NEUBERGER BERMAN

Asset Allocation Committee Outlook 2Q19

On the Wings of a Dove

Last quarter we anticipated mean reversion after the December sell-off, and for three months markets have delivered it. There has been no real improvement in economic data, however, and in China and Europe they have worsened. The turn in sentiment is mostly due to central banks' dovish stances. In our view, U.S. risk-asset pricing is now back in line with our expectations for a soft landing, while value remains available in other markets. But volatility is likely to persist until better data from China and Europe puts firmer foundations under the market's change of mood.

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ABOUT THE

ASSET ALLOCATION COMMITTEE

Neuberger Berman's Asset Allocation Committee meets every quarter to poll its members on their outlook for the next 12 months on each of the asset classes noted and, through debate and discussion, to refine our market outlook. The panel covers the gamut of investments and markets, bringing together diverse industry knowledge, with an average of 27 years of experience.

COMMITTEE MEMBERS

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Anthony D. Tutrone
Global Head of Alternatives

Market Views

Based on 12-Month Outlook for Each Asset Class

	Underweight		Neutral		Overweight
EQUITY					
Global Equities	○	○	○	●	○
U.S. All Cap	○	○	●←	○	○
U.S. Large Cap	○	○	●←	○	○
U.S. Small and Mid Cap	○	○	●←	○	○
Developed Market—Non-U.S. Equities	○	○	○	●	○
Emerging Markets Equities	○	○	○	●	○
Public Real Estate	○	○	→●	○	○
FIXED INCOME					
Cash	○	○	→●	○	○
Global Bonds	○	●	○	○	○
Investment Grade Fixed Income	○	●←	○	○	○
U.S. Government Securities	○	●	○	○	○
Investment Grade Corporates	○	○	●←	○	○
Agency MBS	○	○	●	○	○
ABS / CMBS	○	○	●	○	○
Municipal Bonds	○	○	→●	○	○
U.S. TIPS	○	○	○	●	○
Non U.S. Developed Market Bonds	●←	○	○	○	○
High Yield Corporates	○	○	●	○	○
Emerging Markets Debt	○	○	○	●	○
REAL AND ALTERNATIVE ASSETS					
Commodities	○	○	●←	○	○
Lower-Volatility Hedge Funds	○	○	○	●	○
Directional Hedge Funds	○	○	○	●	○
Private Equity	○	○	●	○	○

As of 2Q 2019. Views shown reflect near-term tactical asset allocation views and are based on a hypothetical reference portfolio. Nothing herein constitutes a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. See disclosures at the end of this publication, which includes additional information regarding the Asset Allocation Committee and the views expressed.

Regional Focus

Fixed Income, Equities and Currency

	Underweight		**Neutral**	Overweight	
REGIONAL EQUITIES					
Europe	○	○	○ →	●	○
Japan	○	○	○	●	○
China	○	○	○	●	○
Russia	○	○	●	○	○
India	○	○	●	○	○
Brazil	○	○	●	○	○
REGIONAL FIXED INCOME					
U.S. Treasury 10 Year	○	●	○	○	○
Bunds 10 Year	●	○	○	○	○
Gilts 10 Year	○	●	○	○	○
JGBs 10 Year	○ →	●	○	○	○
EMD Local Sovereign	○	○	○	●	○
EMD Hard Sovereign	○	○	○	●	○
EMD Hard Corporates	○	●	○	○	○
CURRENCY					
Dollar	○	●	○	○	○
Euro	○	○	●	○	○
Yen	○	○	●	○	○
Pound	○	○	○	●	○
Swiss Franc	●	○	○	○	○
EM FX (broad basket)	○	○	○	●	○

"I never understood the argument that the Fed had to raise rates to give them the space to respond to a future downturn—that's like dying in the desert because you saved your water for next week."

Anthony D. Tutrone | Global Head of Alternatives

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"Q1 delivered the first important step toward substantiating our soft landing thesis: looser financial conditions due to stronger markets and the accommodative turn from the Fed and the ECB. We look for another step on trade over the coming weeks and the final steps on economic stabilization in China and Europe over the coming three to six months."

Erik L. Knutzen, CFA, CAIA
Chief Investment Officer—Multi-Asset Class

On the Wings of a Dove

Last quarter, we anticipated mean reversion after the December sell-off, and for three months markets have delivered it with confidence and momentum. There has been no real improvement in fundamental economic data, however, and releases in China and Europe have worsened. The turn in sentiment is mostly due to the dovish stances adopted by the Federal Reserve and European Central Bank. In our view, U.S. risk-asset pricing is now back in line with and perhaps even slightly ahead of our expectations for a soft landing and an extension to the cycle, while value remains available in other markets. But volatility is likely to persist until better data out of China and Europe puts firmer foundations under the market's change of mood.

The market views we articulated three months ago were contrarian. Considering that we expanded our existing risk-asset overweights in emerging markets and U.S. large-cap equities to include U.S. small-company stocks, Japanese equities, broad credit and commodities, some would have said they were heroic. Today, with global equities having clawed back two-thirds of their Q4 losses, high yield bond spreads 150 basis points tighter and oil up by some 30%, we are back in the mainstream.

Underneath it all, the Asset Allocation Committee's ("AAC" or "the Committee") fundamental expectations for the economy remain unchanged. We anticipate a freeze on interest rate hikes from the Federal Reserve to provide the cushion for a U.S. soft landing. We believe that monetary and fiscal stimulus should arrest China's downturn and deliver a boost to Europe, Japan and the emerging world. And we think the resulting convergence of global growth rates can help the current business cycle extend into 2020 to become the longest on record.

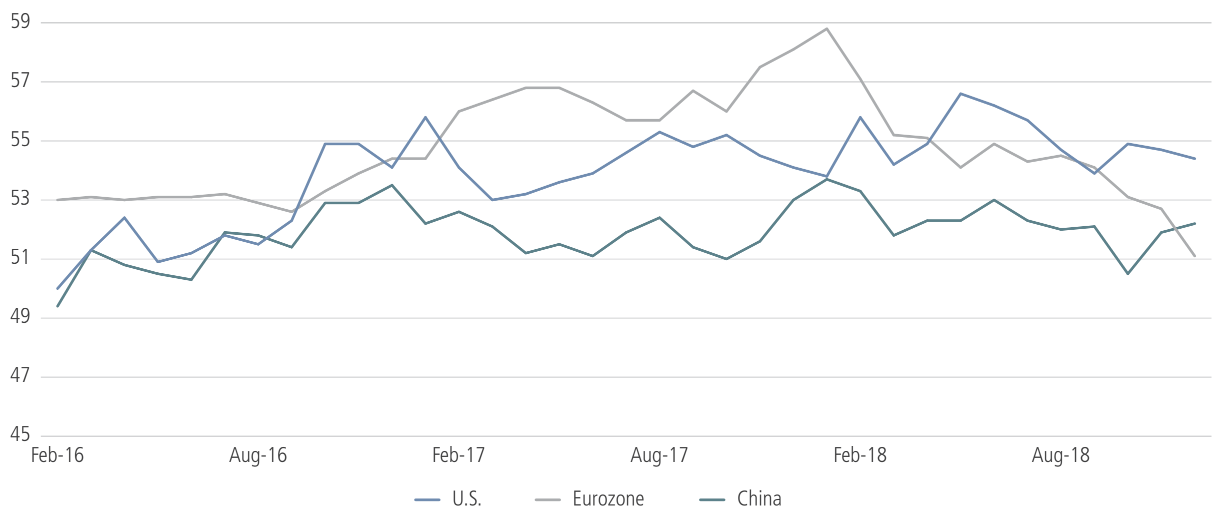
A Dovish Turn

While market sentiment has realigned with these views, and in some cases even run slightly ahead of them, economic data have yet to catch up.

U.S. numbers remain stable: Q4 GDP provided an upside surprise, wage inflation is picking up steam, consumer confidence and

WHILE U.S. DATA REMAINS STABLE, ELSEWHERE THE NEWS HAS WORSENED

Composite Purchasing Managers' Indices



Source: Bloomberg.

corporate capital expenditure intentions appear robust and Purchasing Managers' Indices (PMI) have settled at quite high, expansionary levels. Poor retail sales during the holiday season and weak payrolls in February give pause, but on the whole the U.S. feels solid.

Elsewhere, if anything, the news has worsened since the New Year. Manufacturing sectors in Europe and Japan have shown further signs of stress and fatigue as the engine of the global economy, China, continues its steep slowdown. Here, industrial output is sluggish and unemployment is rising. An uptick in fixed-asset and property investing and signs of credit expansion are encouraging, but that amounts to far less than a recovery.

If sentiment has improved, then, it is not due to confirmation of an economic stabilization and recovery, but to a dovish turn from the Federal Reserve in January and the European Central Bank (ECB) in March.

At its most recent meeting the Fed confirmed that rates were very unlikely to rise in 2019, and that its balance sheet run-off would be done by September rather than stretching into December. But the message had already been sent in January, when the normally hawkish Boston Fed President Eric Rosengren pointed to China's economy, tensions over trade and "heightened volatility" as reasons to remain "flexible and patient" with policy, and Vice Chair Richard Clarida hinted that the central bank's balance sheet policy could change if necessary. It was Jerome Powell himself who helped spark the New Year risk rally with his remark that "we're listening with sensitivity to the message that markets are sending." Given the steady hum from the U.S. economy and the fact that inflation is on target, many took this to be akin to a "Powell Put."

In the euro zone, the sluggish economy, struggling banks and negative rates already had commentators using the 20th anniversary of the Bank of Japan's zero interest rate policy to muse on the "Japanification" of Europe. The ECB's surprise early announcement of a third program of Targeted Long-Term Refinancing Operations ("TLTRO 3"), and an extension to its forward guidance on rates, added to the theme in March. The initial market response was more muted than that which met the Fed's earlier adjustments. That was partly because the announcement came alongside severe cuts to the ECB's near-term growth and inflation forecasts, partly because there was initially no discussion about the difficulties banks have with negative rates, and partly because it was unclear whether the terms of TLTRO 3 would be economical for the banks that need it. Nonetheless, ultimately the move is likely to be seen as adding to the accommodative environment.

Risks Remain Live

As a result, having implemented overweight views in investment grade bonds, U.S. equities and commodities in December to take advantage of what we saw as an attractive value opportunity, we have now nudged back to neutral. The market rally and downward revisions to 2019 earnings estimates have helped U.S. equities return to what we consider full valuation, and fixed income markets are now pricing in a long period of frozen rates.

Indeed, the AAC questioned how sustainable the current upward momentum is. We would not be surprised to encounter more volatility in the near term, as investors see those lower earnings estimates become hard reality during the second quarter, just as they are looking for further confirmation of a bottoming-out in the global slowdown and getting to grips with the special challenges of late-cycle positioning. It is for these reasons that the AAC maintained its overweight views in hedge fund strategies, which offer the potential both to mitigate and take advantage of volatility. We also stand ready to respond to volatility with additional tactical allocations to risk assets, just as we did back in December.

We do remain overweight non-U.S. equity markets and underweight non-U.S. investment grade bonds, however. Risk assets in these parts of the world not only started from a lower base at the start of the year, but also lagged on the way back up. Given our fundamental soft-landing and global-convergence expectations, we still see value there. Looser policy and a weakness in both the U.S. dollar and euro would reinforce that value (see "Up for Debate: Is the Dollar Rally Done?" on page 9), and both the emerging world and Europe would be highly geared to any recovery in China, trade confidence and global economic activity.

The signals remain mixed, however. Consider Europe, for example. From the bottom up, some of our equity analysts and portfolio managers report talk of "green shoots" in Europe from company management on both sides of the Atlantic. With the exception of a few days' disappointment at some of the details of the ECB's recent announcements, bank stocks have led the market recovery. That indicates growing confidence in the underlying economy. On the other hand, the German yield curve has again flattened substantially, dipping below zero as far out as nine years. That indicates quite the opposite.

Those mixed signals reflect the fact that the risks to our soft-landing and global-convergence thesis remain live. Those risks include the potential for further dollar strength; the potential failure of U.S.–China or U.S.–Europe trade talks, and the possibility that the auto sector gets dragged into the disputes; and the potential for further disappointment from China's economy.

Progress on containing the dollar and improving the data in China really needs to be evident by the next time the AAC meets in June (see "Up for Debate: Will China's Stimulus Gain Traction?" on page 6).

Before that, we should get a sense of how successful the U.S.–China negotiations have been. While an agreement has been pushed back from the end of March, it does appear likely that one will be reached eventually. Now the U.S. has signaled that raising tariffs from 10% to 25% is off the table, we think it would be very difficult, politically—both domestically and internationally—to put it back on again. The result is therefore likely to be a transactional agreement for China to buy more U.S. natural gas, soybeans and other products, perhaps with a cosmetic agreement around the bilateral trade balance and currency and some modest progress on intellectual property protections, but little or no progress on structural change to China's economic model. That will not eliminate all uncertainty for multinational companies doing business in or with China, but it will likely be enough for both sides to declare satisfaction, and to remove the most disruptive tail risk from the global economy and markets.

To summarize, the first quarter of 2019 has delivered the first important step toward substantiating our soft-landing thesis: looser financial conditions due to stronger markets and the accommodative turn from the Fed and the ECB. We remain cautious in our positioning views as we look for another step on trade over the coming days and weeks; and the final steps on economic stabilization in China and Europe over the coming three to six months.

Markets are currently soaring on the wings of a central-bank dove—but that dove still flies through strong headwinds over rough seas, with the land still obscured by fog.

UP FOR DEBATE

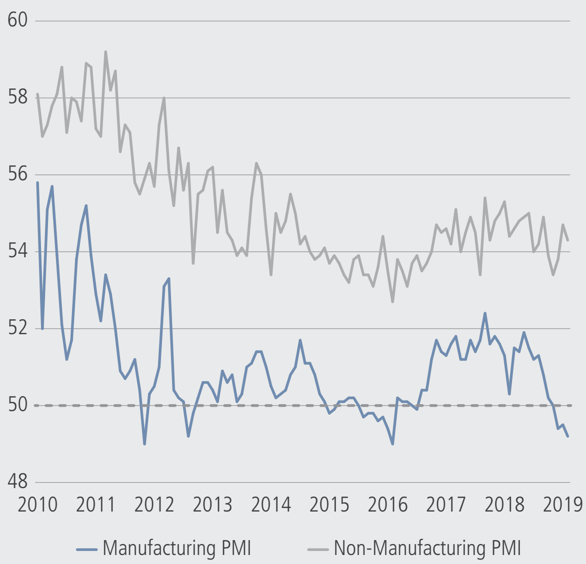
Will China's Stimulus Gain Traction?

Seasoned China watchers have told members of the Asset Allocation Committee ("AAC" or "the Committee") that its economic and fiscal position is the worst they have seen in their careers.

The official GDP growth of 6.6% in 2018 is projected by the International Monetary Fund (IMF) to fall to 6.2% in 2019 and 6.0% by 2021. Most analysts would counsel taking one or two percentage points off that to get to the real number. Industrial output is growing at its slowest rate since the financial crisis 10 years ago. Retail sales growth is the slowest for 15 years. China's fiscal position has deteriorated sharply relative to official targets and in absolute terms.

CHINA'S ECONOMY IS SLOWING…

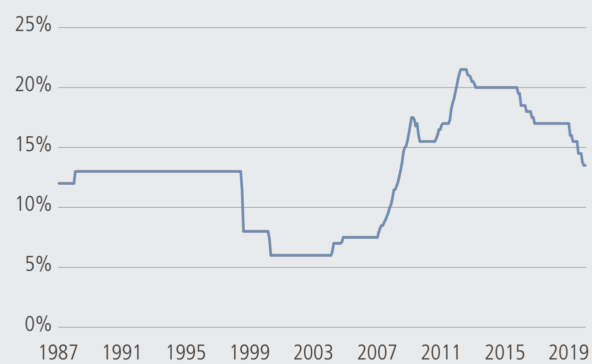
Purchasing Managers' Indices



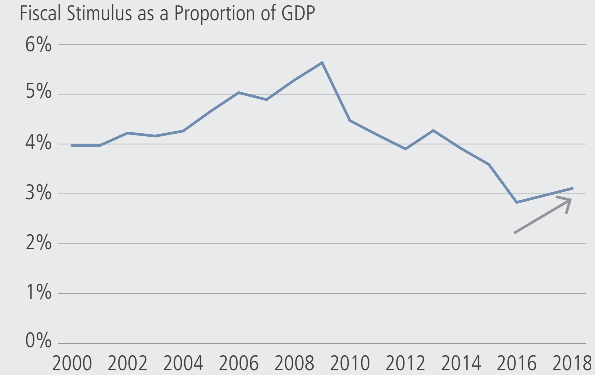
Source: Bloomberg.

… BUT THE AUTHORITIES ARE ACTING

Required Reserve Ratio for Large Banks



Fiscal Stimulus as a Proportion of GDP



Source: Bloomberg.

At the same time, the authorities recognize the scale of the problem. There is not much more flexibility left in the People's Bank of China's (PBOC) required reserve ratio for commercial banks, but Governor Yi Gang has indicated that there is at least some. The China Banking and Insurance Regulatory Commission

(CBIRC) has announced that it considers structural deleveraging to have reached its target, opening the door to further stimulus.

So far, the majority of the measures have been aimed at the Chinese consumer rather than at fixed asset or infrastructure investment as in the past. There have been tax cuts for small businesses and the manufacturing sector. Measures have been taken to reduce the social-security burden on employers. VAT and individuals' income tax have been cut. A variety of measures are being introduced to boost the domestic auto industry.

We regard this as a substantial reflation effort and anticipate some traction in the economic data over the coming three to six months. The first place to look for the evidence will be in credit growth (promising so far this year, but still volatile) and Purchasing Managers' Indices (which tend to be led by credit growth). In addition, it will be important to monitor key indicators that are one or two steps removed from the official Beijing data bureaucracy, such as electricity consumption, vehicle sales, airline passengers, container ship and rail freight, and industrial apparent consumption of basic commodities. A non-disruptive end to trade negotiations with the U.S. would help lay the foundations for an improvement.

Positive news from these sources would represent the final required steps to confirm our expectations for a global soft landing this year, and an extension of the global business cycle into 2020. Disappointment may well require us to reconsider our current appetite for market risk.

FIXED INCOME

Investment Grade Fixed Income

The Asset Allocation Committee ("AAC" or "the Committee") downgraded its view from neutral to underweight.

- The Federal Reserve has rate hikes on hold for the foreseeable future and inflation remains benign, but markets are now pessimistically-priced.
- The Fed will remain data-dependent as it attempts to engineer a soft landing in the U.S.
- Shorter duration is preferred over longer duration given the flat yield curve.

Investment Grade Corporates

The Committee moved its view from overweight to neutral.

- The change to the view came in response to the high valuations reached during the fourth quarter of 2018.

Municipal Bonds

The AAC moved from an underweight view to a neutral view.

- Longer maturities (30 years) are more attractively valued relative to taxable bonds; below five-year maturities, taxable bond yields are more attractive.
- This richening in munis relative to taxable bonds is due to seasonal patterns in supply and demand rather than fundamentals-based re-pricing.

Treasury Inflation Protected Securities

The Committee maintained its overweight view.

- Real yields are attractive and suggestions of structural changes in the Fed's actual or perceived mandate could be positive for the asset class.

Developed Market Non-U.S. Debt

The Committee downgraded its view to very underweight from underweight.

- The European Central Bank (ECB) and Bank of Japan (BOJ) still lag the U.S. in tightening policy: The ECB does not intend to raise interest rates until 2020 and inflation is not expected to pick up until at least 2022.
- The ECB added to the accommodative environment with its announcement of an additional round of Targeted Long-Term Refinancing Operations (TLTRO 3) for the euro zone's banks.

High Yield Fixed Income

The Committee voted to maintain a neutral view.

Emerging Markets Debt

The Committee maintained an overweight view.

- Valuations are still attractive.
- A stronger dollar could pose a headwind to the asset class.

EQUITY

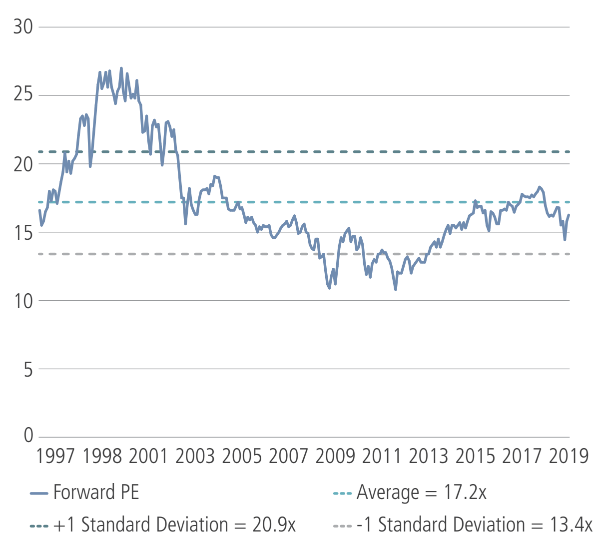
U.S. Equities

The AAC moved to a neutral view for U.S. Large Cap and U.S. Small & Mid Cap.

- Valuations are fair and near historical averages.
- Bottom-up estimates of U.S. earnings growth for 2019 are 4–6%, year-on-year, in a soft-landing scenario for the wider economy.
- Job and wage growth as well as consumer data have been strong over the past few months.
- Trade negotiations are underway, but trade enforcement could be difficult to measure.

U.S. EQUITIES REMAIN FAIRLY VALUED

S&P 500 Index Forward P/E Ratio



Source: Bloomberg.

Public Real Estate

The Committee voted to upgrade its underweight view to neutral.

- REITs had been one of the best performers in the first quarter of 2019, and we regarded them as at risk from rising rates, albeit gradually rising rates.
- While we still anticipate marginally higher yields at the long end of the curve and regard the upside for REITs to be limited, given the further dovish turn from the Fed in March and the high dividend yield available, we believe the downside risk is modest.

Non-U.S. Developed Market Equities

The Committee maintained its overweight view on Developed Non-U.S. Equities.

Europe

- Despite softer economic data the committee is constructive on Europe, believing that the market is overly skeptical and that data is very unlikely to fall further than current levels.
- Current expectations for 2019 are for a 4% dividend and earnings growth of 7–8%, delivering a 12x–13x price-to-earnings ratio.
- The ECB remains accommodative, but European Parliament elections in May could increase political risk, as could the threat of U.S. tariffs on autos.

Japan

- Japan is sensitive to marginal changes in global growth, trade and stimulus out of China.
- Relative valuations look attractive after a period of market underperformance.
- The BoJ remains committed to its yield-targeting policy; additional fiscal stimulus is due in the third quarter of this year.
- Risks include the consumption tax hike due in October this year, a breakdown in trade negotiations and a stronger yen.

U.K.

- Political and economic risks around Brexit remain elevated and very fast-moving. As we published, the original deadline for the U.K. to leave the European Union had passed without a withdrawal agreement after Prime Minister Theresa May sought an extension in which to win further support for the negotiated deal, and Parliament had attempted to wrest control of the process away from the government.

UP FOR DEBATE

Is the Dollar Rally Done?

Two years ago, we argued that the U.S. dollar had put in a long-term top at the end of 2017. That call remains good—but the diverging fortunes of the U.S. and the rest of the world during 2018 led not only to a marked flattening of the U.S. yield curve, but also a dollar surge that brought that 2017 high back in sight.

Since November, momentum has stalled and the dynamics around the currency appear finely balanced. As ever, the U.S. current account deficit is the factor that would be expected to weigh on the dollar. Higher forward interest rates relative to the rest of the world, driven by economic outperformance and a more advanced tightening cycle, provided the upward pressure last year. Improving performance out of China and Europe would likely help to close that gap and weaken the dollar, but, in a classic chicken-and-egg problem, those improvements would be much easier to attain with a weaker dollar.

While the Federal Reserve could never cite dollar strength or interest rate differentials in its rationale for monetary policy for fear of being accused of currency manipulation, members of the Asset Allocation Committee ("AAC" or "the Committee") assume they are part of their considerations. Global weakness and dollar strength tighten financial conditions and make it more difficult to maintain the Fed's mandated inflation target, after all. These factors may have informed the Fed's dovish turn in January, which it doubled down on in March, and which has led to a narrowing of global interest rate differentials. The European Central Bank's (ECB) interventions in bank liquidity and forward guidance in March reversed some of that, but, seen alongside its new forecasts for growth and inflation, these moves have been regarded as less dovish than the Fed's. The net effect was a slight narrowing of rate differentials through the course of the first quarter.

Could these recent dynamics go even further? Might we see an even looser policy stance from the Fed later this year? Fed funds futures markets have been pricing in rate cuts for 2019, not rate hikes. As one AAC member observed, we are going through one of those once-every-five-year periods when the nature of the central bank's mandate comes under scrutiny, fueled by renewed discussion of nominal GDP targets and "Modern Monetary Theory," not to mention a recognition that U.S. inflation needs to reach 3% or more for the Fed to hit its long-term average target of 2%.

Ultimately, debate led us to the view that the Fed would hold rates for the rest of 2019. In the event of more stimulus being required, we think that an adjustment to forward guidance or the quantitative tightening program is more likely than a rate cut.

That informs our 12-month asset class views in several ways. First, it reaffirms the underweight to the dollar that we put in place three months ago. Second, it supports our existing overweight in Treasury Inflation Protected Securities (TIPS), which we consider undervalued given the central bank's incentives to stoke price rises and lean on the dollar. It would have caused us to maintain an overweight view on commodities, too, had these assets not already rallied strongly in the New Year. Third, it informs our upgrade for U.S. dollar cash, for similar reasons as with TIPS: we believe markets have flattened the curve beyond what is reasonable, as they have priced out any near-term increase in inflation.

And finally, it supports our central soft-landing and global-convergence views, which informs our confidence in positioning views in non-U.S. risk assets.

Emerging Markets Equities

The Committee maintained its overweight view.

- Current valuations remain attractive.
- Fiscal and monetary easing in China are in the pipeline to counteract a slowdown. China has already cut individual income taxes, and further stimulus measures will likely include cuts to VAT and enterprise taxes, infrastructure spending and changes to corporation's social security contributions on behalf of employees. These measures will benefit consumers most and, if they are successful, we would expect to see improvements in China's growth during the rest of this year.
- A trade agreement between China and the U.S. has been delayed from March until possibly June: the eventual agreement will likely include some commitments from China to buy U.S. products, alongside minor details on intellectual property theft and some language regarding the bilateral trade deficit. Enforcement is likely be difficult.
- Dollar strength, trade disputes and China's managed slowdown and its potential impact on global growth remain the key risks.

REAL AND ALTERNATIVE ASSETS

Commodities

The AAC voted to downgrade to a neutral view from an overweight.

- OPEC will continue to adhere to production cuts set last year to reduce the global oil glut, but the duration of those cuts remains unclear; some countries advocate extending cuts until the end of the year, while others note that U.S. sanctions make forecasting supply difficult.
- Oil is fairly to attractively valued, but demand could slow if global growth moderates.
- Chinese stimulus, which is being directed mainly at the consumer, may not provide the same impact to commodities as in the past.
- We expect a weaker dollar, which would be a tailwind for commodities.

Hedge Funds

The Committee maintained its overweight view on Lower-Volatility Hedged Strategies and in Directional Hedged Strategies.

- Correlations between stocks and bonds tend to be high toward the end of the business cycle, and uncorrelated strategies can provide a ballast against this risk.
- More dispersion is being seen across assets, creating a richer environment for alpha opportunities; merger spreads have widened and are now attractive relative to risk; while long-short strategies that unwound during the fourth quarter of 2018 are now bouncing back, and that recovery looks set to continue.
- Distressed strategies may become more attractive over the coming months.

Private Equity

The Committee maintained its neutral view.

- The AAC acknowledges high valuations, but recommends a consistent and disciplined strategic investment plan.

Opportunistic

- Collateralized Loan Obligations (CLOs) have lagged other fixed income sub-asset classes and may present an opportunity.
- Preferred securities currently offer attractive yields.

Currencies

USD:

The AAC maintained its small underweight view.

- Market participants are still long.
- The dollar is overvalued based on purchasing power parity (PPP) metrics.
- The Fed has taken a dovish stance, signalling a pause on interest rates and willingness to ease financial conditions; and inflation remains benign.
- A U.S. slowdown and a recovery elsewhere should reduce the global growth differential.
- The U.S. is running a twin deficit.
- Risks to the view include the growth differential, which leaves us with short-term yield differential that is supportive of the dollar; and the potential for risk aversion following a breakdown in trade discussions.

Euro:

The AAC maintained a neutral view.

- ECB monetary policy will continue to be accommodative as inflationary pressures are still weak.
- The euro zone is a beneficiary of the expected pick-up in global growth.
- The euro zone runs a large current account surplus.
- PMIs may be stabilizing, but the U.S. has still not addressed the proposed tariffs on European cars; and Brexit, the European Parliament elections and elections in Spain may again cause concerns about the strength of populism on the Continent.

Yen:

The AAC maintained a neutral view.

- Japan runs a current account surplus.
- Extremely low unemployment should support inflation.
- PPP and real exchange rates suggest the yen is undervalued and long-yen remains a valid trade during periods of risk aversion.
- The BoJ's yield-curve policy exacerbates yield differentials against the yen.
- Market participants are likely still long following the fourth-quarter sell-off, and a continuing rebound in risk sentiment could lead to further weakening.

GBP:

The AAC maintained its small overweight view.

- The GBP is undervalued based on PPP measures.
- Job creation and wages have been stronger than expected.
- Despite Brexit uncertainty, overall activity has remained remarkably healthy and job creation and wage growth have been stronger than expected.
- Risks to the view include political uncertainty around Brexit; weakness in the trade balance, manufacturing and consumption; and the likely fading-out of the effects of pre-Brexit stock building.

Swiss Franc:

The AAC maintained its large underweight.

- The franc is still very overvalued based on PPP measures.
- Safe-haven flows should continue to be unwound if Europe's prospects improve.
- Inflation remains subdued.
- The CHF is one of the most attractive funding currencies for global carry trades.
- Risks to the view include Switzerland's current account surplus; the potential for Switzerland to benefit from improvements in European growth; and the potential for political uncertainty to cause risk aversion.

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