Life after Brexit

A mid-year update on the global economy and markets

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IN BRIEF

- We had hoped to move into the second half of 2016 with uncertainties around the UK's relationship with Europe removed. Instead, they have intensified, with the Brexit vote bringing volatility to markets, a sharp fall in the pound and a new British Prime Minister by the autumn. We expect the Brexit decision to cut UK growth, push up inflation and leave a cloud of uncertainty hanging over the country for years. But now more than ever, European investors need to take a global view.
- Looking beyond the immediate market reaction, the broad global environment sketched out in our last outlook paper remains broadly in place. The eurozone recovery had been slightly stronger than expected and there is less fear than there was then that financial instability in China is about to spread to the rest of the world. But concerns about the strength of the US recovery remain, along with longer-term worries about central bank potency and the continued slump in productivity in the developed economies.
- This underscores our message from January: investors should have modest expectations for developed market (DM) equity returns from here and explore alternate asset classes to diversify and—potentially—raise their risk-adjusted returns.
- The key points of focus for the rest of the year will be politics, the US Federal Reserve (the Fed) and the strength of recovery in the eurozone and the US. Though the dollar has risen recently, the weakening of the US currency, coupled with a stronger oil price, were striking and welcome developments in the first part of 2016. It would be costly for the global economy and especially for emerging markets if the dollar rose markedly in the second half of the year. But the most important focus will be growth in US productivity and profits. Both of these need to strengthen in the second half of 2016 for fears of recession to subside.

J.P.Morgan
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OVERVIEW – KEY THEMES FOR 2016

The EU referendum result is a political earthquake for the UK, with important economic consequences that will hang over the country for years. But the impact for other countries and markets will depend on how close they are to the epicentre. Below we lay out what we see as the key trends shaping the global economic landscape for investors in 2016, before drawing out the key implications for investors. We end with a focus on the key risks hanging over markets—and the judgments we will be monitoring most closely as we look to the rest of 2016 and beyond.

1. Brexit will dent Europe, but the global productivity slump poses a larger threat

In the short term, we expect Brexit-related uncertainty to take at least 1 percentage point from UK growth over the next year, while the fall in the pound should add around 2 percentage points to inflation. The eurozone economy is also likely to be negatively affected, both by the hit to business confidence and investment and a reduction in exports to the UK, which in the case of Belgium, the Netherlands and Ireland represent a significant chunk of their GDP (see **Exhibit 1**).

However, we believe the immediate hit to eurozone investment and growth ought to be manageable. The eurozone economy grew at an annualised rate of 2.2% in the first quarter. Sentiment indicators had been rising in the lead-up to the Brexit vote and unemployment has continued to decline. Investment has made a rising contribution to growth in the region in the past 12 months and we had hoped to see this continue, supported by the European Central Bank's (ECB's) enhanced focus on supporting business lending. There is a risk that this turnaround in capital spending will get caught up in the after-shocks of Brexit—notably, the dramatic sell-off in European bank stocks. But we do not think a eurozone recession is imminent, whether due to Brexit or anything else.

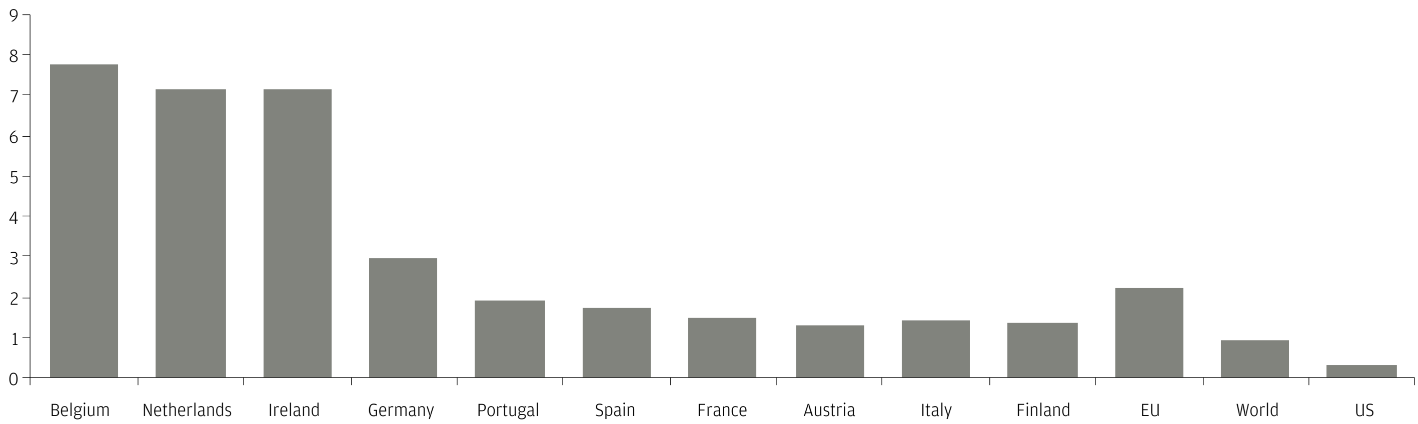
In our view, the continued slump in global productivity—output per head—poses a much more serious long-term threat to the recovery. The problem is global and has actually affected emerging market (EM) economies even more than developed ones. But it is fair to say that the US is now at the forefront of these concerns. That is not merely because the US is the world's most important economy, but being further along in the cycle, it is also where the downside of weak productivity for profits and growth could now be starting to bite.

This problem was less urgent when there was a lot of spare capacity in the economy, after the global financial crisis. With wage growth subdued, companies could make up for the lack of productivity by hiring more workers. But unemployment in the US is now 4.7% and wages have firmed somewhat. In response, companies have only three options: they can raise prices, cut costs or allow profit margins to take the strain. Until now they have generally chosen to maintain jobs growth and instead cut capital spending. The historically high level of margins also gave some safe space for profits to fall. But the risk is that profitability has now weakened enough to trigger cuts in employment and—potentially—a recession.

Belgium, the Netherlands and Ireland will feel the effects of any slowdown in exports to the UK

EXHIBIT 1: EXPORTS TO THE UK

% of GDP, 2015



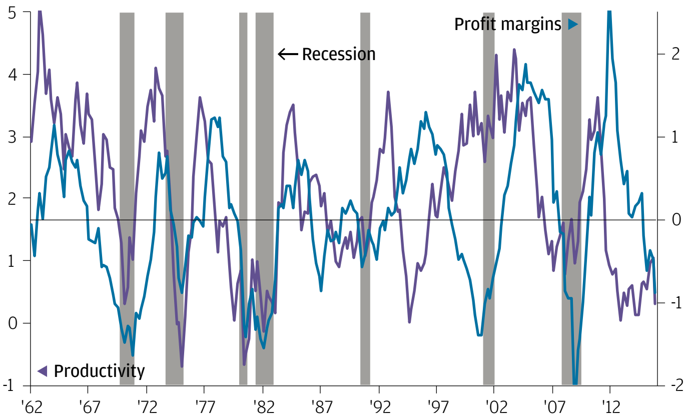
Source: IMF Direction of Trade, IMF WEO April 2016, J.P. Morgan Asset Management. Data as at 29 June 2016.

It's possible that the downturn in profits is being exaggerated by the fall in oil prices in 2015 and that productivity is about to pick up. In previous cycles, a stronger dollar has sometimes spurred faster productivity growth in the US. If that happens, we could see a virtuous cycle of rising productivity, profits and capital spending, leading to faster nominal incomes and continued recovery. This process would be helped, in the second half of 2016, if commodity prices continued to stabilise and that headwind to US profits were removed. But the weak US employment numbers for May were not very encouraging and investors should be watching closely to see whether that weakness continues.

An improvement in US productivity growth is sorely needed to support profitability and a rise in capital spending

EXHIBIT 2: US PRODUCTIVITY AND PROFIT MARGINS

% 2 year change (LHS); % 2 year change annualised (RHS)



Source: J.P. Morgan Economic Research, J.P. Morgan Asset Management. Profit margin economy-wide National Income and Product Accounts (NIPA) data. Data as of 29 June 2016.

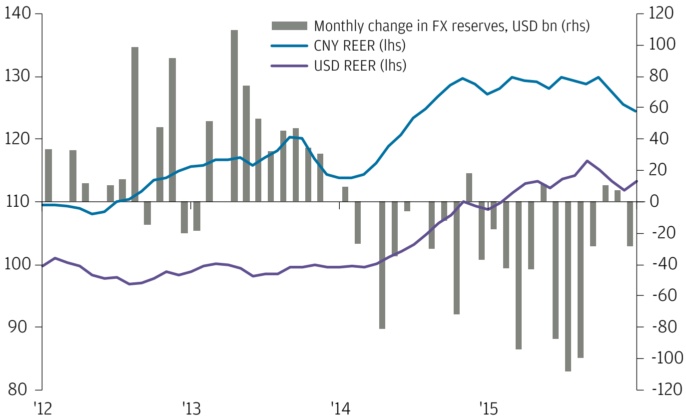
It has been a challenging year so far for Japan. It is not right to say that Abenomics has failed. Annual inflation is now in the region of 1%, compared with an average of -0.1% in the decade before Shinzo Abe took power. That is a crucially important achievement in an economy for which deflation appeared to have become a fixed part of the landscape. But 1% is not 2%—and there seems little prospect of growth rising much above 1% either. Prime Minister Abe is unlikely to think that sufficient, but in the absence of radical structural reforms such as increased immigration or an overhaul of the corporate tax regime, it may be the best he is going to get.

As mentioned previously, China was a key source of uncertainty at the start of the year, when the authorities spooked investors with their apparent inability to handle either volatility in the stock market or a gradual change in the value of the Chinese currency. Since then the situation in both the real economy and the exchange rate appear to have stabilised and monthly capital outflows have fallen sharply (see **Exhibit 3**).

Chinese capital outflows have eased, in part because of weaker dollar

EXHIBIT 3: CHINA'S MONTHLY CHANGE IN FX RESERVES AND REAL EFFECTIVE USD, RMB

USD bn (LHS); Index level (RHS)



Source: Bank for International Settlements, FactSet, People's Bank of China, J.P. Morgan Asset Management. Data as of 29 June 2016.

Cheap credit for China's housing market and a new burst of state investment spending has helped push growth back up to 6.7% in the first three months of 2016. Property sales have risen by a third since the start of the year. But the authorities do not want to risk excessive credit growth in this part of the economy and the signs are that they will avoid further easing this year, if the economy lets them.

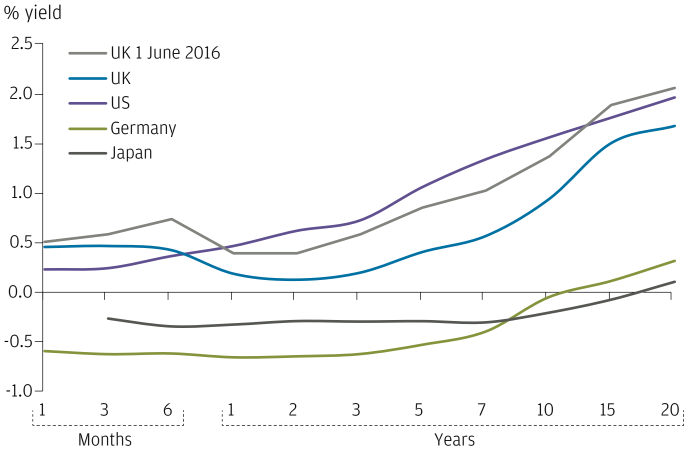
The scare is not over: parts of the emerging market world still have to reconcile themselves to China's growth being slower in future, and there are questions about the commitment to the new regime for the exchange rate. The authorities had said the renminbi would now be linked to a broader basket of currencies, rather than just the dollar. But that only seems to apply when the dollar is rising. When the dollar was falling in the first half of 2016, they allowed the renminbi to depreciate against the broader basket and only rise slightly against the dollar. This could give them some breathing space if the dollar starts to rise again, but it does suggest their commitment to the new regime is less than total. For now, the China worriers are less prominent in global markets and that has helped support risk sentiment at the margin, especially in the emerging markets.

2. Implications for monetary policy and the cost of money

There have been some novel trends in global markets in recent months, but one that has become all too familiar has been the further shift down in interest rates, right along the yield curve, to the point where 74% of global government bonds are trading at an implied yield of less than 1%, and the yield is negative for more than 30%.

10-year government bond yields have turned negative in Japan and Germany fell sharply in the UK after the Brexit vote

EXHIBIT 4: YIELD TO MATURITY OF GOVERNMENT BONDS



Source: Bloomberg, FactSet, J.P. Morgan Asset Management. Data as of 29 June 2016.

To some, the Bank of Japan demonstrated the limits of monetary policy effectiveness at the start of the year, when it took the policy rate into negative territory and the currency went up and the equity market fell. They have battled with yen strength ever since and the currency has risen by 15.5% on a trade-weighted basis since the end of 2015. With a 3.4% of GDP current account surplus and demographics bringing structural savings flows coming back to the country, we believe it will be difficult for the Japanese to push down the currency from here. But the less they achieve on this front, the more they will have to give up on the target of inflation of 2%.

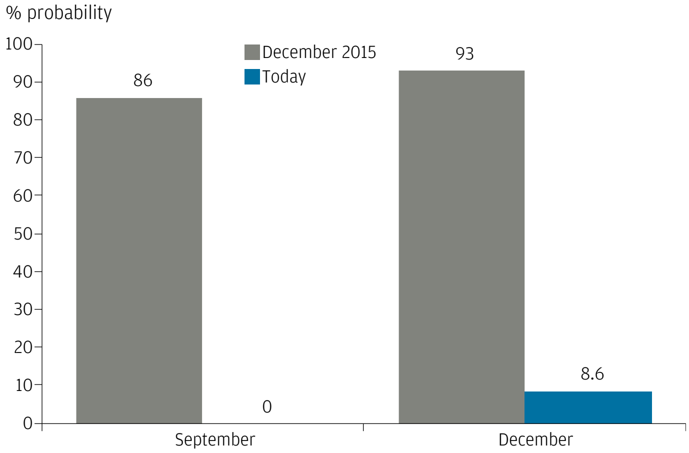
The ECB inspired more confidence with its multi-pronged action in March to increase lending and activity and boost inflation. Before the Brexit vote, we thought it was in the balance whether the ECB would need to expand or prolong its quantitative easing policies—sovereign bond purchases. It now seems much more likely, but the Governing Council will need to gauge carefully any effect on inflation and growth before acting, and we do not expect any movement before the autumn.

At its later stage in the cycle, the UK was more on the US side of the policy divide until a few months ago. Ironically, the rejection of the EU has pushed Britain's central bank closer to Europe. Rates look unlikely to rise for the duration of the cycle, and the betting is now on rate cuts to support the slowing economy—with the possibility of further quantitative easing—bond purchases—or extra support for lending if the economy looks in danger of slipping into recession. Within days of the vote, Bank of England (BoE) governor Mark Carney signalled that some further action was likely during the summer.

The shift in expectations for US rates has been almost as dramatic and much more consequential for world markets. As **Exhibit 5** shows, market prices have all but ruled out a July rate rise in the US, and in the absence of a startling turnaround in jobs growth, inflation and/or business spending, most do not now expect a rate increase this side of the November Presidential Election. Indeed, for the September 2016 meeting, markets are now pricing in a more than 10% chance of a rate cut.

Investors were expecting several US rate hikes in 2016. Now they see more chance of a cut than a fall.

EXHIBIT 5: PROBABILITY OF A RATE HIKE AT SELECTED FED MEETINGS IN 2016



Source: Bloomberg, J.P. Morgan Asset Management. Data as of 29 June 2016.

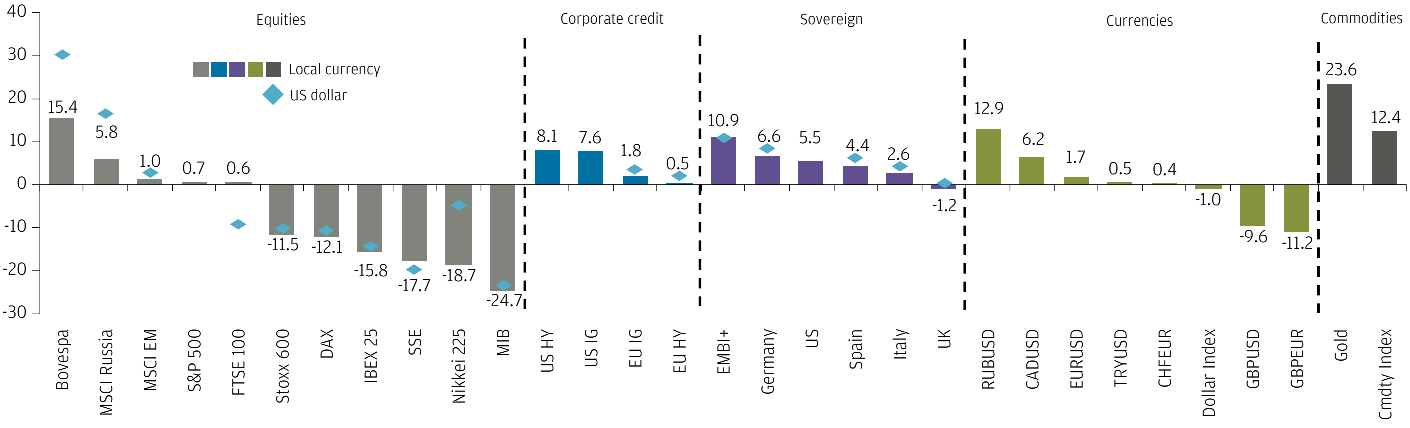
3. Prospects for investors

Longer-term bonds have again outperformed stocks in developed markets so far in 2016—in some cases, by a wide margin. (See **Exhibit 6**). This was disappointing for any investors who were betting strongly on risk assets, but those with a more balanced portfolio have been well protected. Indeed, a basic portfolio of 50/50 DM stocks and longer-term government bonds has delivered a total return of more than 4% in the first half of the year. The same portfolio barely broke even in the 2015 calendar year.

Commodities and fixed income markets have produced the highest total returns for investors in 2016 so far

EXHIBIT 6: YEAR TO DATE RETURNS

% total return of assets, year to date



Source: FactSet, J.P. Morgan Asset Management. Data as of 29 June 2016.

With so many cross-cutting themes in equity markets this year, it's perhaps no surprise that the best-performing national equity markets have been in places at very different stages in their economic cycle: Russia, Brazil and the US. Russia and Brazil have gained from a perceived bottoming-out in their economic prospects, coupled with extremely attractive valuations. At the low point for emerging markets in mid-February, the price/book ratio for EM assets as a whole was 1.5x, not far from the historic low of the 1990s. Russia's P/B ratio was 0.63x–significantly lower than its dividend yield. Since that time, the Russian market has also benefited more than most from the weaker dollar and the rise in the price of oil.

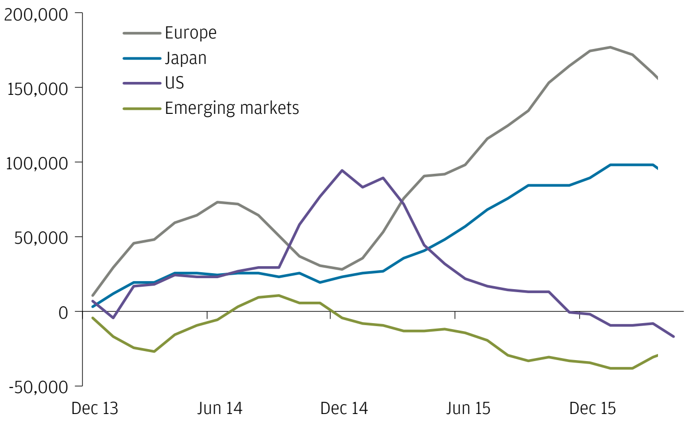
Japan and the eurozone were the best-performing equity markets in 2015 in dollar terms. So far, 2016 has been very different, with Japan, especially, being hampered by the stronger yen and perception that Abenomics is "running out of road" (see the previous discussion of Japanese monetary policy). As shown in **Exhibit 7**, we have seen investor money flow out of these two regions in the first half of this year, and outflows from emerging markets have eased.

As usual, in looking at European equities, it pays to look past the headline numbers, which were distorted by the losses of energy companies in 2015 and more recently, by a collapse in valuations in the financial sector, which alone accounts for 25% of the value of the index. Financials are down 25% year to date, having taken another beating following the Brexit vote. This has made it extremely difficult for the index as a whole to recover the ground lost at the start of the year.

Money has flowed out of Europe and Japan in the first part of 2016, but outflows from emerging markets are easing

EXHIBIT 7: CUMULATIVE NET EQUITY FUND FLOWS

USD millons



Source: Morningstar, J.P. Morgan Asset Management. Data as of 29 June 2016.

With the eurozone domestic economy continuing to recover and the euro at a less competitive level than a year ago, we might have expected more domestically oriented stocks to outperform export-oriented ones. Brexit and a general risk-off mood in markets may have put that story on hold, as far as investors are concerned, but we believe the macroeconomic fundamentals are still broadly supportive of eurozone equities. For income investors, a 3.7% average dividend yield on European equities compares very favourably with either the 0.7% yield on European corporate bonds or the 2.1% dividend yield now available in the US.

It is possible that EM assets have seen their low point for the current cycle. We said at the start of the year that it was a bad time to be underweight emerging markets and that has been borne out by events—rather more quickly than we had expected. If the dollar and commodities stabilise from here and we see confidence in the US recovery reassert itself that is likely to attract further flows to emerging markets. But we would not bet heavily on these economies while fundamental improvements in competitiveness and corporate earnings growth have yet to be won.

That leaves many investors looking, once again, to US equities, especially large-cap companies, for their defensive benefits and to higher-duration, higher-quality bonds for both income and relatively safe returns. This is an environment in which investors expect moderate growth to continue, but not with any great conviction. A neutral stance on bonds and equities makes sense in such a world. So does a more flexible approach to portfolios, using alternative assets and approaches to provide additional forms of "safety", as well as potentially adding to returns. The merits of these are discussed further in an upcoming paper.[1] But investors should also understand that the returns on even a high-performing portfolio are going to be significantly lower than in the earlier part of the cycle.

4. Key risks and open questions

We said at the start that the broad economic environment had not changed radically since the start of 2016. But even before the Brexit vote, there had been some developments of central importance to investors.

The first is a further shift down in yield curves and loosening in both current and prospective global monetary policy. This has flattened yield curves even as investors have sought income in higher-duration bonds. The second is that long-term worries about the underlying health of the US and global recovery have intensified in response to continued weakness in profits and capital spending.

In our view, these developments are much more important for global investors than Brexit, but the UK vote adds another unpredictable factor to the mix. We do not see a risk of an imminent recession, or bear market, but the risk of a downturn is clearly higher than it was a few years ago.

With that in mind, these are the key calls for the rest of the 2016 and beyond that we believe investors will need to keep under closest review:

- Brexit contagion is local and containable: Brexit has triggered a full-blown political crisis in the UK and the longer the period of radical uncertainty persists, the greater chance that it will tip the economy into recession. This would dent Europe's recovery and could also dampen global business confidence. But we do think the damage will be containable—economically, if not politically. It will be important to monitor European economic and financial data to make sure this is the case—and to look out for any further risk-off move into the dollar.
- US productivity and profits stage a partial recovery: Higher US productivity would make it easier for businesses to maintain or increase their profit margins, and will hopefully pave the way for somewhat stronger earnings and capital spending. It will also support faster wage growth and—potentially—allow the Fed to resume increasing interest rates. We are hopeful that a broadly stable dollar and commodities in the second half will support this kind of improvement in US fundamentals. But the weak employment data in May and recent declines in global sentiment have given everyone pause. This benign outcome is certainly not guaranteed.

[1] *Safety in the new normal*, David Stubbs, Market Insights, J.P. Morgan Asset Management, July 2016.

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