VIEWPOINTS

Global analysis designed to keep you abreast of the latest economic and market changes.

OUTLOOK

August 2016

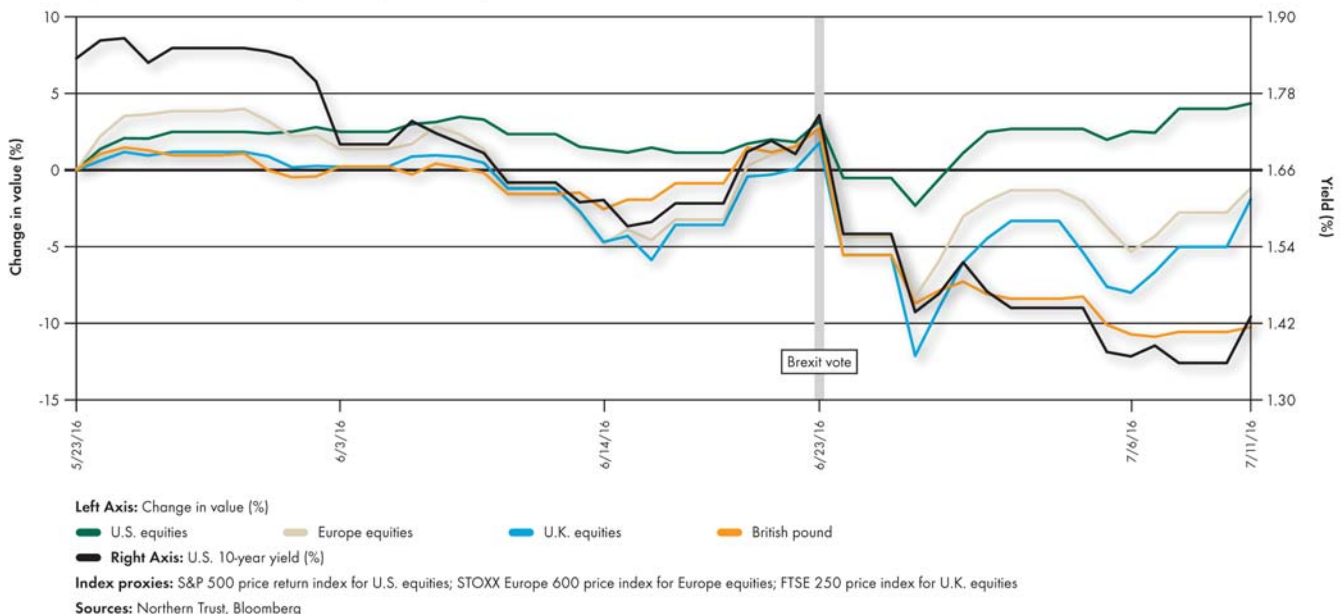
The British vote to leave the European Union (EU) was a shock to the markets, and we have now had several weeks to assess the initial fallout. The impact of Brexit on growth will clearly be negative for the United Kingdom — and, to a lesser extent, the EU — as uncertainty leads businesses and consumers to defer or cancel spending plans. Even though the Conservative party has moved quickly to name Theresa May as its new prime minister, the actual negotiation to exit the EU will likely take longer than two years. Markets were quick to differentiate the most vulnerable (British pound, domestic British stocks) from the less affected (the United States and emerging markets).

We think the slow, but durable, global economic expansion remains underway, and the effects of rising populism will take years to form. Even though Brexit could lead to a major near-term falloff in U.K. growth, we think the effect on Europe will be lesser and will likely not be noticeable in U.S. or Chinese figures. U.S. progress is highlighted by the improvement in the June payroll report, while European growth has steadily improved since March. China's foreign currency reserves unexpectedly increased in June, a further salve to hard-landing concerns. In fact, equity markets have steadily rebounded and recently exceeded their pre-Brexit highs — supported by these signs of global economic improvement in recent months. One of the most significant developments since the Brexit vote on June 23 has been the tremendous rally in government bond yields: the U.S. 10-year Treasury fell from 1.75% to a low of 1.36%, after starting the year at 2.27%. Lower interest rates for longer remains our core belief.

The biggest risk to the expected slow-but-durable economic expansion is populist politics. The political message from the Brexit vote is clear: Voters have tired of weak income growth and concerns over loss of sovereignty — including immigration policy. We think this rise of populism is in its early stages, and how individual countries respond will be critical to their investment outlook. The next test of the populist wave will be the Italian constitutional referendum in October, followed by the U.S. presidential election in November. Germany and France will also see critical national elections in 2017.

SHOCK, THEN DIFFERENTIATION

Equities have rebounded post-Brexit, while the pound and interest rates remain low.



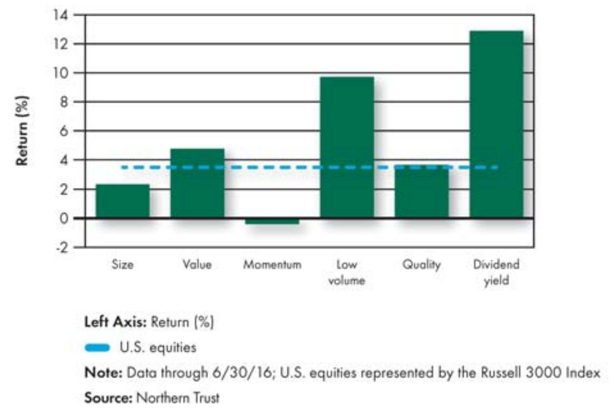
U.S. EQUITY

- U.S. equities have shrugged off Brexit concerns, reaching new all-time highs.
- Low volatility and dividend yield factors have performed best, reflecting the current environment.

One could be forgiven for believing Brexit was all just a bad dream. The U.S. equity market regained the 6% post-Brexit drop in a little over a week, going on to reach fresh all-time highs. However, a breakdown of equity returns suggests a pinch will still hurt. The material outperformance of both low-volatility and high-dividend-yielding stocks suggests recent stock market appreciation is more reflective of the frustration with low interest rates than an optimistic growth outlook. Help may be coming in the second half of the year in the form of reaccelerating earnings as dollar strength and energy weakness begin to roll off the year-over-year comparisons. Meanwhile, ongoing low interest rates should continue to support equities of all stripes. We remain overweight U.S. equities in the recommended portfolio.

TAKING THE SAFER ROUTE

Solid U.S. equity performance has been driven by "safe haven" factor performance.



Left Axis: Return (%)
U.S. equities
Note: Data through 6/30/16; U.S. equities represented by the Russell 3000 Index
Source: Northern Trust

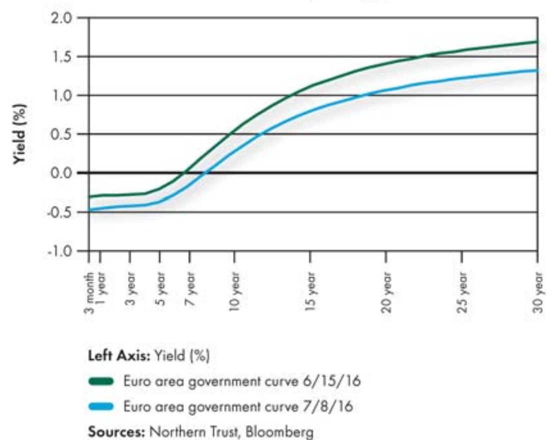
EUROPEAN EQUITY

- The Brexit vote has led to expectations of further central bank easing.
- European financials are a particular market concern.

The accompanying chart illustrates the drop in the EU yield curve following the Brexit vote. European investors now expect further easing by central banks across the continent. The United Kingdom especially has seen a dip in gilt yields, with most issues moving 20 to 30 basis points lower across the curve. For financial institutions such as banks, this development points to continued net interest margin pressure in the coming quarters. This could also make it more difficult for some to meet looming regulatory capital requirements given the additional expected pressure on earnings. We expect European central banks to be cautious around the risk of contagion given Britain is the first country to attempt leaving the EU, and this could also hold back credit extension.

BREXIT FURTHER PRESSURES RATES

Yields have fallen noticeably during just the last three weeks.



Left Axis: Yield (%)
Euro area government curve 6/15/16
Euro area government curve 7/8/16
Sources: Northern Trust, Bloomberg

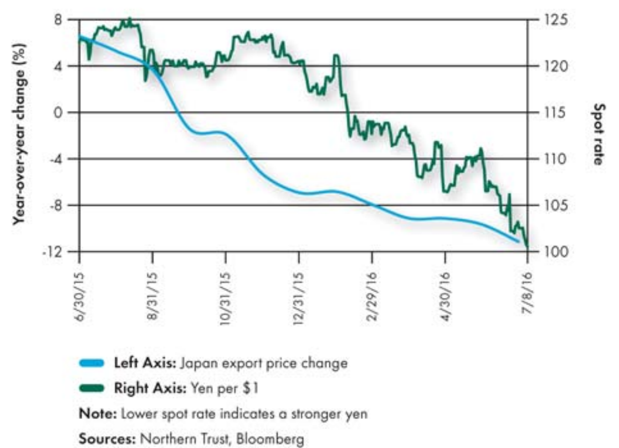
ASIA-PACIFIC EQUITY

- The appreciating yen is putting a dent in export growth on a price basis.
- The Bank of Japan (BOJ) may use EU chaos as cover to weaken the yen again.

The link between worldwide currency value and the total price received for export goods is illustrated in the accompanying chart. During the last year, and continuing into July, the yen's strength has significantly hurt year-over-year export growth in Japan. Strong export prices support top-line growth, creating operating leverage against the cost of production and increasing profit margins. In this case, weaker export prices will create the opposite effect for Japanese companies, sending goods and services out of Japan. The BOJ may use any accommodative actions by the EU in the wake of Brexit as cover for weakening the yen to better drive price inflation.

THE BANK OF JAPAN CAN'T BE HAPPY

Currency strength is hurting Japanese exports and the country's recovery.

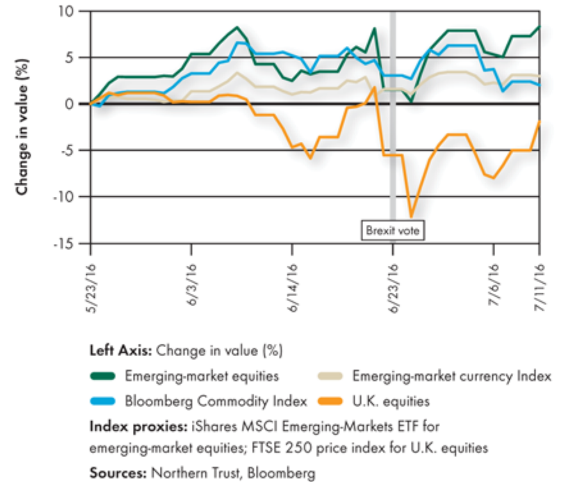


Left Axis: Japan export price change
Right Axis: Yen per $1
Note: Lower spot rate indicates a stronger yen
Sources: Northern Trust, Bloomberg

EMERGING-MARKET EQUITY

- Emerging-market equities have maintained their solid momentum.
- Reduced risks around China and a more patient Federal Reserve are supportive.

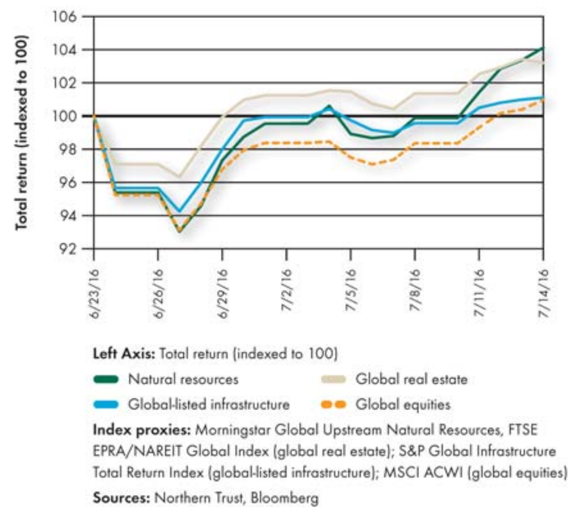
The strong relative performance of emerging-market equities wasn't disrupted by the Brexit-related market turmoil of late June. The underpinnings of better performance — including reduced Chinese risks and a more patient Fed — have lately been further substantiated. China's foreign currency reserves unexpectedly rose in June, giving further evidence of the government's control over capital outflows. Brexit has resulted in the markets now not fully pricing in the next Fed rate hike until June of 2018. While financial market forces have turned more favorable toward emerging markets, the outlook for improving economic momentum remains uneven. We'll need to see better growth trends before we consider going overweight emerging-market equities.



REAL ASSETS

- Real assets have provided stability and solid returns to global portfolios.
- We recommend strategic weights for all asset classes in the real asset bucket.

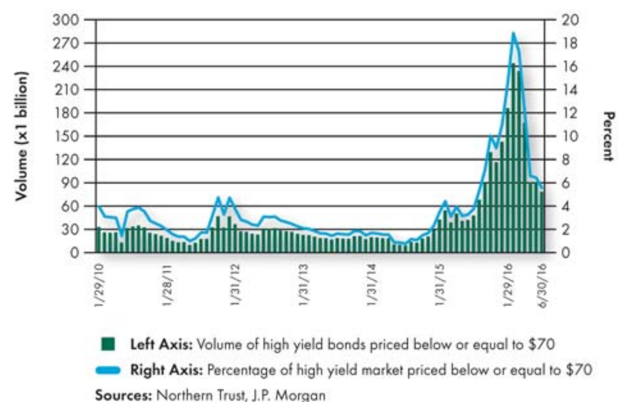
Real assets were mostly unscathed in the Brexit episode, coming out higher than they went in. The initial post-Brexit reaction pushed global equities down 7%, but global real estate and global-listed infrastructure were able to mitigate losses, benefiting from lower interest rates. Global real estate was especially quick to regain its losses (and then some). Natural resources fell alongside global equities initially, but have outpaced equities since then as markets priced in zero Fed rate hikes this year. We moved our natural resources allocation to equal weight to avoid further drag on the tactical portfolio from possible continued outperformance. The asset class is up 25% year-to-date, but it has still underperformed global equities by 11% annually during the past five years.



U.S. HIGH YIELD

- High yield returns in 2016 have been driven by the lowest-quality credits.
- The proportion of distressed bonds shows the extent of the recovery.

High yield returns this year have been driven by the lowest-rated segments of the market. Close to 20% of the high yield market was at a distressed level in the first quarter of 2016. After a dramatic recovery, primarily in April and May, the distressed portion of the market is now less than 6%. The Ca-D rating category has returned 42.7%, and CCC securities have returned 18.5%. The distressed segment was primarily commodity sectors, and three sectors accounted for more than half of the market's return in the second quarter of 2016. The distressed portion of the market is now more representative of a high yield market, with defaults concentrated in selected sectors. Lower-rated securities still have the potential to outperform higher-rated securities, but the extreme moves appear to have run their course.



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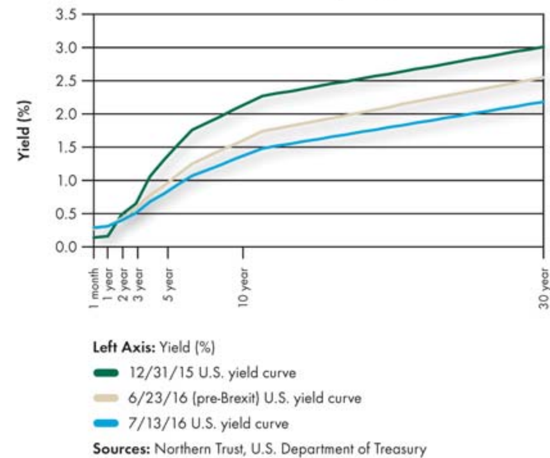
U.S. FIXED INCOME

- Yields on 10- and 30-year U.S. Treasuries have hit record lows.
- The U.K. vote has reinforced our view that interest rates will remain lower for longer.

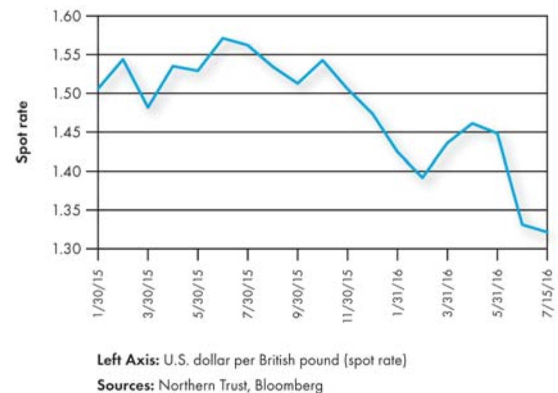
In an already slow-growing world, the U.K. referendum has added more political uncertainty for investors. While many questions remain unanswered, most believe the vote will lead to slower economic growth, lower inflation and a continuation of accommodative monetary policies. Investors' reaction to the news was immediate and accelerated the year-to-date flattening of the U.S. yield curve. Yields on both 10- and 30-year U.S. Treasuries hit all-time lows as the economic and political uncertainty created by the vote led investors toward safe havens. While not a cataclysmic event, we believe the vote increases the potential for populist politics to lead to slower economic growth. As such, it reinforces our view that interest rates will remain lower for a longer period.



EUROPEAN FIXED INCOME

- Markets were caught off guard by the Brexit outcome.
- Negative yields sweep across the euro bond market courtesy of the European Central Bank (ECB) put.

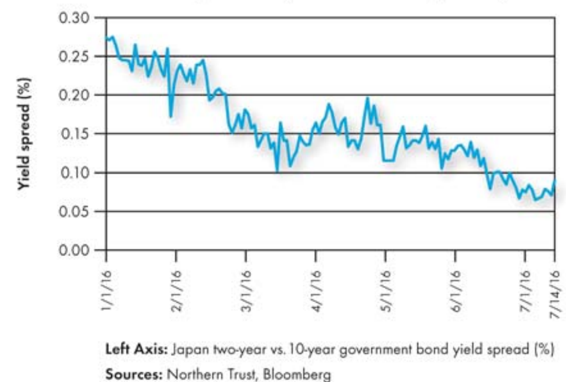
The United Kingdom surprisingly backed Brexit, albeit with a less than convincing 3.8% majority. The political turmoil led to a change in government leadership and economic concerns, and as a result, the pound fell to a 31-year low against the U.S. dollar. The economic risks are clearly to the downside, and the Bank of England is expected to ease monetary policy. Markets are pricing in an interest rate cut in the third quarter, although targeted stimulus may be preferable against potential inflation risks. The euro area faces a heavy calendar of political events just as it deals with the blow of the U.K.'s decision. This emphasizes the need for the ECB to prolong its lifeline to the financial markets, which is dragging European government bond yields increasingly into negative territory.



ASIA-PACIFIC FIXED INCOME

- Japanese bond yields moved lower as markets debate helicopter money.
- A dovish Fed may reignite the global currency war.

Recent economic and inflation indicators have disappointed, and with the yen showing little sign of weakening, the outlook for Japan has deteriorated. This has culminated in Japanese government bond yields moving lower while the yield curve continues to flatten, reflecting weaker growth expectations. As Japan cuts its official growth and inflation forecasts, markets are debating the potential for helicopter money: printing money to directly fund a fiscal expansion as a last ditch effort to beat deflation. While not impossible, it seems likely that the BOJ will first attempt further monetary accommodation. Although the immediate safe haven bid has culminated in a stronger dollar, lower for longer interest rates could drive demand back toward higher carry markets and reignite the global currency war.



CONCLUSION

Market action during the last month again highlights the importance of being anticipatory and the potential costs of being reactionary. With perfect foresight, being underweight the British pound and overweight U.S. Treasuries would have been a lucrative trade. However, we felt the vote was going to go in the other direction, as did many others. What matters next is the reaction to the unexpected outcome. Risk assets fell immediately and sharply, limiting the opportunity to reduce exposures — and many assets have subsequently recouped all their losses. We've chosen to stick with our disciplined asset allocation process, which we think helps us focus on the future as opposed to reacting to the past.

We've been fairly active in our tactical asset allocation recommendations so far this year, with our July meeting producing our third set of changes this year. The recommendations are a continuation from developments earlier in the year, but are also influenced by the post-Brexit environment in which we see slower growth in the United Kingdom and Europe, and lower interest rates globally. Reflecting the strong rally in U.S. high yield this year, and the currently improved market liquidity, we reduced our recommended overweight by two percentage points. We also recommended a 2% reduction in our exposure to developed ex-U.S. stocks, reflecting both a reduction in our strategic weighting along with a reduced growth outlook post-Brexit. The proceeds were split evenly between investment-grade bonds and natural resources. The move toward investment-grade bonds reflects both our sanguine outlook for interest rates and our desire to not increase overall risk in the portfolio. The move on natural resources takes us from underweight to our strategic weighting — reflecting the expectation of continued easy monetary policy and a relatively steady outlook for the U.S. dollar.

This month we updated our previous three risk cases by clearly tying them into a single theme: the risk of populist politics disrupting our channel growth outlook. By channel growth, we mean the durable nature of developed country growth — with growth neither too slow nor fast. This takes on increased importance in a world of decreasing central bank firepower. The vote-gathering success of Donald Trump and Bernie Sanders in the United States, along with the Brexit vote, are clear signs of the breadth of the populist interest, which we would characterize as being in its early stages. We'll see further tests with the Italian constitutional referendum in October, the U.S. presidential election in November, and German and French elections in 2017. Recent elections in Spain, Australia and Japan may show some ceiling on the impact of populist politics, but we still expect this to affect politics and economic growth in coming years.

INVESTMENT PROCESS

The asset allocation process develops both long-term (strategic) and shorter-term (tactical) recommendations. The strategic returns are developed using five-year risk, return and correlation projections to generate the highest expected return for a given level of risk. The objective of the tactical recommendations is to highlight investment opportunities during the next 12 months where the Investment Policy Committee sees either increased opportunity or risk.

The asset allocation recommendations are developed through the Tactical Asset Allocation, Capital Markets Assumptions and Investment Policy Committees.

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