

Be Careful of What You Think You Know

MARKET INSIGHTS

Third Quarter 2016

IN BRIEF

- Funding the UK's large current account and budget deficits could prove more challenging in an uncertain post-Brexit environment.
- In the globalization trend that began in the early 1980s, free trade arrangements were seen as the ideal, but now, in a sea change, they are being called into question.
- In addition to the US presidential election this fall, there are important elections and plebiscites across Europe over the next 12 months.

It's too early to suggest that Brexit heralds the peak of globalization, but it's clear that populism is on the rise on both sides of the Atlantic. And the investment implications have the potential to be market- unfriendly over the medium term.

Why was the market so caught off guard by the Brexit result? Because after a series of referenda in recent years, market participants thought they'd figured out a pattern for how referenda typically play out.

We thought we knew that when public opinion polls are close, undecided voters ultimately break in favor of the status quo — in the case of Brexit, in favor of the United Kingdom remaining a member of the European Union. We thought we knew that a jump in voter turnout would favor Remain, because that would be indicative of a surge in youth turnout, and public opinion surveys showed that British youth were heavily in favor of remaining in the EU. And we thought we knew that betting markets were more reliable than pollsters, given all the methodological hurdles facing the polling industry in the age of the mobile phone. So what we thought we knew turned out to be precisely wrong in the case of the Brexit vote. With an Italian constitutional reform referendum and a US presidential election this fall, it remains to be seen if these lessons prove valuable.

Nowhere to run to, nowhere to hide

While there are not many attractive alternatives out there for yield-hungry investors, looking at the global landscape, we prefer US fixed income markets over those in Europe and Japan on a relative basis given the largely negative yields on offer in those markets. Against a backdrop of fairly conservative US corporate balance sheets, we favor a mix of high-grade and high-yield corporate bonds over Treasuries. In the equity income area, dividend paying stocks are quite competitive with the yields paid by US Treasury bonds, though it is important to be selective. Don't chase the stocks with the highest yields — they can be dangerous— but look for sustainable cash flow growers which can support, and eventually grow, payouts.

Now that the UK has voted to leave the EU, what are the most immediate concerns on investors' minds? The first is that the UK's external balance sheet is very much out of balance. The UK's current account deficit — the value of imports of goods, services and investment income which exceeds exports — is running at 7% of gross domestic product, the highest in its history. In order to fund that deficit, the UK must provide an attractive rate of return for foreign investors. The plunge in the foreign exchange value of the pound sterling in the aftermath of the Brexit vote is a consequence of investors demanding a discount in return for investing in the UK. As Bank of England Governor Mark Carney put it recently, the UK is increasingly dependent on the kindness of strangers to finance its trade deficit. As such, attracting foreign investment in an uncertain post-Brexit environment could prove challenging.

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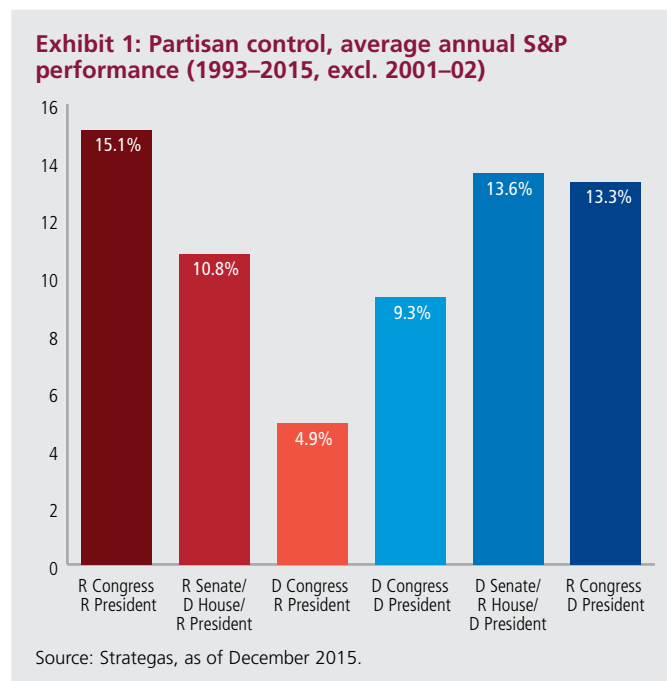
In addition to the current account shortfall, the UK government runs a substantial budget deficit in excess of 4% of GDP, which needs to be funded. The UK's sovereign credit rating was cut by the credit rating agencies in the wake of the Brexit vote but the promise of lower rates from the Bank of England and the potential for renewed quantitative easing has contributed to a fall in UK gilt yields despite the somewhat less rosy long-term credit outlook.

Newly installed British Prime Minister Theresa May has installed a so-called "Brexit cabinet", ending any speculation that the UK would somehow avoid triggering Article 50 after all. Looking ahead, the UK's focus will be on securing the best possible deal with the EU, one that limits UK immigration and EU budget contributions while gaining maximum access to the EU single market. Maintaining access to the EU market for financial services will be a prime target of UK trade negotiators. Financial services are Britain's most significant export and its area of greatest comparative advantage. The UK could now find itself in a much less advantageous position regarding its access to the EU market than it did prior to Brexit. That likely would damage the City of London, and more broadly, the UK economy.

While Brexit does not necessarily signal the end of globalization, it is a clear sign that voters in the western world are growing concerned that large-scale immigration and the free movement of trade and capital often come at some cost. Brexit may actually signal that globalization is entering a new phase, one in which costs and benefits are more closely scrutinized. In the globalization trend that began in the early 1980s, free trade arrangements were seen as the ideal, but now, in a sea change, they are being called into question, from the European Union on one side of the globe to the Trans-Pacific Partnership on the other.

Political calendar bears watching

Looking ahead to the US presidential election, markets are said to favor divided government, by which we mean times when the White House is occupied by one of the two major parties and



at least one house of Congress is controlled by the other party. At present, markets appear priced for such a scenario this fall. Divided government is thought to keep checks and balances in place, assuring that policy doesn't veer too far toward either political extreme. The most worrisome electoral outcome for markets this year would seem to be clean sweeps by either party. A Republican sweep of the White House and both houses of Congress could cause significant market jitters owing to widespread policy uncertainty surrounding

presidential candidate Donald Trump, who has never held elective office and has no record on which we might judge. Conversely, a Democratic sweep could spark fears of higher taxes and

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heavier regulatory burdens. At the moment, the odds of a clean sweep in either direction are probably about the same as those of divided government in my view, so it is important to be prepared for a potential surge in volatility later in the year.


In addition to the US presidential election, there are important elections and plebiscites across Europe over the next 12 months, beginning with a constitutional referendum this October on reforming the power and makeup of the Italian Senate. If the referendum fails, we could see Prime Minister Matteo Renzi lose his grip on power like David Cameron did in the UK — in Renzi's case to the anti-establishment and Eurosceptic Five Star Movement.

Furthermore, in the coming years, the tenures of some of the world's most important central bankers could come to an end, perhaps leading to uncertainty as to the monetary policies of their replacements. The terms of two notable central bankers are set to expire in 2018 — The US Federal Reserve's Janet Yellen and the Bank of Japan's Haruhiko Kuroda. The Bank of England's Mark Carney indicated at the time of his appointment that he would step down five years into his eight year term, which also ends in 2018. European Central Bank President Mario Draghi's term ends in 2019.

As a procedural matter, Yellen and Carney are eligible to be reappointed while Draghi is not. BOJ governors traditionally serve a single five-year term but can be reappointed with the approval of the Japanese Diet. As we saw during 2013's "taper tantrum," shifts in monetary policy expectations can impact markets quite dramatically, with 10-year yields moving more than 100 basis points. It probably makes sense to begin thinking through the implications for monetary policy and markets of new leaders potentially taking the helms of the world's most important central banks in the years ahead.

Exhibit 2: Geopolitical event calendar

POLITICAL ELECTIONS/ REFERENDUMS		
	Italian constitutional referendum	October 2016
	US Presidential election	November 2016
	Dutch election	March 2017
	French Presidential election	April/May 2017
	German federal election	August/October 2017
CENTRAL BANK LEADERS TERM ENDS		
CHAIR/PRESIDENT	CENTRAL BANK	TERM END
Yellen	Federal Reserve	2018
Kuroda	Bank of Japan	2018
Draghi	European Central Bank	2019
Carney	Bank of England	2018 voluntarily to 2020


Beware of future taper tantrums

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Lots of risk but not a lot of reward

With upwards of 35% of the Citibank World Government Bond Index trading with negative yields as a result of quantitative easing programs and negative policy rates, central banks are buying a great deal of outstanding sovereign — and in some cases corporate — debt. Rates are being pushed lower, yield curves are flattening and central banks are being forced farther out the yield due to self-imposed restrictions and the desire to get some bang for their buck (or yen, or euro). For example, ECB rules state that they cannot buy bonds that trade at yields lower than their -0.40% deposit facility. That rules out much of the German yield curve, forcing the ECB to buy longer maturities. Additionally, national finance ministries are issuing longer dated securities in this environment, which has the effect of increasing the duration — or interest rate sensitivity — of benchmark bond indices. Investors are being pushed further out the curve, and are being forced to accept more risk for increasingly less return. They find themselves buying sovereign debt in countries that offer more yield, being pushed into credit markets, and in some cases out of bond markets entirely, into historically riskier asset classes.

We travel the world conducting our own investment research, evaluating corporate management teams and analyzing the competitive landscape. We listen to central bankers and other policymakers to put together a picture of where world economies are heading. We collaborate across our global research platform to share our best ideas.

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