PGIM GLOBAL PARTNERS

# GLOBAL INVESTMENT OUTLOOK & STRATEGY

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John Praveen, PhD
Managing Director


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**FOR MORE INFORMATION CONTACT:**


Kristin Meza
Phone: 973-367-4104
Email: kristin.meza@prudential.com


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## Stocks likely to remain Volatile with Trade & Geo-political Tensions. However, Strong Earnings Results & GDP Rebound after Soft Q1 Likely to Lift Stocks as Trade & Syria Tensions Cool

***Global stock markets remain under the shadow of trade and Syria tensions. However, stocks are likely to stabilize and rebound as trade and geo-political tensions cool. Stock markets remain supported by strong earnings outlook with Q1 earnings surprising on the upside and global growth expected to rebound after the Q1 soft patch. Monetary conditions remain accommodative as policy normalization is likely to be gradual as trade tensions increase risks to global growth. Further, equity valuations have improved with markets declining and earnings rising.***

***Stock Market Outlook:*** Global equity market volatility remained elevated in April as the US-China trade tensions escalated and Middle East tensions flared up with a military strike by the U.S. & its Allies on Syria in response to a chemical attack on civilians. Stocks stabilized with cooling of trade tensions and strong Q1 earnings reports. ***The Developed Markets gained 1.8% in April, trimming 2018 YTD decline to -1%. The Emerging Markets index rose 1.2% for YTD gains of 1.4%.***

***Looking ahead, stock markets remain supported by: 1) Strong earnings outlook with Q1 earnings results surprising on the upside:*** The U.S. Q1 earnings season started in mid-April with earnings tracking over 25% and a record 79.4% of companies beating expectations. Global earnings are expected to grow around 18% in 2018 led by the U.S. (21%), Emerging Markets (16%) and Japan (34%); ***2) Global growth outlook remains solid despite Q1 moderation. Trade tensions pose downside risks to growth:*** After ending 2017 on a strong note, global growth paused in early 2018 with Q1 GDP growth moderating in the U.S. (to 2.3%) and UK (to 0.4%) and Eurozone on track to slow to 2%. However, the Q1 growth moderation is weather related and a payback for the strong Q4. Global growth outlook remains solid driven by business and consumer confidence which remains robust despite coming off multi-year highs; ***3) Policy normalization by developed central banks likely to be gradual*** as trade tensions raise risks to growth. Markets continue to receive liquidity support from the QE buying by the ECB and BoJ. Emerging central bank policies are likely to be mixed; ***4) Valuations continue to improve*** with P/E multiples falling on rising earnings and markets declining. ***However, while Korea tensions have eased, stock markets face other risks, including: 1)*** Trade tensions spiraling into a trade war; ***2)*** Military conflict expands in the Middle East; and ***3)*** A U.S. constitutional crisis if Trump fires Mueller and DoJ officials. ***Our base case is that the trade and Syria tensions will cool, and the strong Q1 earnings results and growth rebound will enable stocks to stabilize and recover.***

***Bond Market Outlook:*** Bond yields rose in April with bonds supported by safe haven demand, but rising oil prices and strong wage growth put upward pressure on yields. ***Looking ahead, bond yields are likely to be supported in the near-term by: 1) Safe haven demand*** with trade and Syria tensions; ***2) Continued QE Stimulus*** from the BoJ and ECB as inflation remains below target. Other developed central banks are likely to be cautious in normalizing policies as trade tensions raise risks to growth; ***3) Inflation remains below target*** in Japan and Eurozone though creeping higher in the U.S. and U.K. ***However, bond yields are likely to face upward pressure with: 1) Global GDP growth on track to rebound*** after the Q1 growth moderation in the U.S., U.K. and Eurozone; ***2) Policy normalization*** with rate hikes by the Fed and BoE, and the ECB on QE taper track; and ***3) Inflation creeping higher*** in the U.S. and U.K. with elevated oil prices and reduced slack.

## Stocks Remain Volatile with Trade & Syria Tensions. However, Strong Earnings Results & GDP Rebound after Soft Q1 Likely to Lift Stocks as Trade & Syria Tensions Cool

## Bonds Supported in Near-term with Safe Haven Demand from Trade & Syria Tensions. Yields Likely to Face Upward Pressure with GDP Growth Rebound & Ongoing Policy Normalization

***Stock Market Outlook (May): Global equity markets remained volatile in April as US-China trade tensions escalated and Middle East tensions flared up with the joint military strike by the U.S. and its allies on Syria in response to a chemical attack on civilians.*** In early April, the U.S. proposed tariffs on $50 bn worth of imports from China. China retaliated by announcing 25% tariff on US exports, including soybeans, automobiles, chemical and aircrafts. President Trump responded by threatening $100 billion of additional tariffs, raising the specter of an all-out trade war. However, stocks recovered with strong Q1 earnings results and easing of trade tensions following Chinese President Xi's speech at the Boao forum in Hainan where he committed to a more open China. U.S. stocks (S&P 500) rose 0.3% in April, trimming YTD losses to -1%. Eurozone stocks gained 4.6% during the month led by strong gains in Italy (7.1%) and France (6.3%) taking YTD gains to 1.5%. Japanese stocks rose 4.3% as the Yen declined against the US$, trimming YTD losses to -2.2%. ***The Developed Markets gained 1.8% in April, trimming the YTD decline to -1%. The Emerging Markets rose 1.2% for YTD gains of 1.4%.***

***Looking ahead, equity markets are likely to remain volatile with a tug of war between trade and Syria tensions versus strong Q1 corporate earnings results and global growth rebound. Equity markets remain supported by:*** 1) Strong earnings outlook with Q1 earnings results surprising on the upside; 2) Global growth outlook remains solid despite Q1 moderation; 3) Policy normalization by developed central banks likely to be gradual; 4) Valuations continue to improve.

***1) Strong Corporate Earnings Outlook with Q1 Earnings Results Surprising on the Upside:*** The U.S. Q1 earnings season started in mid-April with earnings tracking over 25% and a record 79.4% of companies beating expectations. Global earnings expectations for 2018 continue to be revised higher with earnings growth expected around 18% for the year after 16% growth in 2017. Japanese earnings expectations remain high at 34% growth for 2018, but likely to be revised lower with yen remaining above firms' expectations for the yen exchange rate. Eurozone earnings expectations have been revised lower to 8% for 2018 after 10% growth in 2017. U.K. earnings are likely to be dragged by the continued impact of Brexit on the U.K. economy and earnings. The Emerging Markets earnings outlook continues to be revised higher, with earnings expected to rise around 16% in 2018 after 23% in 2017, driven by the rise in energy and commodity prices and solid global growth. EM Asia earnings are expected to rise 14% in 2018 after a strong 26% pace in 2017. The Latin American earnings outlook remains solid at 18% in 2018 after 16% in 2017, while EMEA earnings have been further revised higher to 16% growth in 2018 after 17% in 2017.

***2) Global growth outlook remains solid despite Q1 moderation:*** After ending 2017 on strong note, global growth slowed in early 2018 with Q1 GDP growth moderating in the U.S. and U.K. and Eurozone on track to slow. However, the Q1 growth moderation is weather related and a payback for the strong Q4. Global growth momentum remains solid in 2018 driven by business and consumer confidence which remains strong despite coming off multi-year highs.

After three quarters of around 3% annualized GDP growth, ***the U.S. economy slowed in Q1 to 2.3% annualized growth from 2.9% in Q4 2017.*** The U.S. economy continues the seasonal pattern of Q1 slowdown. However, Q1 2018 growth of 2.3% is better than in Q1 2017 (1.2%), Q1 2016 (0.6%) and 2009-2017 average Q1 growth of 1.3%. ***Despite the Q1 GDP moderation, the U.S. economy remains solid and on track to rebound in Q2*** as consumer spending reaccelerates with low unemployment, rising wages and the boost from Trump tax cuts to consumer and investment spending.

***Eurozone growth is on track to moderate in Q1 to around 2%*** due to temporary factors (cold weather, strikes and timing of Easter), and a pull-back from strong growth in Q4. The ECB acknowledges that the Q1 slowdown is broad-based by country and sector, but expressed confidence in the ***continued "solid & broad-based expansion" of the Eurozone economy.*** U.K. GDP growth slowed to 0.4% annualized in Q1 from 1.6% in Q4 2017 as severe weather added to Brexit uncertainty to depress growth. Japanese GDP growth is expected to remain above-trend in Q1. Emerging Markets remain on track for solid growth with strong oil and commodity prices, and solid growth in the developed economies.

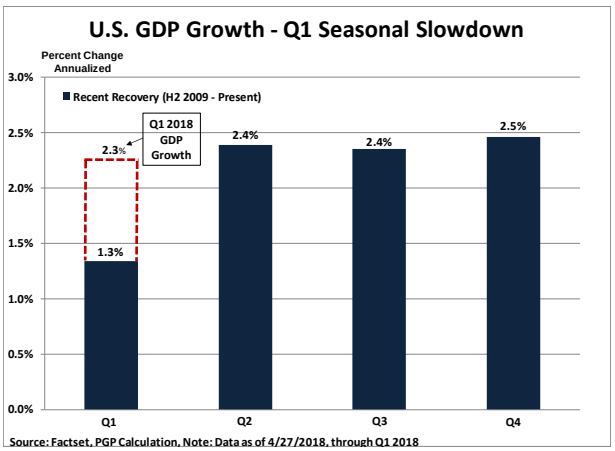
### U.S. Q1 Earnings Surprise on the Upside, Leads Strong Global Earnings Growth

**Global Equity Markets - EPS Growth**

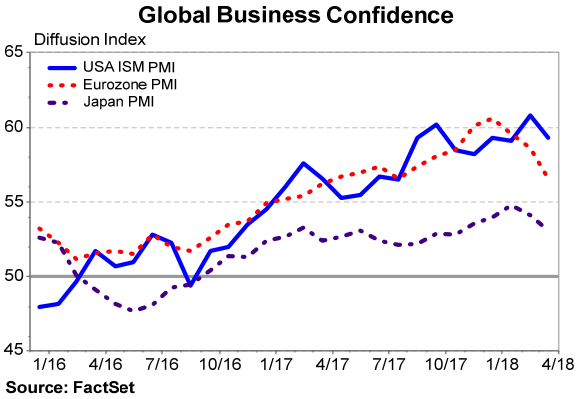
| | 2018 (%) Forecast | 2017 (%) Actual |
|---|---|---|
| USA | 21 | 13 |
| UK | 8 | 23 |
| Eurozone | 8 | 10 |
| Japan | 34 | 25 |
| Emg Mkts | 16 | 23 |
| EM Asia | 14 | 26 |
| Latin America | 18 | 16 |
| EM EMEA | 16 | 17 |
| World Index | 18 | 16 |

Source: IBES, Reuters, Factset

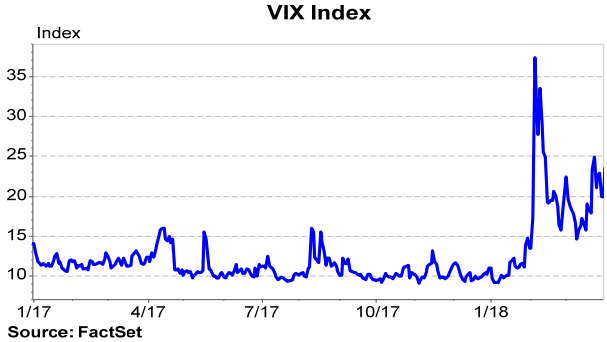
### U.S. Economy Solid. Q1 GDP Moderation Follows Seasonal Pattern




### Business Confidence Comes off Multi-Year Highs but Still Solid




### Volatility Declines as Inflation Concerns Ease but Still Above 2017 Levels




***3) Policy Normalization by Developed Central Banks likely to be Gradual as Trade Tension Raise Risks to Growth:*** Developed central banks continue to normalize policies and reduce stimulus. However, the central banks noted the recent escalation of trade tensions and expressed concern about the downside risks to economic outlook if these tensions spiral into a trade war. Consequently, the central banks are likely to be cautious and gradual in normalizing policies.

***Markets are likely to continue to receive liquidity support from QE buying by the Bank of Japan, the ECB and Emerging Central Banks maintaining easy monetary policies. The U.S. Fed raised interest rates by 25bps at their March meeting. The Fed is likely to be on hold in May but raise rates two more times in 2018.*** The Fed's April statement and minutes give an upbeat assessment of the U.S. economy with forecasts for real GDP growth revised higher, the unemployment rate revised lower and modest revision to inflation forecast. ***The ECB left monetary policy and forward guidance unchanged at the April meeting.*** The ECB devoted the April meeting to a discussion of Eurozone's recent soft economic data and external risks from trade tensions to export-oriented Eurozone economy. However, the ECB and Draghi reassured that data remains consistent with "solid & broad-based expansion" in Eurozone. ***In U.K., the BoE is likely to hike rates in May*** due to the longer-term inflation outlook***. Emerging central bank policies are likely to be mixed***, with rate cuts in some markets and rates on hold in other EMs.

***4) Equity Valuations Continue to Improve with Price Declines & Rising Earnings: Equity valuations continued to improve*** as stocks declined on growing trade tensions. The Developed Markets (MSCI World Index) P/E multiple eased to 19.6X in March from 21.0X in February and is now below the long-term average multiple of 20.4X (20-year average). ***The trailing P/E multiple for the S&P 500 eased further to 20.8X in April*** from 21.3X in March with the S&P 500 eking a 1.1% gain in April, after declining in March ( -2.7%) and February (-3.9%). The P/E multiple for Japanese stocks (TOPIX) rose to 14.6X in April from 14.2X in March with Japanese stocks down -2.2% in 2018 YTD. In Eurozone, the STOXX P/E rose to 16.3X in April with Eurozone equities rising 4.1%.

***The Emerging Markets (EM) P/E multiple eased further to 14.7X in April after falling to 15.4X in February from 16.0X in January***, and is slightly below their long term (20-year) average of 14.9X. EM valuations remain attractive relative to Developed Market stocks. ***Stocks remain cheap relative to bonds on an Earnings Yield Gap basis,*** with the yield gap widening on an increase in stock P/E multiples and pull-back in bond yields.

***Bottom-line:*** ***Global stock markets remained volatile in April*** as the US-China trade tensions escalated and Middle East tensions flared in Syria. Stocks stabilized with cooling of trade tensions and strong U.S. Q1 earnings results. ***The Developed Markets gained 1.8% in April, trimming 2018 YTD decline to -1%. The Emerging Markets rose 1.2% for YTD gains of 1.4%.***

***Looking ahead, equity markets are likely to remain volatile with a tug of war between fears of a trade war and Syria tensions versus strong corporate earnings results and global growth on track to rebound. Equity markets remain supported by: 1) Strong earnings outlook with Q1 earnings results surprising on the upside:*** The U.S. Q1 earnings season started in mid-April with earnings tracking over 25% and a record 79.4% of companies beating expectations. Global earnings are expected to grow around 18% in 2018 led by the U.S. (21%), Emerging Markets (16%) and Japan (34%); ***2) Global growth outlook remains solid despite Q1 moderation. Trade tensions pose downside risks to growth:*** After ending 2017 on strong note, global growth slowed in early 2018 with Q1 GDP growth moderating in the U.S. (to 2.3%) and U.K. (to 0.4%) and Eurozone on track to slow to 2%. However, the Q1 growth moderation is weather related and a payback for the strong Q4. Global growth momentum remains solid driven by business and consumer confidence which remains strong despite coming off multi-year highs; ***3) Policy normalization by developed central banks is likely to be gradual*** as trade tensions raise risks to growth. Markets continue to receive liquidity support from QE buying by the BoJ and the ECB. Emerging central bank policies are likely to be mixed; ***4) Valuations continue to improve*** with P/E multiples falling on rising earnings and markets declining.

***However, while Korea tensions have eased, stock markets face other risks which could keep market volatility elevated, including: 1)*** US-China trade tensions spiral into a trade war; ***2)*** Military conflict expands in the Middle East with potential Russian retaliation for U.S. & Allies military strikes in Syria; ***3)*** A U.S. constitutional crisis if President Trump fires Special Counsel Mueller and DoJ Officials. ***Our base case is that the trade and Syria tensions will cool, and the strong Q1 earnings and growth rebound will enable stocks to stabilize and recover.*** However, if trade tensions spiral into a trade war, it will undermine global growth and cut into earnings, leading to further weakness in stock markets.

## *Bonds Yields Edge Up in April. Bonds Supported in Near-term with Safe Haven Demand. Yields Face Upward Pressure with Growth Rebound & Policy Normalization by Fed, ECB & BoE*

Developed market bond yields rose in April. The U.S. 10-Year Treasury yield rose 19bps to 2.93%. Eurozone yields rose 8bps to 0.57% and U.K. gilt yield rose to 1.43%. Japanese JGB yields edged up just 1bp to 0.05%.

***Looking ahead, bond yields are likely to be supported in the near-term by: 1) Safe haven demand*** with trade and Syria tensions; ***2) Continued QE Stimulus*** from the BoJ and ECB as inflation remains below target. Other developed central banks are likely to be cautious in normalizing policies as trade tensions raise risks to growth; ***3) Inflation remains below*** target in Japan & Eurozone though creeping higher in the U.S. and U.K. ***However, bond yields are likely to face upward pressure with: 1) Global GDP growth on track to rebound*** after the Q1 growth moderation in the U.S., U.K. and Eurozone; ***2) Policy normalization*** with rate hikes by the Fed and BoE, and the ECB on QE taper track; and ***3) Inflation creeping higher*** in the U.S. and U.K. with elevated oil prices and reduced slack.

## Investment Strategy:

### *Asset Allocation:* *Reduce overweight in Stocks as Trade & Syria Tensions Overshadow Strong Q1 Earnings*

**Stocks:** ***Reduce Overweight*** as equity markets are likely to remain volatile with trade and Syria tensions casting a shadow on strong Q1 earnings. However, the strong Q1 earnings results and GDP rebound are likely to help stocks to stabilize and rebound as trade and Syria tensions cool.

**Bonds:** ***Raise to Neutral*** as bonds are likely to be supported in the near-term by safe haven demand with trade and Syria tensions, BoJ QE buying and low inflation in Eurozone and Japan. However, bond yields are likely to face upward pressure with GDP growth rebound and ongoing policy normalization.

## *Global Equity Strategy: Strong Q1 Earnings Results likely to help U.S. Stocks Outperform Europe & Japan as Trade & Syria Tensions Cool*

**U.S.:** ***Overweight*** as U.S. stocks are likely to stabilize and rebound with strong Q1 earnings results, tracking over 20%, and GDP growth expected to rebound after the soft Q1. Volatility likely to be elevated with trade and Syria tensions.

**Emerging Markets:** ***Overweight*** with solid earnings outlook and GDP growth with strength in oil and commodity prices, and solid global growth. However, US-China trade skirmishes and Syria tensions carry risks for EM stock markets.

**Japan:** ***Remain Neutral*** as yen strength remains a risk for earnings and GDP growth. Earnings expectations elevated at 34% with risk of disappointment, especially with strong yen. BoJ continues QE and GDP growth remains above-trend.

**Eurozone:** ***Remain Neutral*** as Eurozone earnings are likely to be modest relative to the double-digit earnings in the U.S., Japan and Emg Mkts. However, Eurozone GDP growth remains solid & ECB likely to move slowly in ending QE.

**U.K.:** ***Remain Modest Underweight*** as U.K. stocks are likely to underperform with soft earnings and weak GDP growth with Brexit uncertainty. BoE likely to hike interest rates in May and again in Q3 due to longer-term inflation outlook.

## *Global Bond Market Strategy: Bonds Supported in Near-term with Safe Haven Demand with Trade and Syria Tensions but GDP Rebound likely to Push Yields Higher*

**Japan JGBs:** ***Modest Overweight*** as the outlook for Japanese JGBs remains modestly positive with BoJ continuing QE buying, even as other major central banks are on track to remove stimulus. Inflation remains low and well below target.

**EM Debt:** ***Modest Overweight*** with Emerging Market bonds expected to continue to benefit from healthy fundamentals, solid growth, and still favorable valuations. However, trade and Syria tensions carry risks for EM debt.

**U.S.** ***Treasuries: Raise to Neutral*** as U.S. Treasuries are likely to be supported in the near-term with safe haven demand from trade and Syria tensions. However, yields likely to face upward pressure with GDP rebound and Fed rate hikes.

**Eurozone:** ***Modest Underweight*** as the outlook for Eurozone bonds is modestly negative as low yields and solid GDP likely to push yields higher. However, inflation remains low and ECB likely to be slow to remove monetary accommodation.

**U.K. Gilts:** ***Modest Underweight*** as the outlook for U.K. Gilts remains modestly negative with BoE likely to raise rates on longer-term inflation outlook, Brexit uncertainty remains though differences narrowed. Weak GDP growth is a positive.

## *Global Sector Strategy:*

***Overweight:*** Industrials, Financials, Information Technology; ***Modest Overweight:*** Consumer Discretionary & Energy; ***Neutral:*** Healthcare, Materials & Telecomms; ***Underweight:*** Consumer Staples, Real Estate & Utilities.