Introduction

Welcome to the 2020 outlook edition of Vantage Point. This is our end-year document and is a bit more comprehensive than some of the updates you’ll have seen earlier this year. It’s a bit longer than those, but hopefully just as interesting and with more detail for you to pick over.

The second half of 2019 saw fears about the 2020 outlook peak but then start to stabilize again towards the end of the year. A common theme of all our Vantage Points this year has been that a global recession in 2020 was odds against, but with risks skewed to the downside. That remains a feature of this outlook, but we’re a bit more optimistic in this edition with growth stronger in our single most likely scenario. A number of indicators suggest the world manufacturing slowdown might have stabilized, though much depends on the course of US-China trade negotiations from here. We have seen a substantial relaxation of global monetary and financial conditions this year and we would expect that to affect global demand with a lag. There are signs that the US housing market is already responding strongly to it.

The evolution of our thinking is reflected both in the probabilities we attach to our four economic scenarios and the performance of the economy within our central scenario. The probabilities have shifted towards the more positive scenarios. Inflation is likely to remain subdued in 2020 and the major central banks are either on hold or in easing mode. Add to that a rising chance of fiscal relaxation in some of the major economies and the potential for an upside surprise has increased.

We’re not getting carried away though. Averaging across the scenarios, global growth is likely to be around 3% in 2020, and the balance of risks is negative. That said, compared with a bond market that is still pricing in a US recession, or something close to it, our outlook is relatively positive and, with rates on hold, equities and other risk assets should make progress. Moreover, we are more positive about Eurozone equities – not because the economy is likely to be strong, but because global stabilization plus ultra-easy monetary policy suggests high-beta markets like Europe could outperform. Similarly, any Brexit resolution will boost UK equities too. Our overall investment advice remains to stay invested close to benchmarks but to favor high-beta, harvest outsize risk or illiquidity premiums, and get some exposure to underperforming sectors and asset classes. As the negative correlation between fixed income and equities will persist, fixed income remains a natural hedge in a multi-asset context when overall macro risks are skewed to the downside. Finally, investors are encouraged to maintain an overweight to diversifying alternatives, thematic investments and active investment strategies.

Vantage Point takes you through all of this using the same logical structure as ever. From what we think – in the form of economic scenarios – to what the market thinks and drawing investment conclusions from where the big differences lie. We hope you enjoy reading it and look forward to a prosperous 2020.
Contents

EXECUTIVE SUMMARY 4
SECTION 1. ECONOMICS 8
1A) SCENARIOS 9
1B) FORECASTS 13
SECTION 2. CAPITAL MARKETS 15
2A) WHAT IS PRICED IN 16
2B) MARKET SENTIMENT 19
SECTION 3. INVESTMENT CONCLUSIONS 22
Executive Summary

WHAT WE THINK – ECONOMIC SCENARIOS

40%

Turning the Corner

Our most likely scenario is slightly more positive this quarter. Progress on trade talks helps stabilize global manufacturing. The sharp fall in bond yields during 2019 helps ease financial conditions and boost demand in the major economies. The Federal Reserve, having stabilized 2019 GDP growth at approximately 2% with three rate cuts, remains on hold in 2020. Other central banks are either on hold or in easing mode. The manufacturing revival in 2020 improves the Eurozone outlook. The Chinese economy underwhelms at below 6.0% y/y growth but manages to avoid a hard landing. Equity prices are buoyed by a revival in earnings growth, while the US dollar remains stable with a softening bias against major currencies. Yields drift higher as fears about an imminent recession continue to fade.

10%

US: leader of the pack

Growth fears are overdone and the US economy is more resource constrained than we think. Labor market tightness leads to higher wage inflation and spills over into general inflation. Rest of world turns the corner led by Europe and China. Fed initially accommodates the positive growth surprise generating even greater inflationary pressure. Inflation expectations shift higher, Fed realizes it’s behind the curve in early 2021, and starts to raise rates and re-taper more quickly. Growth slows sharply by mid-2021 – possibly recession. Higher rates and dollar prompt capital flight from some emerging markets, exacerbating the downturn worldwide.

The tariffs announced to date aren’t large enough to account for the global manufacturing slowdown we’ve seen. Fear of something more fundamental has held back investment. In this scenario, two interrelated and compounding forces seem to be in play: Businesses and investors are worried about a fundamental shift in the geopolitical order: a protracted, full-scale de-globalization; and China’s slowdown is more severe than the official numbers suggest. Unlike the first scenario, the situation gets worse not better over the next 18 months. World 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.
CAPITAL MARKET PRICING – WHAT THE MARKETS THINK

Rates

- Markets are still pricing in a rate cut for 2020.
- Our interest rate fan chart is flattish with some skew to the downside reflecting our more sanguine view of US growth from previous editions. Nevertheless despite firmer growth prospects, inflation is likely to remain subdued in 2020 and the major central banks are either on hold or in easing mode.
- The market is moving more in line with our relatively benign outlook than in previous quarters where it feared a looming recession.

Equities

- Despite subdued but stabilizing growth and soft earnings, sentiment has been buffered by expectations of greater central bank stimulus, low interest rates, and easy financial conditions.
- Earnings estimates into 2020 remain firm due to expectations of an imminent trade deal and the cumulative effect of 75 basis points easing by the Fed within three months.
- Hints of global manufacturing stabilization has created a “reversion to the mean” with recent upticks in comparatively underperforming sectors and asset classes. The big question for 2020 is whether this is simply a tactical trade or the beginning of the next leg of growth.

Fixed Income

- Yields have moved higher and there has been modest steeping of the entire yield curve since early October reflecting the cumulative effects of global central bank easing and fundamental global economic data coming in on a firmer footing.
- Fixed income markets and yield curves also appear to track progress or lack thereof of a trade deal making the signing of a “Phase 1” deal critical to markets.
- Our 10-year yield fan chart shows the mostly likely path for yields to drift upward with a notable skew to the downside. However, any downturn or capital markets shock could send yields markedly lower and below previously established historical lows.

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.
INVESTMENT CONCLUSIONS

**Equities**
- We expect US equities to be supported by more positive earnings growth after a flat year, and to benefit from continued de-escalation in trade rhetoric and policy.
- Although volatility should be expected during an election year, we believe growth and cyclical stocks can still benefit from a trade deal and a solid US economy.
- We have become more constructive on European equities as the growth slowdown appears to be stabilizing and European markets have a chance to catch-up in valuations.
- Emerging Markets should benefit from the easy fiscal and monetary stance, but various uncertainties remain and selective exposure is key. Any stabilization in trade should help the asset class perform.

**Fixed Income**
- We expect a gradually steepening yield curve into 2020, although demand for US Treasuries is likely to remain solid. Low to negative rates abroad and the need for diversified portfolios for aging populations should prevent a spike in US sovereign yields.
- We continue to view the US investment grade credit market as attractive given a stable consumer and earnings picture in 2020. Further easing from the European Central Bank (ECB) also bodes well for European credit and reduces downside risk as compared to 2019.
- Our more sanguine view on risk appetite has positive implications for high yield bonds and we do not see a meaningful widening in spreads on the horizon. Leveraged loans, however, are more opaque and carry fewer investor protections than in previous cycles.
- We see Emerging Market local currency debt as an attractive option for the long-term, although some hedging of currency risk in trade-sensitive economies is prudent.

**US Dollar**
- Given the relative attractiveness of rates in the US vs. most developed nations, the USD is expected to remain stable, but with a softening bias due to the reduction in recession fears.
- Any stabilization of the European downturn should firm the Euro as compared to the USD.

**Alternatives**
- Non-traditional approaches that fall into the alternatives category, such as multi-asset portfolios, can add another layer of diversification benefit in a year that is likely to be sensitive to headline risks.
SECTION 1

Economics
Some early signs suggest a bottoming of the global manufacturing downturn.

Eurozone soft and hard indicators showing signs of improvement.

Global Sentix index tracks the general state of the economy as it relates to businesses. Data as of November 2019. Source: BNY Mellon Investment Management using data from Bloomberg.

Citi Economic Surprise indices track whether economic data are progressing relative to consensus forecasts of economists. Data as of November 25, 2019. Source: BNY Mellon Investment Management using data from Bloomberg.

Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.

40% Scenario #1
Turning the Corner (40% Probability)

Our most likely scenario has become slightly more optimistic since the previous quarter. We now see firmer global growth in 2020 thanks in part to central bank policy easing in 2019 and the consequent loosening in global financial conditions, coupled with a deescalating US-China trade war.

The Federal Reserve, having stabilized the US 2019 GDP growth at approximately 2% with three rate cuts, remains on hold in 2020. US growth picks up in H2 2020 as H2 2019 rate cuts translate into higher real economic activity.

In 2020, major central banks are either on hold or in easing mode. The global manufacturing slowdown bottoms out as sentiment improves on trade and Brexit. Revival of the manufacturing sector in 2020 helps the Eurozone growth outlook improve. Growth prospects of major EMs (ex-China) improve thanks to the lagged effects of easy monetary and fiscal policies of 2019 and a de-escalation of the US-China trade war. Chinese economic growth underwhelms at below 6.0% y/y but manages to avoid a hard landing.

A (skinny) US-China trade deal is reached by Q2 2020 given the US election cycle; still, the longer-term realignment of foreign policy remains a concern for markets, as de-globalization of the world economy continues.

Secular stagnation in the industrialized world means equilibrium real interest rates remain low in all the major economies. Inflation and inflation expectations in developed economies pick up slightly but remain subdued. Equity prices are buoyed by a revival in earnings growth, while the US dollar remains stable with a softening bias against major currencies. Yields drift higher as fears about an imminent recession continue to fade.
Strong labor markets continue to put upwards pressure on wages and could spill over into higher than expected inflation if growth surprises to the upside.

Easier monetary policy and increased stimulus could spur higher than expected global growth.

10%

Scenario #2
US leader of the pack (10% Probability)

After starting 2019 with a 20% probability, we subsequently lowered the likelihood of our US-led upside scenario to 5% in our last report. Given increased stimulus from monetary policymakers, US-China trade progress, some signs of a growth stabilization, and a US consumer that remains resilient, we have raised the probability to 10% for this edition.

In this scenario, the US remains the strongest economy and driver of global growth powered by a healthy consumer. US growth improves in 2020 while the Eurozone finally turns the corner and gets a boost from fiscal stimulus and even easier monetary policy. China’s stimulus stabilizes the downturn and growth reverses course thanks in part to a US-China “phase 1” deal. EM benefits from easier global financial conditions, improved trade, stronger Chinese growth, and reduced political uncertainty.

While modest at first, growth surprises to the upside in the first half of 2020 and accelerates in the latter half of the year. This synchronized global growth, reduced political uncertainty, and increased stimulus shifts inflationary expectations off their historical lows. Renewed resource constraints finally lead to upwards inflationary pressure.

At first, the move is modest and inflation stays below target so central banks remain on hold and let inflationary momentum build. The US finally escapes the post-financial crisis regime. Realized inflation and expectations continue to rise and above target, eventually forcing the Fed to reassess its dovish guidance in early 2021. Central banks realize they are behind the curve and the Fed pivots to rate hikes in 2021 and also re-tapers.

Given how investors have become overly accustomed to easy monetary policy, rate expectations are subsequently revised up sharply and bond yields rise significantly. With growth and the associated policy shift the greatest in the US, the USD strengthens and investors pull capital from risky assets and emerging markets. Growth slows sharply with potential recession 6-9 months after the tightening begins.


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Low sovereign interest rates and the surfeit of negative yielding debt globally continue to intensify the search for yield causing investors to underprice risk and leaving them vulnerable to a sudden shift in risk sentiment.

Consumers exposure to the stock market is near the highest in history leaving growth more exposed to a market sell-off.

Scenario #3
Tail wags dog (25% Probability)

Slowing growth and inflation led to rate cuts worldwide in 2019. With expectations that inflation will remain below target and growth to improve only modestly, central banks remain handcuffed and keep policy easy. As a result, the search for yield is prolonged and intensified, especially with more than 20% of total debt worldwide yielding negative rates. Financial stability risks rise even further as the search for yield distorts market pricing relative to fundamentals leaving risk premiums suppressed. Investors, without knowing, remain exposed to hidden and underpriced risks.

With investors more sensitive to end-of-cycle signals, a negative shock to sentiment triggers increased financial market volatility leading to heightened recession fears. Given investor complacency and overreliance on central banks, monetary policy is unable to stabilize the decline in sentiment. Contagion follows as investors pull capital from risky assets, financial conditions tighten, and previously exposed vulnerabilities such as in corporate credit (leveraged loans) are revealed and exacerbate the downfall.

A credit crunch ensues. The rapid reversal in risk aversion and coinciding market correction becomes a self-fulfilling prophecy spilling over into the real economy with growth slowing sharply. However, 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. This limits the subsequent contagion associated with banking-system-failure-led crises. As a result, the extent and duration of the downturn is limited and a Global Financial Crisis (GFC) 2.0 is avoided, though we could see something like a re-run of the 2000-2001 credit crunch (Dotcom 2.0)
Estimates show that China is slowing more and faster than suggested by official data.


25% Scenario #4 Globalization is Dead!

We don’t think the US-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 geopolitical order – particularly a protracted, full-scale de-globalization. They fear that the implication of this for world trade will be severe and result in a steady fall in global growth and productivity over the next decade, lowering the return on capital. As investors expect lower returns on investment, they reduce investment spending. Absent any major tariff de-escalation, a vicious cycle of self-fulfilling fears ensues. Fear of de-globalization leads to less investment and recession. The global manufacturing slowdown ultimately spills over to the services sector and hits corporate profits, consumer sentiment and spending.

In addition, a related and compounding force seems to be in play. The intensity in the growth slowdown of the world’s second largest economy, China is more severe than the official numbers suggest. With China’s growth much slower than suggested by the official data (~6%), global growth continues to decelerate. China’s slowdown reflects not only cyclical but also structural issues, such as the aging population, declining labor force, and the tight financial regulation limiting the policy easing efforts. The stimulus proves ineffective to revive slowing domestic demand: both the scale and economic impact of easy stimulus are much smaller than in previous easing cycles. Knock-on effects are severe for emerging Asia through tight supply chains to China, and Europe that is overly-dependent on global demand.

Faced with worsening economic fundamentals and tightening financial conditions, central banks ease monetary policy significantly. Due to its prominent role in world trade, 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 Eurozone moves into recession. As the Fed accommodates the market’s rate cut expectations, equities remain relatively insulated. Global flight to safety and dollar rises sharply, hitting emerging markets hard – especially those with large dollar funding exposure.

Trade tensions are hurting confidence and investment.

*CEO confidence index measures CEO confidence in the economy one year from now. Business investment is US gross domestic nonresidential investment. Quarterly data as of Q3 2019. Source: BNY Mellon Investment Management using data from Bloomberg. Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.
Since our previous Vantage Point, the global economy has tracked our most likely scenario, which we previously labeled “more of the same”, more closely than any other. We detect straws in the wind that suggest the worst of the trade-induced slowdown may be behind us. Surveys of manufacturing activity are no longer deteriorating, with the proportion of countries reporting rising output in that sector increasing in September and October. Germany unexpectedly avoided technical recession in Q3. President Trump spoke in October of improved relations with China, and although a deal is yet to be signed, some proposed tariff increases have been scrapped. Against this backdrop, we have decreased slightly the weights we attach to each of our downside scenarios – “Globalization is dead!” and “Tail wags dog”. Our single most likely scenario, now labelled “Turning a corner”, is a touch more optimistic than before, and it has a slightly higher weight, as does our upside scenario “US leader of the pack”.

The adjustments we have made to our four macroeconomic and financial market scenarios, and the weights we attach to each, are evident in our fan charts. Our modal, or single most likely outcome sees US growth picking up steadily through next year, to around 2½% on a four-quarter basis. Nevertheless, with our two downside scenarios retaining a combined weight of 50%, risks to the modal path remain to the downside. We see around a 1-in-5 chance of an outright contraction in US GDP in the four quarters to 2020 Q4. In our previous Vantage Point, that figure was around 1-in-4. As with the US, we judge that the outlook for the Eurozone is a little brighter than it had appeared a few months ago, and the single most likely outcome is for four-quarter growth to pick up slightly through next year. With a lower trend rate of growth – a consequence in part of poorer demographics – the odds of an outright contraction in GDP are larger in the Eurozone than in the US. China’s economic growth model, which has included sustained high levels of investment, and a reliance on trade, means that the magnitude of the downside risks to economic growth in that country are larger than elsewhere, particularly as we start to look further ahead.

The single most likely path for US inflation sees it move back towards target next year. Nevertheless, as with growth, risks lie to the downside. Eurozone inflation has been weaker than expected in recent months. Our modal projection sees it fall further below target, reaching a trough in the early part of next year. Nevertheless, given the severity of our two downside scenarios, outright deflation in the Eurozone remains a genuine threat, as our fan chart makes clear.
In our most likely case, having implemented insurance cuts totaling 75 basis points through 2019, the Fed is content to sit on its hands through 2020. Even in our upside scenario, where faster economic growth puts greater upwards pressure on inflation, the Fed decides to wait until above-target inflation is established before tightening. With the US central bank cutting close to, and perhaps through the zero lower bound (ZLB) in each of our downside scenarios, the US policy rate fan chart retains a significant downward skew. With the economic data flow proving a little better than many had expected, beliefs among investors about the outlook for US monetary policy have moved closer to ours, and to those of the Fed. That is the principle reason why the fan chart for US Treasury yields now has a downward skew, to match that of the policy rate. The most likely scenario sees yields drifting higher as fears about an imminent recession continue to fade. But with yields likely to fall sharply in each of our downside scenarios, we see a 15% chance of the US Treasury yield dropping below zero by the end of next year.

Equities continue to rise in our most likely scenario throughout the forecast period. There are downside risks to equity prices, reflecting the downside risks to growth and inflation. Nevertheless, the probability that major indices drop back below the lows recorded in late 2018, at around 1-in-10, is less than it was at the time of our previous Vantage Point.

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SECTION 2

Capital Markets
SECTION 2A

Capital Market Pricing – What is Priced In?

INTEREST RATES
The downshift in interest rate expectations moderated and then reversed course in the fourth quarter. Optimism towards a “phase one” trade deal between the US and China increased and economic data signaled a potential turning point had been reached, particularly in the manufacturing sector. The market expects another rate cut in 2020 while our fan chart suggests rates will likely remain on hold. We also expect inflation to remain subdued, another reason why we see rates finishing 2020 unchanged. Yet, risks to our forecast remain to the downside largely due to the 50% probability attached to our downside scenarios – ‘Tail Wags Dog’ and ‘Globalization is Dead.’ Further improvement in manufacturing hinges on progress in US-China trade negotiations. If recent optimism were to reverse course and trade conditions were to deteriorate significantly we would expect further easing. In addition, the market remains sensitive to end-of-cycle concerns and the search for yield has left investors to move up the risk curve and underprice risk, therefore an unspecified and negative shock to market sentiment would also lead to additional easing.

GOVERNMENT BONDS
Similar to rates, we remain more optimistic towards growth than what is suggested by pricing in sovereign fixed income markets, however the gap has narrowed compared to our last report. While forward curves have shifted higher in the US and even more so in Germany, current market-implied estimates still remain below our relatively more optimistic forecasts. In addition, forward curves suggest rates will only modestly increase from current levels. The previously inverted US Treasury yield curve suggested that markets felt the Fed was too tight given the outlook for growth and inflation, and the entire curve has dis-inverted in Q4 as the market became less fearful and closer to our central forecast. Ten-year real yields in the US have improved from negative territory and the lowest in over three years in August but have remained range-bound and only marginally positive since. Going forward, we expect limited upside as a result of the global savings glut.

Overall, our forecasts for yields imply a market that is still too pessimistic but less so since the last Vantage Point. We see a higher probability of an upward drift in yields as growth stabilizes and improves in 2020.

INFLATION
The market continues to expect subdued inflation to persist. US and Eurozone estimates remain near historical lows and continue to struggle to maintain persistent upside momentum. Since our last report, estimates increased both in the US and Eurozone but more so in the US and only slightly in the Eurozone. Like our previous editions and similar to bonds, the markets’ view of future inflation is more in-line with our downside scenarios. We still remain more optimistic and like growth, we see the slowing inflationary backdrop to moderate and improve modestly over the next twelve months. However, like growth, risks are skewed to the downside particularly in the Eurozone as evident in the fan charts.

EQUITIES
2019 earnings growth estimates for the S&P 500 have fallen from 1.8% at end the end of Q3 to 0.9% but have held steady so far for 2020 between ~9-11%. While year-ahead estimates typically drift lower, we do expect earnings improvement in 2020 of 5%-7%. This is more in line with our “Turning the Corner” scenario where growth improves in 2020. However, risks to growth remain skewed to the downside as seen in our growth fan charts which similar to our prior reports are not reflected in measures of implied volatility. Global equity returns were largely driven by multiple expansion in 2019 and will likely need higher earnings in 2020 for the rally to continue. However, there is limited upside to the earnings outlook unless a trade deal is reached between the US and China. Increased stimulus from central banks and lower interest rates have helped to compress volatility. While we are more optimistic relative to our last report, when compared to our forecasts we still believe current measures of volatility suggest a market that has become overly complacent and susceptible to an exogenous shock – see our Tail Wags Dog Scenario.
Global central bank easing and some evidence of a stabilization of the global downturn have reignited investor enthusiasm. The fear of a looming recession which forced investors into fixed income and high dividend defensive equities during the third quarter reversed itself during the fourth quarter as investors moved into more cyclical sectors which had lagged for most of the year. Investors have shaved expectations to one rate cut in 2020. The US yield curve steepened along every maturity signaling greater faith in the path for US growth. Nevertheless, investors do not expect inflation to spike even with an inflection in growth and the long end of the curve remains depressed with limited upside. After trading in a range for the better part of 18-months, the equity market finally pushed to new highs, led by the former laggards in finance, industrials and tech.

Investors are faced with the following question: Is this is a tactical trade, a kind of reversion to the mean for underperforming sectors, and therefore short-lived, or is the global economy about to have an inflection of growth? An uptick in growth would boost earnings, support multiples and allow global markets to move higher. Typically, markets tend to anticipate changes in the real economy and it seems as if this time is no different. Certainly in the US, the evidence is that the bottom has been reached. New home sales have moved upwards, PMIs are improving, and individuals continue to come into the labor force from the sidelines. While evidence of a bottoming in global data, particularly in Europe seems early, there are some green shoots in the German sentiment and manufacturing data. With EM and European equities underperforming US equities over the last 10-years, a more benign global backdrop could prompt flows into these asset classes.

The intensifying trade conflict with China has softened the US growth outlook, reduced capital expenditures and threatens to shave earnings in 2020. With the hit to the US economy, investors now expect a “Phase 1” deal to be reached sometime in the next couple of months which would boost growth, investment and reduce uncertainty. Importantly investors also expect some rollback of the September 1 tariffs. Earnings forecasts suggest the market remains constructive on US growth, expecting GDP to come in around 2+% as the hit from tariffs is expected to be reversed. Earnings remain firm into 2020, a likely risk heading into next year as estimates tend to move lower from this point. With re-booted positive sentiment after a summer swoon, investors need to see economic fundamentals turn upward to sustain the rally.
A total of 25 bps cut in 2020

- Reimplementation of quantitative easing (QE) in Europe including purchase of equities
- A phase 1 trade deal with roll-back of September 1 tariffs
- 8% earnings growth in 2020 for the S&P 500
- 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
- A negotiated Brexit
- More China stimulus and a China soft landing

Cyclicals outperformed defensive stocks in Q4 as the S&P 500 reached all time highs.

Earnings are expected to improve in 2020.


Charts are provided for illustrative purposes and are not indicative of the past or future performance of any BNY Mellon product.
Market is pricing in a phase 1 trade deal with roll-back of September 1 tariffs.

Growth expectations, while still sluggish, are improving in Germany.
**Portfolio Perspective**

In this edition, we are introducing a fan chart to illustrate the impact our scenarios could have on a portfolio including both US equities and fixed income. We compare the forecasted performance of a portfolio holding 80% US equities/20% US fixed income (“risk bull”) with one holding 80% US fixed income/20% US equities (“risk bear”). The relative outperformance of the risk bull portfolio is shown here, and suggests for 2020 that our most likely scenario sees stronger return potential for portfolios that are more highly exposed to equities. Interestingly, when looking at the mean outcome of all four scenarios, and given the remaining downside risks, there is little difference between the outcomes of the risk bull and risk bear portfolios for 2020, and the skew remains to the downside for risk-on allocations. In simpler terms, this suggests that even for risk-averse investors, the risk of “missing out” on returns in 2020 is limited and that being fully present in the market rather than sitting on the sidelines in cash is the critical factor in meeting investment objectives.

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**EQUITIES**

**US Equities:** The strong performance from US equities in 2019 served as a reaction to both the 20% drop in Q4 2018 and the Fed’s quick dovish turn early in the year. Nevertheless, decisive new highs were only reached in October as the market digested the effects of 75 basis points in cuts from the Fed, global central bank easing, the bottoming of the global slowdown, and movement towards a “Phase 1” trade deal. Earnings growth that is expected to be closer to long-term averages after a flat year, and continued de-escalation in trade rhetoric and policy should support US equities into 2020. Investors should expect some volatility throughout an election year, but in the end we expect positive returns in both large and small-cap equities. We believe investors should be exposed to cyclical sectors that have both recently underperformed and will benefit from progress on a trade deal. After a long period of growth outperforming value stocks we expect some reversal of that trend as long as the yield curve steepens. Nevertheless we believe both growth and cyclical stocks can generate attractive returns, particularly if a trade deal is reached in 2020. Absent a trade deal, we would expect growth to continue its outperformance over value.

**European Equities:** Europe just managed to avoid a manufacturing-led recession in 2019 even as European markets, similar to their US cousins, had a strong year. With the growth slowdown stabilizing, we have yet to see a meaningful pickup in growth or inflation. Despite this, European equities have an opportunity to catch up in valuations with a more stable, albeit slow, economic backdrop. We expect continued support from the ECB to provide protection against sharp drawdowns and create a friendly environment for equity investors. Further, we believe that the UK is likely to withdraw from the EU in an orderly fashion by the end of January 2020, eliminating years of uncertainty. As such, we are constructive on European equities, including the UK, going into 2020.

**Emerging Markets (EM) Equities:** Valuations are stretched, but we believe EM-ex China growth will likely benefit from 2019’s global easy fiscal and monetary policy stance – a positive for earnings growth. EM is not a homogenous asset class; US-China trade tensions and US election uncertainty are lingering and several EMs face idiosyncratic vulnerabilities – hence, a selective stance is key for positive return outcomes. We see more interesting investment opportunities in countries like...
Brazil, Mexico, and Russia which have room for further monetary easing, and resilient earnings growth. Further, EM equity valuations are far below those in the US and any glimmer of trade stabilization should help the asset class perform.

**FX**

**US Dollar and Foreign Exchange (FX):** A reduction in recession fears in Europe and signals of de-escalation in the trade war should slow capital flight into the safe-haven USD. Given the relative attractiveness of rates in the US vs. most developed nations, the USD is likely to remain stable in 2020, but could gradually soften as the Euro, Pound and Yuan stabilize due to fewer geopolitical headwinds.

**Euro:** Any stabilization of the European downturn should firm the Euro as compared to the USD. While we are not calling for a huge upside move for the Euro given ECB liquidity and struggling upticks in growth, we do believe that the relative underperformance versus the US will reverse somewhat and therefore firm up the currency.

**Alternatives:** Non-traditional approaches that fall into the alternatives category, such as multi-asset portfolios, can add another layer of diversification benefit in a year that may be sensitive to day-to-day political headlines. These portfolios can serve an important role of hedging out risks that long only traditional assets cannot avoid. In this lower for longer interest rate world, attractive income can still be found in forms of private locked up capital for investors with long-term time horizons.

**Fixed Income**

**Sovereign Debt:** We expect a gradually steepening yield curve going into 2020, particularly due to the Fed’s message to the bond market that the bar is set high for further rate cuts but higher for hikes. A steepening curve gives further confidence in the economic outlook although there is likely to remain a constant defensive trade and demand for US Treasuries. Low to negative rates abroad and the need for diversified portfolios for aging populations should prevent a spike in US sovereign yields. Diversification benefits are stronger on the mid- to long-end of the curve and we expect the negative stock/bond correlation to continue to support exposure in this space.

**Global Investment Grade Credit (IG):** In the US, a strong consumer and labor market picture bodes well for corporate earnings and revenue stability in 2020, which we expect to support the investment grade credit market as an attractive investment option. Reduced fear of a global recession and a less hostile trade outlook should be positive for corporate credit appetite through the spectrum to BBB-rated securities. However, investors must practice discretion in security selection, as fundamentals vary widely across the BBB universe. Corporations in both the US and Europe are set to benefit from the global easing cycle in 2019. Although we do not expect further cuts from the Fed in 2020, the environment continues to be a friendly one for corporate credit. Furthermore, our view that the ECB will remain vigilant in supporting the region makes European credit a more sound investment option with less downside risk than in 2019.

**High Yield (HY) and Leveraged Loans:** Our more sanguine view on risk appetite has positive implications for high yield bonds and we do not see a meaningful widening in spreads or increased default risk on the horizon. Spreads are tight by historical standards, however, and the amount of return potential is limited. High yield still provides an attractive income source and absent recession or increased default fears, the space should hold up into 2020. Investors need to pick sectors wisely as spreads are wider in energy and retail. The leveraged loan space is more opaque and offers fewer investor protections than in previous cycles. As such, for income potential in liquid bond instruments, we favor high yield over leveraged loans.

**EM Hard Currency Debt:** A stable to slightly weakening USD makes us more cautious for EM hard currency debt from a relative perspective. Within hard currency debt, we favor corporates over sovereigns, and those with strong fundamentals in countries with improving macroeconomic trajectories (such as Mexico and Brazil).

**EM Local Currency Debt:** We view EM local currency debt as an attractive investment for the long-term, but selective risk taking is advised. Although valuations start to get stretched (they are still more favorable compared to DMs), continuation of easing inflation in emerging markets and further rate cuts are expected make local debt attractive. Countries with steep curves and high real rates offer attractive opportunities (such as Brazil, Russia, and Mexico). Given the continued uncertain trajectory of trade negotiations and policy volatility, we believe hedging local currency risk can dampen volatility.
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**

- **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)** measures the value of the US dollar relative to a basket of currencies of the most significant trading partners of the US including the euro, Japanese yen, Canadian dollar, British pound, Swedish krona, and Swiss franc. The **MSCI EM Index (Emerging Markets Equities)** 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. The **Europe STOXX 600 Index** represents the performance of 600 large, mid and small capitalization companies across 18 countries in the European Union. The **Bloomberg Barclays US Corporate High Yield**: covers the universe of fixed-rate, non-investment grade corporate debt in the US. The **Bloomberg Barclays US Corporate Investment Grade**: designed to measure the performance of the investment grade corporate sector in the US. The **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. The **Fed funds Rate**: the target interest rate for overnight lending and borrowing between banks. The **Purchasing Managers Index (PMI)**: An economic indicator derived from monthly surveys of private sector companies. A level above 50 indicates expansion compared to the prior month and below 50 contraction.

**STATISTICAL TERMS**

- **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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