PGIM GLOBAL PARTNERS

GLOBAL INVESTMENT OUTLOOK & STRATEGY

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Sharp Correction in October as Stocks Spooked by Rate Fears, Trade Tensions & High Oil Prices. But Healthy Growth Momentum, Solid Q3 Earnings & Better Valuations Likely to Help Stocks Stabilize & Recover.

Stock Market Outlook:

Global equities sold off sharply in October as bond yields surged on concerns about more aggressive Fed rate hikes, US-China trade tensions, elevated oil prices, Italian budget tensions and Brexit roller coaster. However, stocks recovered at month-end to pare losses and remain underpinned by strong fundamentals and improved valuations.

Looking ahead, we view the October sell-off as a correction in an ongoing bull market. Our view is that stock markets are likely to stabilize and rebound as they remain supported by...

1. **Strong Q3 earnings results** especially in the US where Q3 earnings are beating expectations, tracking near 25%. Global earnings are on track to grow around 18% in 2018.
2. **H2 growth momentum that remains healthy if uneven,** with the US still on solid footing, the Eurozone coming off a big (but likely short-lived) Q3 disappointment, the UK and Japan still growing modestly, and slowing EMs from trade tensions, high oil prices and rate hikes.
3. **Policy normalization that remains gradual.** While comments by Fed Chair Powell spooked markets, and both the Fed and ECB remain on track with their respective normalization schedules, the central banks also continue to highlight risks to growth from trade tensions. Hence, market fears of more aggressive rate hikes appear to be exaggerated.
4. **Improved valuations** as the recent sell-off and continued strong earnings has improved valuations with P/E multiples below long-term average in most markets.

However, stocks still face several risks which could keep markets volatile…

1. **Elevated US-China trade tensions** (although prospects for an agreement are rising)
2. **Continued stress in EM**
3. **Geopolitical churn** from **Italian** fiscal tensions, **Brexit** talks on a roller coaster and **US midterm elections** uncertainty.

Bond Market Outlook:

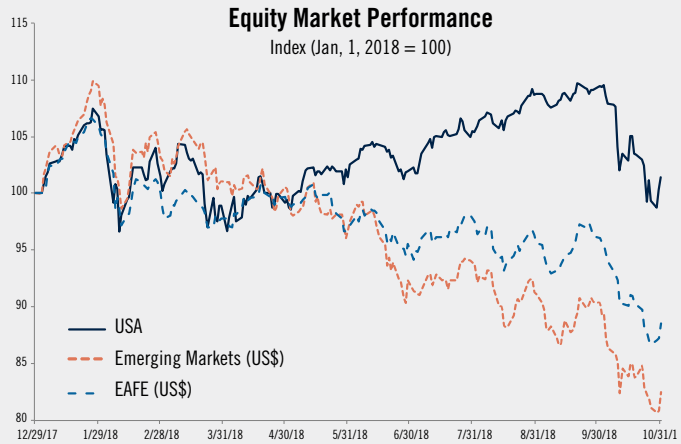
Bond yields are likely to be range-bound with…

1. **Bonds remaining supported by safe-haven demand,** with US-China trade tensions still elevated, continued stress in EM, the Bank of Japan continuing to indefinitely provide liquidity, and low inflation especially in the Eurozone and Japan.
2. **But bond yields facing upward pressure** from healthy (albeit uneven) GDP growth momentum, the Fed on track to hike rates in Q4 and in 2019 and the ECB set to end QE in December, and upward pressure on inflation in the US, UK and EM.

Stocks Sell-off on Rate Fears, Trade Tensions & High Oil Prices. However, Solid Q3 Earnings, Healthy Growth Momentum & Improved Valuations Likely to Help Stocks Stabilize & Recover

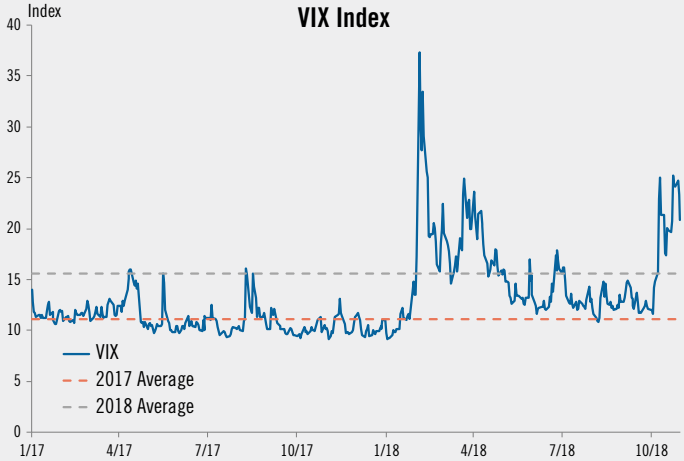
Stock Market Outlook (November 2018): Global equity markets sold off sharply in October on fears of more aggressive Fed rate hikes, US-China trade tensions, elevated oil prices, tensions between Italy and the EU over Italian budget proposals, and the IMF downgrading global growth forecasts for 2018 and 2019. Stocks recovered at month-end to pare losses. **The Developed Markets Index declined -7.4% (US$) in October, wiping out gains for the year, taking YTD returns to -3.9%. Emerging market stocks continued to struggle, falling -8.8% (US$) in October taking YTD declines to -17.5%** (Chart 1). Volatility increased sharply to the April highs (chart 2).

Chart 1: Stocks Sell-off Rate Fears, Trade Tensions & High Oil Prices



Source: FactSet

Chart 2: Volatility Jumps Amidst October Equity Market Sell-off



Source: FactSet

Looking ahead, despite the fears that triggered the October sell-off, the underlying earnings and growth fundamentals remain solid and Fed rate hike fears may be exaggerated. Further, there is the possibility of a US-China trade deal at the G20 Summit in Buenos Aires in late November. Thus, stocks continue to be supported by:

1. **Strong Earnings:** Despite recent market concerns, global earnings outlook remains solid for H2 2018 and into 2019. Globally, earnings remain on track to grow around 18% in 2018 and moderating to around 10% in 2019. **The US Q3 earnings season continues to provide upside surprises with Q3 earnings tracking around 25%,** well above expectations of 20% earnings growth. US earnings are expected to grow 23% in 2018 and slower but still solid 10% growth in 2019 as the Trump tax effect wears off.

   Eurozone earnings expectations remain stable around 7% growth for 2018, improving to 10% in 2019. European Q3 earnings are tracking around 14% YoY, with sales growth of around 7%. **Financials sector earnings remain under focus in the Q3 earnings season, with likely impact from Turkey exposure.**

   Japanese earnings are expected to grow around 7% for 2018 and 8% for 2019. Japanese GDP growth is expected to remain around trend pace. Further, the yen has depreciated and is currently trading around 112/$.

Chart 3: Global Earnings Outlook Remains Solid and likely to Support Markets

Global Equity Markets - EPS Growth

	2018 (%)	2019 (%)
	Estimate	Forecast
USA	23	10
UK	10	8
Eurozone	7	10
Japan	7	8
Emg Mkts	15	12
EM Asia	13	10
Latin America	16	18
EM EMEA	24	9
World Index	18	10

Source: IBES, Reuters, Factset; Data as of 10/15/2018

However, Japanese companies have kept their exchange rate assumption around 109/$ while revising higher their capital spending plans. These suggest that there is scope for positive revisions for Japanese earnings going forward. However, trade tensions and slower global trade remain risks to the earnings outlook.

Emerging markets earnings are expected to grow around 15% in 2018 and 12% in 2019. However, the earnings outlook remains clouded by trade tensions, currency weakness and high oil prices. EM Asia earnings are expected to rise 13% in 2018 and around 10% in 2019. EMEA earnings have been revised higher to around 24% in 2018 on back of higher oil prices but revised lower to around 9% for 2019. Latin American earnings are expected to rise 16% in 2018 and strengthen to around 18% in 2019, with upside risks following the positive elections outcome in Brazil.

2. **Healthy (Though Uneven) Global Growth Momentum:** The global economy enters final quarter of 2018 with good momentum, though growth remains uneven and less synchronized. Growth in the US remains solid with Q3 GDP rising 3.5% annualized from 4.2% in Q2. Eurozone Q3 GDP growth disappointed, rising only 0.8% annualized but is expected to rebound to over 1.5% in Q4. Eurozone growth in H1 was hamstrung by a rolling series of shocks, including the immigration crisis which threatened to bring down Angela Merkel's government in Germany, Italian political drama, trade tensions and Brexit stalemate. The UK economy was weighed down by Brexit uncertainty, but still managed to post modest growth, around 1.6% in Q2. With prospects for a Brexit deal and easing of uncertainty, UK growth is likely to improve to around 2% in H2. Japanese growth remains volatile, with Q3 growth around 1% after the sharp rebound in Q2 (3%). However, Japan's growth is expected to remain above potential growth.

   Emerging markets continue to face growth challenges. The US-China trade skirmish, Fed rate hikes and dollar strength, and high oil prices have contributed to slowdowns in several EM economies, including China. Many EM currencies have weakened sharply, which combined with higher oil prices have raised inflation risks forcing central banks to hike interest rates, raising growth risks.

Chart 4: Uneven Global Growth with US Solid, Modest Growth in Europe & Japan

Developed Economies - GDP Growth

	QoQ Annualized %			
	Q1 2018	Q2 2018	Q3 2018 E	Q4 2018 F
USA	2.2%	4.2%	3.5%	3.0%
Eurozone	1.6%	1.6%	0.8%	1.8%
Japan	-0.9%	3.0%	0.7%	1.5%
UK	0.4%	1.6%	2.0%	1.8%

Source: Bloomberg, Forecast (QMA)

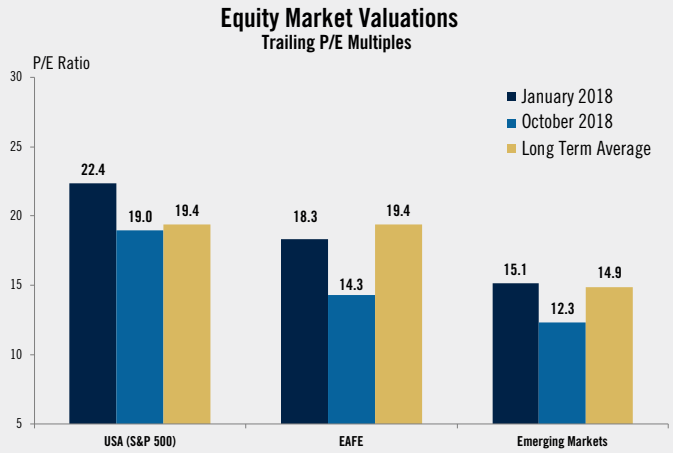
3. **Gradual Policy Normalization (At Least in DM):** Developed central banks continue to undertake policy normalization with rate hikes and unwinding the balance sheet, leading to tightening of financial condition. The Fed is on track to hike rates in Q4 and continue tightening in 2019. The ECB is expected to end QE in December. Fed rate hikes and comments by Fed Chair Powell led to a sharp rise in US Treasury yields triggering a sharp sell-off in stock markets, in a repeat of last February's sell-off. But while developed central banks remain on a policy normalization track, the Banks continue to highlight risks to growth from trade tensions and slowing emerging economies growth. **Hence, market fears of more aggressive rate hikes appear exaggerated.**

   At the same time, Fed rate hikes and policy normalization by other developed central banks **have led to sharp declines in many EM currencies.** The currency weakness combined with elevated oil prices have raised inflationary pressures, **forcing many EM central banks to raise rates.**

4. **Improved Valuations:** Equity market valuations improved in October with the sharp stocks sell-off. The P/E multiples for EAFE and Emerging Markets are down sharply from the beginning of the year and remain well below long-term averages. The US P/E multiple (S&P 500) also declined and is now modestly below its long-term average of 19.4X (Chart 5). Meanwhile, the valuation gap between developed and emerging markets has widened sharply (Chart 6). Within Emerging Markets, EM Europe remains the cheapest, while Latin America is the most expensive. Stocks also remain cheap relative to bonds as the rise in bond yields has been more than offset by the rise in equity yields following the October equity sell-off.

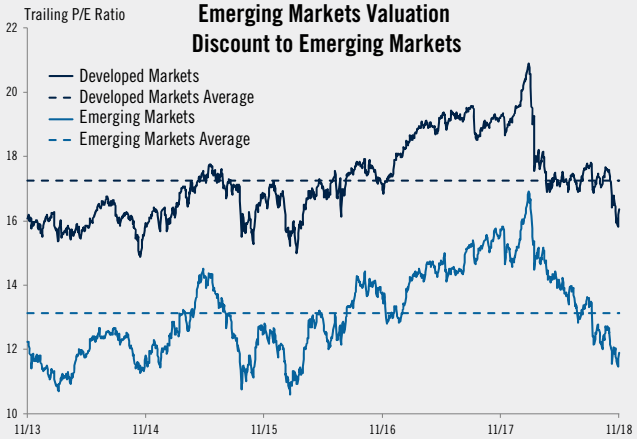
5. **Meanwhile, the valuation gap between developed and emerging markets has widened sharply** (Chart 6). Within Emerging Markets, EM Europe remains the cheapest, while Latin America is the most expensive. **Stocks also remain cheap relative to bonds** as the rise in bond yields has been more than offset by the rise in equity yields following the October equity sell-off.

Chart 5: Improved Valuations Following October Equity Sell-off



Source: FactSet, LT Average over last 20 years

Chart 6: Valuation Gap between Emerging & Developed Markets Has Widened



Source: FactSet

Summary: We view the October sell-off as another correction and not the end of the bull market. Looking ahead, despite the fears that triggered the October sell-off, the underlying earnings and growth fundamentals remain largely intact. Stocks remain underpinned by strong earnings outlook and healthy GDP growth momentum, though growth remains uneven and trade tensions pose risks to growth. Valuations have clearly improved with the October sell-off and continued strong earnings. Further, Fed rate hikes are likely to be gradual and market fears of aggressive tightening and a policy mistake by the Fed appear to be exaggerated.

However, stocks continue to face risks which could keep markets volatile, including: 1) US-China trade tensions that remain elevated as the Trump administration threatens to expand tariffs on the remaining US$267bn of Chinese exports, with China certain to retaliate. However, there are signs of a breakthrough with a potential agreement at the G-20 Summit in Buenos Aires in late November; **2) Continued stress in EM** as Fed rate hikes keeps pressure on EM currencies, raising growth and inflation risks; **4) General geopolitical churn,** with risk of showdown between Italy and EU over Italy's budget proposals, and Brexit talks still on a roller-coaster, with some progress but no deal yet as the Irish border issue remains intractable.

Conclusion: While equity markets suffered a big sell-off in October, and critical risks loom, strong Q3 earnings results, healthy growth momentum and improved valuations are likely to help stocks stabilize and recover.

Bond Yields Surge in October on Concerns about Solid Growth & Aggressive Central Bank Rate Hikes. Yields remain under Pressure with Solid Growth but Supported by Safe Haven Demand with Trade Tensions

Developed market bond yields rose sharply in the US, but more modestly in the other markets in October. US Treasury yields rose sharply to over 3.2% on fears of the Fed raising rates more aggressively and to above the neutral rate. However,

downward surprises on US CPI data and a sharp equity market sell-off put downward pressure on Treasury yields. **The US 10-Year Treasury yield rose to a high of 3.25% before ending October at 3.15%, a gain of 10bps. Eurozone yields eased to 0.39% a -8bps decline, while U.K. yields fell -11bps to 1.46%. Japanese yields held steady at 0.12%.**

In the near-term, bond yields are likely to pull back after the recent surge as fears of more aggressive Fed rate hikes appear exaggerated. Bond yields are likely to be range bound in the medium-term. **Bonds are likely to remain supported by: 1) Safe haven demand** as US-China trade tensions remain elevated, though there are signs of a breakthrough, while EM continues to struggle; **2) The BoJ continuing to provide liquidity** by maintaining accommodative monetary policy "for an extended period of time"; and **3) Inflation that remains low** and below target in Japan and the Eurozone, though creeping higher in the US and EM.

However, bonds face upward pressure with: 1) Solid (albeit uneven) growth momentum in Q3, with the US still on solid footing, the Eurozone looking likely to reverse its feeble performance in Q3, and the UK and Japan still growing modestly; **2) Developed central banks continuing their policy normalization,** with the Fed on track to hike rates in Q4 and further in 2019 and the ECB set to end QE in December; and **3) Upward pressure on inflation** in the US with strong GDP growth and a tight labor market, and in EM with high oil prices and currency weakness.

Investment Strategy:

Asset Allocation: Remain Overweight in stocks as strong Q3 earnings & healthy growth should help stocks recover

Stocks: Remain Overweight. While equity markets suffered a sell-off in October on interest rate fears, trade tensions, high oil prices and other risks, strong Q3 earnings results, healthy GDP growth momentum and improved valuations after the recent sell-off are likely to help stocks stabilize and recover.

Bonds: Remain Neutral. Bond yields are likely to be range bound with support from safe haven demand on trade tensions, EM stress, BoJ QE buying & low inflation in Eurozone & Japan. However, bonds face upward pressure with healthy growth momentum & continued policy normalization.

Global Equity Markets Strategy: Remain overweight in US on strong Q3 earnings & growth. Remain Underweight in EM on continued stress

US: Remain Overweight as US stocks are likely to continue to outperform other markets with relatively stronger Q3 earnings and GDP growth.

Japan: Raise to Modest Overweight with BoJ continuing QE stimulus, GDP growth remains above trend, and weak yen likely to boost earnings.

Eurozone: Neutral with growth expected to improve in Q4 after the Q3 disappointment, but risks of a budget crisis in Italy and a showdown with the EU.

UK: Raise to Neutral with GDP growth improving and BoE rate hikes likely to be gradual. However, Brexit talks remain on roller coaster with progress on talks, but no deal yet.

Emerging Markets: Remain Modest Underweight with currency weakness from Fed rate hikes, trade tensions and EM rate hikes with inflation risks. Slower EM growth with trade tensions and tightening of global financial conditions. Thaw in US-Turkey relations and positive outcome in Brazil elections offset by problems in India's shadow banking sector.

Global Bond Market Strategy: BoJ QE & low inflation support JGBs. US Treasuries supported by safe haven demand from trade tensions

Japan JGBs: Modest Overweight with the BoJ continuing QE buying, low inflation and modest GDP growth.

EM Debt: Neutral as trade tensions & currency weakness offset by attractive EM spreads, easing US-Turkey tensions & positive election outcome in Brazil.

US Treasuries: Neutral as Treasuries supported by safe haven demand, but under upward pressure from strong growth outlook and Fed rate hikes.

UK Gilts: Raise to Neutral with modest GDP growth and inflation easing. No Brexit deal yet but UK and EU inching closer to an agreement.

Eurozone: Modest Underweight with ECB on track to end QE and Italian budget uncertainty but supported by low inflation and modest growth.

Global Sectors:

Overweight: Industrials & Financials; **Modest Overweight:** Information Technology, Energy & Consumer Discretionary;

Neutral: Healthcare & Telecomms;

Underweight: Consumer Staples, Materials, Real Estate & Utilities.