



Outlook 2020

Not the Usual Suspects

Heading into 2020, world economic growth appears sufficiently robust to resist recession, but is slowing enough to prompt a number of governments to implement fiscal stimulus programmes. While the U.S. economy continues to be supported by a healthy consumer and China is stabilising with minimal stimulus, we see the brightest spots as being outside the usual suspects: The opportunities in 2020 appear to be in regions like Japan and the UK, both of which have been out of favour for a number of years.

The United States: Slow and steady

Consumption in the U.S. is healthy, with strong job and wage growth, particularly in lower-wage positions that need to be filled locally, such as leisure, health care and social assistance. Households, which now own considerably more listed equities than they have historically due to low competing bank rates, are also experiencing a positive wealth effect from the S&P's strong climb over 2019.

Housing demand is also picking up. With 30-year mortgage rates dropping over 100 basis points (bps) in the past 12 months, mortgage demand has risen sharply (*Display 1*). And when people buy a house, they also buy furniture and other related goods and services, which further supports consumption and growth.

The weak link in the U.S. has been fixed-asset investment, dampened by tariff-related uncertainty and other idiosyncratic headwinds. But going into 2020, we see several factors that could relieve these pressures:

- **OIL-RELATED INVESTMENTS** fell due to weaker prices in 2018. By the end of 2019, we believe oil prices had steadied, which should reduce the drag on the economy of this factor. This is separate from any upward pressure on oil prices stemming from geopolitical tensions in early 2020.
- **EQUIPMENT INVESTMENT** was stalled by the steep fall in aircraft investments, as two Boeing 737 Max plane crashes triggered a halt in production. A stabilisation in aircraft investment should bring overall equipment investment back into positive territory.
- **INTELLECTUAL PROPERTY INVESTMENT** is benefiting from the rise in the tech-based part of the economy.

Combining these observations with the advanced age of the U.S. capital stock and the still useable temporary provision to fully expense short dated capital investments, we expect non-residential investment to remain constant or rise modestly in 2020. The final component

of U.S. GDP, government consumption, is likely to remain relatively flat, with defence spending receiving a boost.

The net effect of these factors is positive, albeit slow, growth in the U.S. Our model, which has a history dating back to 2004, gives us a base case for EPS growth in 2020 of 5.5% (*Display 2*). This estimate is based on expected GDP growth of 2.1%

and share buyback growth of 3.5%. It diverges significantly from consensus EPS growth estimates, which are 9.8%. Even our bullish scenario implies only 8.0% EPS growth. This discrepancy suggests that investors who expect earnings growth to be in line with the consensus estimates priced into current price-earnings ratios could well be disappointed.

DISPLAY 1

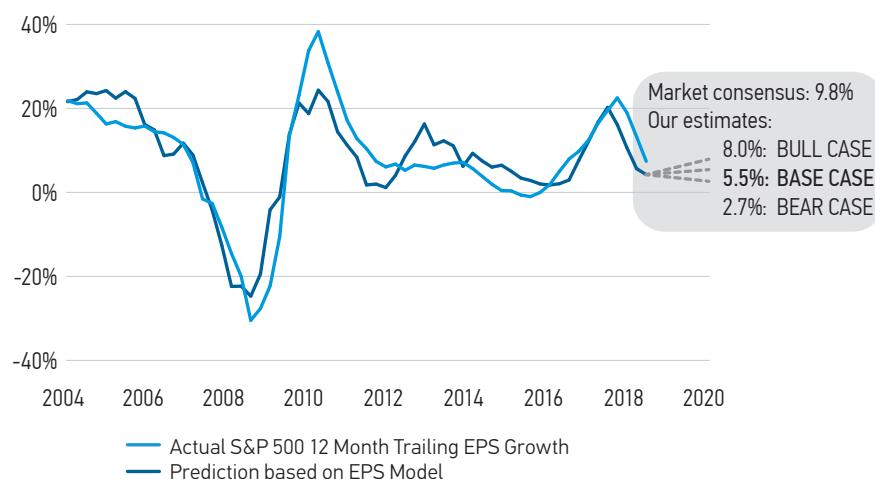
Lower mortgage rates are driving housing sales



Source: Census Bureau, Federal Home Loan Mortgage Corporation, Haver, MSIM. Data as of 30 November 2019.

DISPLAY 2

Our forecast for 2020 EPS growth is below market consensus



Source: Datastream, MSIM, as of 30 September 2019. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

China: Controlled stimulus to maintain stability

While China's slowdown is signalling a need for stimulus, government policy has been focused on transitioning away from indiscriminate investment, towards higher-quality growth. To balance these competing forces, China is likely to continue to apply controlled stimulus that keeps the economy growing at a moderate pace, but not much faster.

In November, the People's Bank of China (PBOC) unexpectedly lowered the rate on one-year medium-term lending facilities by 5 bps, launched a seven-day reverse repo on which it cut its rate to 2.5% for the first time since 2015, and then lowered its one- and five-year loan rates. In January, the PBoC continued its stimulus by pumping \$115 billion into the country's financial system.¹ We expect the PBoC to maintain this cautious easing.

On the fiscal side, two years of government deleveraging have given China the room to increase stimulus and to continue to set a reasonable quota for bond issuance. This gives China the needed tools to maintain growth. But with improving PMI data, an accelerating service sector and November manufacturing activity expanding at its fastest pace in three years, the Chinese government seems less worried about economic growth falling below 6%. Moreover, trade tensions have started to ease as evidenced by a pickup in Chinese imports in recent months (*Display 3*). Therefore, on balance, we are likely to see only targeted fiscal stimulus with continuing structural reform.

Rest of the world: Also shifting towards fiscal policy²

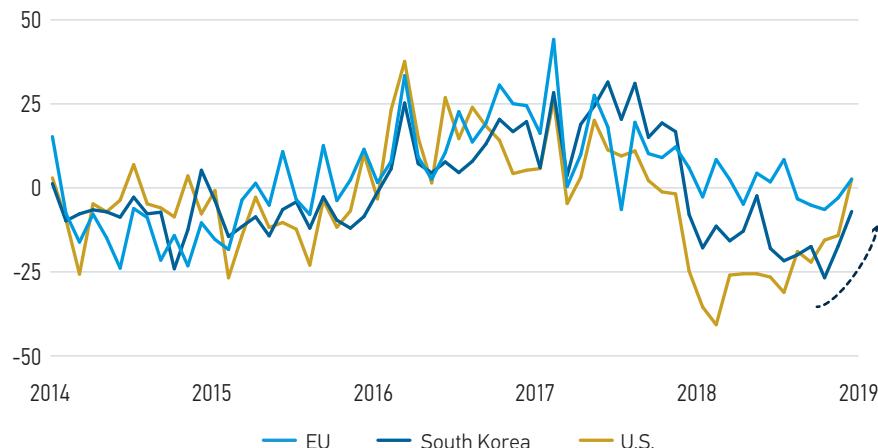
Expectations of slower growth in the two biggest economies are finally driving a meaningful fiscal stimulus response, but it is coming from places investors might not normally expect:

- **JAPAN:** \$120 billion fiscal stimulus (about 1.9% of GDP) over 15 months

DISPLAY 3

Chinese imports have rebounded in recent months

China Imports YoY%



Source: Bloomberg, MSIM, as of 30 November 2019.

- **GERMANY:** With a comfortable budget surplus, the government is considering fiscal stimulus beyond a recently announced \$60 billion climate package. This is on top of the European Green Deal, which envisions over \$100 billion in targeted investments
- **THE UK:** Plans for fiscal stimulus of about 1.2% to 2.4% of GDP from April 2020, in order to help the economy recover from the previous drag of Brexit uncertainty
- **SOUTH KOREA:** Most expansionary budget since 2008-2009, about 1.9% of GDP
- **INDIA:** Stimulus of \$20 billion

We expect these and additional similar stimulus packages to boost global growth—even in the absence of action from the U.S. and China.

Outlook: Equities beat bonds . . .

The stabilisation of manufacturing data, acceleration of credit growth, some restocking of inventories in Asia and easing of trade tensions all point to solid global fundamentals, with some potential

upside as the policy mix shifts from monetary to fiscal stimulus.

Equities generally appear more attractive than bonds. Interest rates are so low they appear to be pricing in a recession and equity positioning remains bearishly skewed. In fact, retail equity fund outflows are at record levels, higher than in 2008—a striking indication of negative sentiment (typically a positive indicator). If we start seeing evidence of moderate growth, it is likely that bond yields will rebound, equities will rise and investors will rotate from bonds into equities.

... in reasonably priced markets

Despite solid fundamentals and negative sentiment—implying the potential for positive surprises—equity investors should be careful. Some markets look very expensive, including the U.S., India, Taiwan, South Korea, Australia and the world as a whole. Looking at the 12-month price-earnings ratios around the world, the U.S. is at the 95th percentile, second only to Australia. As noted earlier, the U.S. ratio reflects a forecast of 9% earnings growth, which we think is excessive.

¹ Source: Financial Times 5 November 2019 and 2 January 2020

² Source: Haver, FT, Morgan Stanley Research, MSIM as of 6 December 2019

We believe other markets offer better value. Many of the regions that are attractively priced have been out of favour for some time, such as Europe, Latin America, the UK, China, Eastern Europe and most notably Japan. *Display 4* shows our positioning implications for major markets.

Fixed income: Negative outlook for long-duration assets

Fixed income markets are pricing in extremely slow growth, if not a recession. We think this has been overdone. With central banks shifting away from aggressive monetary policy and fiscal stimulus strengthening growth, we expect upside pressure on yields, which is a negative for longer-term paper. Meanwhile, the probability of higher inflation in the U.S. is increasing, lifted by both higher wages and residual effects from trade tensions.

We are underweight developed market sovereign bonds, with high-quality, long-duration bonds looking particularly exposed. And we are overweight in emerging market (EM) debt. With the yield curve in the U.S. likely to steepen, Emerging Market (EM) FX cheap, and the duration of hard currency debt higher than that of local currency, we also have a preference for local currency debt over hard currency. *Display 5* shows why. These bonds' Sherman ratios—the amount of interest income generated relative to interest rate risk taken, or the percentage increase in rates that would wipe out the yield—clearly favour high yield and EM sovereign debt.

DISPLAY 4

OVERWEIGHT

The UK	Resolution of Brexit uncertainty should release some pent-up demand. Earnings revisions have been trending lower for three years, but we see a pickup in near-term domestic activity. At 3.6%, ³ dividend yields are attractive and valuations are cheap, particularly in the mid-cap range.
Japan	Improved profit margins in Japan may allow it to shed its reputation as a "value trap." The \$120 billion stimulus package ⁴ is very positive and valuations are cheap, with an improved ROE and our view of a 10% equity market upside potential that would bring it back to a 2018 relative valuation level vs. the world.

NEUTRAL WEIGHT

Asia	Fundamentals are slowly improving, valuations are fair, though sentiment is still quite cautious.
Eurozone	Reduced trade risk, the Green Deal, the possibility of additional fiscal stimulus, neutral valuations and largely negative sentiment (a positive indicator), make the eurozone attractive vs. the U.S. though less attractive than the UK or Japan.

UNDERWEIGHT

U.S.	Despite steady growth, both the earnings growth trend and buyback activity are falling, fiscal stimulus is unlikely and valuations are unattractively high. Sentiment has been reasonably positive in the U.S., which is typically a contrary indicator.
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DISPLAY 5

Emerging market sovereign debt less vulnerable to rising rates

SHERMAN RATIO (YIELD/DURATION)

1	ICE BofAML Global High Yield Index	1.41	More attractive
2	ICE BofAML US High Yield 100 Index	1.24	
3	ICE BofAML Global High Yield European Issuers Index	1.15	
4	EMD Local Currency Sovereign Debt	0.98	
5	EMD Hard Currency Sovereign Debt	0.68	
6	Barclays U.S. Aggregate USD	0.37	
7	Barclays U.S. Credit USD	0.37	
8	Barclays U.S. Government USD	0.27	
9	Barclays Euro Credit EUR	0.10	
10	Barclays Euro Aggregate	0.02	
11	Barclays Euro Government EUR	0.01	Less attractive

Source: Datastream, Bloomberg, MSIM, as of 29 November 2019. Sherman Ratio measures the amount of interest income generated relative to interest rate risk being taken (i.e. percentage increase in rates necessary to wipe out the yield). The index data is provided for illustrative purposes only.

³ Source: Bloomberg, as of December 2019

⁴ Source: Reuters, 5 December 2019

Summary: A year for discerning investors

Decent but not exceptional fundamentals around the world are poised to make 2020, overall, a year of slow but steady growth. However, the return potential across markets differs widely due to the unique circumstances of each. Furthermore, the first week of 2020 has demonstrated the capacity of events that investors simply cannot anticipate to disrupt markets, to increase volatility and, in the case of the heightened

U.S.-Iran tensions, to lead to sharply higher oil prices and demand for safe haven assets. Our process allows us to flexibly adjust our asset allocation if we expect such episodes to be prolonged, seeking to help protect portfolios from downside volatility. Alternatively, we have the option to look through what may prove to be short-term volatility. At the time of writing, we maintain what we consider to be a prudent exposure to risk assets and a slightly higher exposure to gold, as a geopolitical hedge, as we

continue to monitor developments. If their focus returns to the underlying fundamentals, we believe investors will find especially attractive opportunities in Japanese and UK equities (particularly UK mid-caps) over the Eurozone and the U.S. Within fixed income, we believe Emerging Markets Local Currency Debt offers more attractive opportunities than investment grade and high yield credit, or long duration bonds.

Risk Considerations

There is no assurance that the strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. In general, **equities securities'** values also fluctuate in response to activities specific to a company. Investments in **foreign markets** entail special risks, such as currency, political, economic and market risks. **Stocks of small-capitalisation companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market countries** are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs) shares** have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other Investment Funds, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and **Investment Funds** may not be correlated to that of the underlying securities. Derivative instruments can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. The use of **leverage** may increase volatility in the Portfolio. **Diversification** does not protect you against a loss in a particular market; however, it allows you to spread that risk across various asset classes.

DEFINITIONS

A **buyback**, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market. Companies buy back shares for a number of reasons, such as to increase the value of remaining shares available by reducing the supply or to prevent other shareholders from taking a controlling stake. **Gross Domestic Product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports. **EPS Growth Rate** is total earnings divided by the number of shares outstanding. Companies often use a weighted average of shares outstanding over the reporting term. EPS can be calculated for the previous year ("trailing EPS"), for the current year ("current EPS"), or for the coming year ("forward EPS"). Note that last year's EPS would be actual, while current year and forward year EPS would be estimates. **Price-Earnings (P/E)** is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting. The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. **Return On Equity (ROE)** is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

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