricing

**Rates**
- Markets have priced in 75 bp of easing in 2019 and 50 bp in 2020.
- While our highest probability (39%) “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.

**Equities**
- 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.

**Fixed Income**
- 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, 2s7s, 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 outlooks on rates. That said, a capital markets shock could easily send yields back to historical lows and possibly even lower.

**SUMMARY**
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.

Source: BNY Mellon Global Investment Strategy and Bloomberg
What markets think: What’s priced in?

US and Eurozone inflation expectations

- Eurozone
- 200-day moving avg.
- U.S.
- 200-day moving avg.

Market’s interest rate estimates

- Jan-20
- Jul-20
- Jan-21
- Actual Fed Funds

What markets think: What’s priced in?

Market is expecting a US–China trade deal.

Relative Performance: S&P 500 Companies with Most Chinese Revenue Exposure

Chart above is a relative performance index of a China trade basket vs. the S&P 500. The China trade basket includes companies with more revenue exposure to China. Data as of October 1, 2019.

Data as of September 30, 2019. Source: BNY Mellon Global Investment Strategy using data from FactSet
Investment Conclusions

**Equities**
- We remain sanguine on US 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 US 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 US-China trade.
- We still recommend hedging some local currency risk in EM debt given trade and policy uncertainty.

**US 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.

Disclosures

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 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

US 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 US 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 US dollar relative to a basket of currencies of the US’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 US companies. Europe STOXX 600 Index represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. US 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.

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.
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