

GLOBAL INVESTMENT OUTLOOK & STRATEGY

September 2018



John Praveen, PhD
Managing Director

**FOLLOW US
ON TWITTER:**
@prustrategist

**FOR MORE INFORMATION
CONTACT:**

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

PGIM is the Global
Investment Management
Business of Prudential
Financial, Inc.

Turkey Turmoil, Trade Tensions & Brexit Uncertainty Cast Shadow on Equity Markets, but Strong Earnings Outlook & Solid Growth Momentum Likely to Help Stocks to Grind Higher

The Turkish lira crisis, US-China trade tensions, Brexit and Italian fiscal uncertainty continue to cast a shadow on stock markets. However, stocks remain supported by blockbuster Q2 earnings, upward revisions to Q3 earnings expectations, and solid growth momentum. Further, policy normalization by the Fed, ECB and BoE remains gradual.

Stock Market Outlook:

- **August was a microcosm of the up-down-but-generally-up pattern thus far in 2018 and what we expect for the balance of the year.** Stocks (at least in developed markets) generally rose early; sold off in the middle, with the plunge in the lira stoking fears of EM contagion and risks to European banks; and then rallied late in the month, as some of those tail-risk fears subsided. **For the month, DM gained 1.1%, for YTD gains of 4.4%; EM declined -0.7%, taking YTD decline to -3.5%.**
- **Stocks remain supported by 3 major factors...**
 1. **Strong earnings outlook:** Globally, earnings remain solid, around 18% for 2018, led by the US (Q2 tracking around 24% YoY and Q3 earnings expectations being revised higher) followed by EM (16%), Eurozone (7%) and Japan (6%).
 2. **(Mostly) solid GDP growth (for now):** Although trade, Turkey and Fed rate hikes have raised challenges for EM, Q2 saw a strong rebound in US GDP (4.2%), and more modest rebounds in the UK, Eurozone and Japan. Late H2, however, growth could suffer from trade tensions.
 3. **Gradual policy normalization:** Even with the Fed on track to hike rates in September and again in Q4, the BoE raising rates in August, and the ECB planning to end QE buying in December, the policy normalization remains “gradual”. The BoJ, meanwhile, assures that accommodative policy will continue for an “extended period of time.”
- **... but stocks still face 3 major risks:**
 1. **The Turkish lira crisis** still remains unresolved
 2. **While US-EU, US-Mexico trade tensions have eased, tensions between the US and China remain elevated** with the US proposing additional tariffs and China retaliating
 3. **Brexit uncertainty remains high** with no agreement yet between the UK and EU as the October deadline approaches, increasing the risk of “No-Deal” or a “Hard Brexit.”

Bond Market Outlook:

- **Safe-haven demand is back on the table**, with bond yields falling in August from the Turkish lira crisis and EM contagion fears; the same factors, along with rising US-China trade tensions, Brexit and Italian fiscal uncertainty, should support bond prices going forward.
- **Also supportive are the continuation of BoJ liquidity for an extended period,** and **inflation that generally remains low**, especially in the Eurozone and Japan.
- **However, on balance, we see bond yields facing more upward pressure than down, from...**
 1. **Solid GDP growth momentum in Q3** after the Q2 rebound
 2. **Fed on track to hike rates in September and Q4 and the ECB set to end QE**
 3. **Upward pressure on inflation** in the US with strong GDP growth and tight labor market, and in EM with still-elevated oil prices and spreading currency weakness.

Stocks Supported by Strong Earnings Growth. Q2 Earnings Surprise on the Upside, Q3 Earnings Expectations Revised Up. Solid Global Growth Momentum in Q3 with Q2 GDP Rebound. EM Growth Outlook Dented by Fed Rate Hikes, Trade Tensions & Turkey Turmoil

August recap: Global equity markets got off to a mixed start to August as developed market stocks gained on solid Q2 earnings announcements and positive growth outlook, while emerging market stocks continued to decline with ongoing trade tensions, currency weakness and China growth concerns. Stocks sold off in mid-August with the Turkish lira crisis triggering a sell-off in global markets on fears of contagion to other emerging markets and risks for Eurozone banks. Stocks rebounded in late August with a trade agreement between the US & Mexico in place of NAFTA. **The developed markets index gained 1.1% in August, for YTD gains of 4.4%. Emerging market stocks pared losses from the sell-off after the Turkish lira crisis, and ended the month with a modest –0.7% decline, taking YTD declines to –3.5%.**

LOOKING AHEAD, stocks remain supported by strong corporate earnings, solid growth momentum and gradual policy normalization:

1. Strong earnings outlook after blow-out Q2 earnings: Global earnings outlook remain solid with earnings expectations for Q3 being revised higher after blockbuster Q2 earnings. The US Q2 earnings results are coming in stronger-than-expected and currently tracking around 24% YoY, driven by strong GDP and revenue growth, while expectations for Q3 have been revised up to over 20%. Eurozone earnings expectations are around 7% for 2018 and 10% in 2019. However, earnings expectations of European Financials that are exposed to Turkey could be cut in coming months, resulting in downward revisions to overall earnings. European Q2 earnings results are coming in better than expected, tracking around 9.9% YoY, up from expectations of around 8.1% growth earlier. Revenue growth is expected around 3.9% for the quarter. Japanese earnings are expected to rise around 6% in 2018 and improve to around 8% in 2019. Japanese companies are benefiting from GDP growth rebounding to a stronger than expected 1.9% in Q2. Exporters are benefiting from solid global demand and supported by the yen depreciating to around 111/\$ in July from below 110/\$ in Q2. Companies' exchange rate expectations are stronger at 109.66/\$ for FY2018-19. Emerging markets earnings are expected to grow around 16% for 2018. Earnings expectations remain solid although there is a risk that these expectations could be dialed down in coming months with the increase in trade tensions and likely cuts to Turkish earnings and risk of contagion to other emerging markets. EMEA earnings are expected to rise around 20% in 2018 after 17% in 2017. LatAm earnings are expected to improve to 20% from 16% last year. EM Asia earnings expectations remain stable at 14% growth for 2018 after 26% in 2017.

2. Solid growth momentum in Q3: The global growth outlook remains solid in Q3 with a strong Q2 rebound in the US (4.2%), a more modest rebound in the UK (1.6%), a disappointing rebound in the Eurozone (1.6%), and Japan resuming growth with stronger than expected GDP gains in Q2. However, the growth outlook in late H2 is likely to be under strain from elevated US-China trade tensions. Central banks have expressed growing concerns about the increased “uncertainty and risks associated with trade policy.” The first round of US-China trade tariffs seem to have minimal impact, but the impact could

Strong Q2 Earnings Growth & Upward Revisions to Q3 Earnings Expectations Global Equity Markets—EPS Growth

	2018 (%)	2019 (%)
	Estimate	Forecast
USA	23	10
UK	11	7
Eurozone	7	10
Japan	6	8
Emg Mkts	16	12
EM Asia	14	10
Latin America	20	15
EM EMEA	20	10
World Index	18	9

Source: IBES, Reuters, Factset; Data as of 8/29/2018

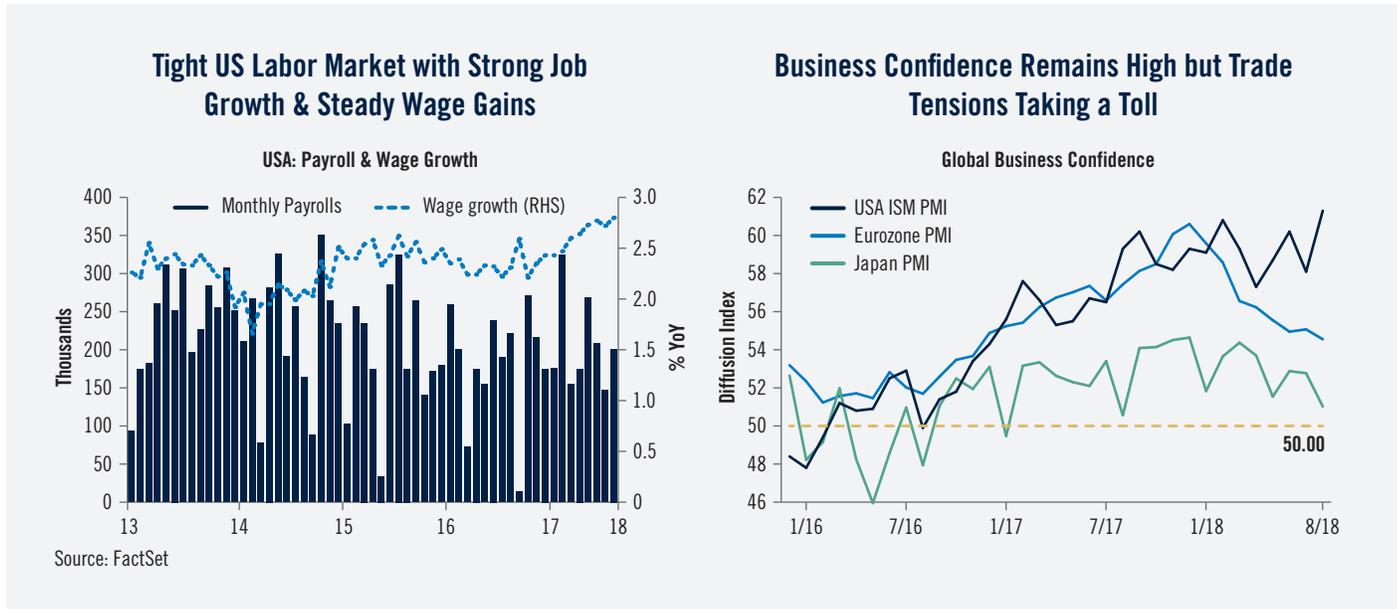
Solid Global Growth Momentum in Q3 with Q2 GDP Rebound Developed Economies—GDP Growth

	QoQ Annualized %	
	Q1 2018	Q2 2018
USA	2.2%	4.2%
Eurozone	1.6%	1.6%
Japan	–0.9%	1.9%
UK	0.4%	1.6%

Source: FactSet

increase with the Trump administration proposing tariffs on \$200 billion of Chinese imports and China beginning to retaliate. Already business confidence and spending is being adversely impacted by trade uncertainty.

GDP growth in the emerging markets was solid in H1 2018, supported by strength in oil and commodity prices. Looking ahead, the growth outlook for EM has become more challenging with escalating trade tensions, Turkey contagion risk, Fed rate hikes and policy normalization by other central banks. Further, many EM currencies have depreciated sharply in response to trade tensions and Fed rate hikes, forcing those EM central banks to hike rates to defend their currencies and/or fight inflation, while limiting the ability of other EM central banks to maintain accommodative monetary policies. In addition to trade tensions and Turkey turmoil, the crises in Argentina and Venezuela, and election uncertainty in Brazil are adding to EM growth challenges.



3. Fed, ECB and BoE continue gradual policy normalization, but policy challenges for EM central banks: The Fed, ECB and BoE remain on track to gradual policy normalization, but the banks have expressed growing concerns about the uncertainty and risks associated with rising trade tensions. The Fed left policy rates unchanged at the early August meeting and upgraded its assessment of US economic activity to “strong” from “solid”. **The Fed remains on track for two more rate hikes in 2018** with the minutes of the August Fed meeting signaling that the next rate hike is likely to be in September. **In the Eurozone, the ECB** remains on track to taper its QE and end it in December. However, the ECB reassured that rates would remain unchanged “at least through the summer of 2019.” **In the UK, the BoE raised interest rates by 25bps in early August.** The BoE assured that future rate hikes are likely to be “gradual” and “to a limited extent,” given increased Brexit uncertainty. **The Bank of Japan (BoJ)** left policy unchanged at its late July meeting but tweaked its policy framework and **introduced explicit forward guidance, pledging to keep accommodative policy “for an extended period of time.”**

Emerging central banks face challenges as inflation risks have increased with sharp depreciation of many EM currencies against the dollar forcing rate hikes to defend currencies and fight inflation, while limiting the ability of other EM central banks to maintain accommodative monetary policies. Additional fears of contagion from currency crises in Turkey and Argentina have increased challenges to other EM central banks.

While stocks remain supported by strong corporate earnings and solid growth momentum, there are several risks which could keep markets volatile, including:

- 1. The Turkish lira crisis** remains unresolved with risks for European banks contagion to other Emerging Markets.
- 2. Trade tensions continue** to ratchet higher with the Trump administration proposing tariffs on another \$200 billion of Chinese exports and China retaliating.

3. **Brexit uncertainty** remains elevated with no deal yet between the UK and EU as the October deadline approaches. Failure to agree on a deal raises the risk of collapse of the May government, “No-Deal” or a “Hard Brexit”.
4. **Italian fiscal uncertainty** with the 5-Star-Lega coalition expected to present a “populist” budget that could breach EU fiscal norms.

CONCLUSION: The Turkish lira crisis, US-China trade tensions, Brexit and Italian uncertainties continue to cast a shadow on stock markets. However, we still expect the strong earnings outlook and solid GDP growth momentum to help stock markets to grind higher.

Bond Yields Fall in August with Turkish Lira Crisis. Bonds Supported by Safe Haven Demand with Trade Tensions, Turkey Turmoil, Brexit & Italian Uncertainties and BoJ QE. Solid GDP Growth & Fed Hikes likely to Push Yields Higher

Developed market bond yields fell in August on safe haven demand as the Turkish lira collapsed, raising fears of contagion to other emerging markets. Falling oil prices had put modest downward pressure on U.S. inflation expectations through the middle of the month, but the recovery in oil prices at the end of the month sent expectations back up to 2%. Further, the Bank of Japan left the 10-Year JGB yield target unchanged at 0% but widened the band “around zero” from $\pm 0.1\%$ to $\pm 0.2\%$ and introduced explicit forward guidance pledging to “maintain the current extremely low levels of short- and long-term interest rates for an extended period of time.” In addition, ongoing trade tensions remain a risk for growth with U.S. leveling new tariffs against China. **The US 10-Year Treasury yield fell to 2.85% in August. Eurozone yields weakened -12bps to 0.33%, while UK yields declined to 1.43%. By contrast, Japanese yields are up 4bps to 0.10%.**

In the near-term, bonds are likely to remain supported by: 1) Safe haven demand as the Turkish lira crisis remains unresolved with risk to European banks and contagion to other emerging markets, US-China trade tensions remain elevated and Brexit uncertainty remains high with no agreement yet with EU as the October deadline approaches raising the risk of “No-Deal” or “Hard Brexit”; **2) The BoJ continues to provide liquidity**, pledging to maintain accommodative monetary policy “for an extended period of time;” and **3) Inflation remains low** and below target in Japan and the Eurozone, though creeping higher in the US and EM. **However, bond yields are likely to face upward pressure with: 1) Solid growth momentum in Q3** with a strong Q2 GDP rebound in the US and a modest rebound in Eurozone, UK and Japan, although growth risks have increased with elevated trade tensions; **2) Developed central banks continue policy normalization** with the Fed on track to two more rate hikes in 2018, while the ECB is set to end QE in December; and **3) Upward pressure on inflation** in the US with strong GDP growth and low unemployment, and in EM with still-elevated oil prices and spreading currency weakness.

Investment Strategy:

Asset Allocation: Overweight in Stocks with Strong Earnings & Solid GDP Growth but Risks from Turkey Crisis & Trade Tensions

Stocks: Remain Overweight. The Turkish lira crisis and trade tensions continue to cast a shadow on global stock markets. However, stocks are likely to grind higher with strong corporate earnings and solid growth momentum. Further, policy normalization by the Fed, ECB and BoE remains gradual.

Bonds: Remain Neutral. Bonds remain supported in the near-term by safe haven demand from Turkish lira crisis, trade tensions, Brexit uncertainty and BoJ to continue QE buying. However, yields are likely to face upward pressure with solid growth momentum, Fed rate hikes and ECB ending QE.

Global Equity Markets Strategy: Overweight US on strong earnings & growth. Remain Neutral in Eurozone & Japan. Remain Underweight in EM

US: Remain Overweight as US stocks are likely to continue to outperform other markets on stronger earnings outlook and solid GDP growth after the strong Q2 rebound. Further, the US is at less risk from the Turkey crisis compared to the Eurozone (banks’ exposure) and EM (contagion).

Japan: Remain Neutral as Japanese stocks are likely to be range-bound with GDP growth recovery and BoJ to continue QE stimulus for an extended period, but offset by increased risk aversion and yen strength from trade tensions and Turkey lira crisis.

Eurozone: Remain Neutral as Eurozone stocks are supported by GDP growth rebound and stronger-than-expected earnings results but offset by concerns about European banks exposure to Turkey's private sector debt, ECB on track to end QE, and risk of Italian fiscal crisis.

Emerging Markets: Remain Modest Underweight as EM stocks are likely to continue to struggle in the near-term with risk of contagion from the Turkish lira crisis, trade tensions and US dollar strength. Inflation risks have risen from currency weakness forcing EM central banks to hike rates to control inflation.

UK: Remain Modest Underweight with Brexit uncertainty, modest GDP growth & BoE rate hikes. Brexit uncertainty remains elevated with UK and EU yet to reach agreement on Brexit with the October deadline approaching, raising the risk of "No-Deal" or "Hard Brexit".

Global Bond Market Strategy: Bonds Supported in Near-term by Safe Haven Demand from Turkey Turmoil, Trade Tensions, Brexit & Italian Fiscal Uncertainty

Japan JGBs: Modest Overweight as the outlook for Japanese JGBs remains modestly positive with the BoJ pledging to maintain monetary stimulus and low rates "for an extended period." Further, increased risk aversion with trade tensions and Turkey turmoil are likely to support JGBs.

EM Debt: Neutral as the outlook for EM Debt remains mixed. While widening spreads is a positive, risk of contagion from Turkey to other emerging markets is a risk. EM spreads widened to over 550bps due to the Lira crisis. However, without a resolution of the Turkey crisis, spreads are unlikely to narrow.

US Treasuries: Remain Neutral as US Treasuries are supported from safe haven demand with trade tensions and Turkey crisis unresolved. However, Treasury yields are likely to face upward pressure from strong GDP growth, rising inflation, and Fed rate hikes.

Eurozone: Modest Underweight as Eurozone bond yields are likely to be mixed with the Turkish crisis supporting German bunds but periphery yields likely to be under pressure with the exposure of the Eurozone periphery banks to Turkey's private sector debt. Further, risk of Italian fiscal crisis carries risk for BTPs.

UK Gilts: Modest Underweight as outlook for Gilts remains negative with elevated Brexit uncertainty. The UK and EU are yet to reach agreement on Brexit with the October deadline approaching, raising the risk of "No-Deal" or "Hard Brexit".

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

PGIM Global Partners is a brand name of Prudential International Investments Advisers, LLC. (PIIA), a Prudential Financial, Inc. (PFI) company. PIIA is an investment adviser registered with the Securities and Exchange Commission of the United States. PFI, a company incorporated and with its principal place of business in the United States of America is not affiliated in any manner with Prudential plc, a company headquartered in the United Kingdom. PGIM Limited registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR is authorized and regulated by the Financial Conduct Authority of the United Kingdom (registration number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued to persons who are professional clients or eligible counterparties for the purposes of the Financial Conduct Authority's Conduct of Business Sourcebook. In certain countries in Asia, information is presented by PGIM Singapore, a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan, a registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM Global Partners is not acting as your fiduciary as defined by the Department of Labor. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM is prohibited. Certain information contained herein has been obtained from sources that PGIM Global Partners believes to be reliable as of the date presented; however, PGIM Global Partners cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Global Partners has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Global Partners and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Global Partners or its affiliates. Any projections or forecasts presented herein are as of the date of this presentation and are subject to change without notice. Actual data will vary and may not be reflected here. Projections and forecasts are subject to high levels of uncertainty. Accordingly, any projections or forecasts should be viewed as merely representative of a broad range of possible outcomes. Projections or forecasts are estimated, based on assumptions, and are subject to significant revision and may change materially as economic and market conditions change. PGIM Global Partners has no obligation to provide updates or changes to any projections or forecasts. These materials do not purport to provide any legal, tax or accounting advice. These materials are not intended for distribution to or use by any person in any jurisdiction where such distribution would be contrary to local law or regulation.

© 2018 PFI and its related entities. The PGIM logo and the Rock design are service marks of PFI and its related entities, registered in many jurisdictions worldwide.