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INVESTMENT STRATEGY QUARTERLY



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The Investment Landscape: Adapt or Get Left Behind

Peter Greenberger, *Director of Mutual Fund Research & Marketing*, takes a deeper look at how the evolving population affects the investing backdrop.

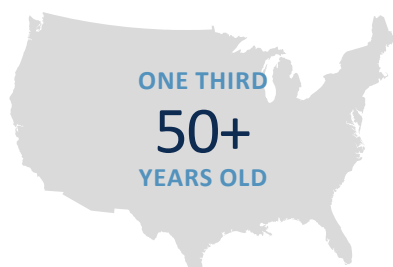
Over the next several decades, countries and regions around the world will experience differing levels of economic growth and investment opportunity, both of which are greatly affected by changing global demographics. There is no set schedule for how these trends will develop, making it critical to stay informed as the changing environment is likely to offer new opportunities for investors. Some industries will benefit from these trends, some will adapt or cease to exist, and new industries will emerge to serve new needs.

AGING POPULATIONS AND UNTAPPED YOUTH

Nearly one-third of the population in the United States is 50 years of age or older. The demographic trend of the aging population is apparent in many developed countries around the world, but to varying degrees. An extreme case is Japan, where nearly 60% of the population is 40 years of age or older.

To the contrary, overall population disparity around the world, particularly within emerging economies, is skewed toward more youthful cohorts. In fact, an estimated 58% of the world's population is 34 years of age or younger. These younger populations have unique needs and wants, including quality education to arm them with the changing skill sets required for future employment.

UNITED STATES POPULATION



WORLD POPULATION



A CHANGING INVESTMENT LANDSCAPE

What industries stand to benefit from these changes? What industries are at risk of becoming obsolete? Next are a few areas likely to be affected by shifting demographics.

HEALTHCARE

The combination of an aging population and growing middle class is a primary driver of growth within the healthcare industry. Demographics are changing the type of treatments and services that patients seek. Both the middle class and older populations will grow over time, putting pressure on the current system.

A likely scenario, already seen in the United States, is the growth of assisted-living facilities and other forms of housing that cater to an aging demographic. Additionally, as middle classes expand worldwide, there will likely be increased demand for both private healthcare and health-related services.

In addition to considering treatment, technological and medical advancements related to early detection and diagnosis of disease are likely to progress. This may mean an increase in the utilization of cyber office visits and electronic patient records, allowing for efficiencies in office management, improvements in patient experience, and improved record retention and data sharing. Patients will be able to track their daily health on their mobile devices through apps that relay important health-related information to their physicians. Much of the above is already happening in the developed world, and it is only a matter of time before it becomes more prevalent in developing nations.

INFORMATION TECHNOLOGY

Information technology companies are likely to benefit from changes in demographics as well. Today, the smartphone allows us to check email, text, stream videos, manage calendars, listen to music, and the list goes on. It was not too long ago that we would have had a separate cellphone, MP3 player and a stylus to manage our time. In addition to

these advances, many new devices are enabling consumers to buy goods and services without ever having to show the vendor a credit card. This trend has directly impacted traditional retail as well as financial service firms, particularly banks.

A 2015 KPMG study that examined mobile banking found that “adoption rates are highest in developing countries – reaching 60 - 70% in China and India – rather than developed nations, such as the U.S., Canada and the UK.” The same study also found that the demographic with the highest utilization were individuals in their mid- to late-30s. With nearly 60% of the world's population under the age of 35, it is hard to imagine a shift away from this trend any time soon.

The up-and-coming “sharing economy” is dramatically changing how consumers obtain transportation, grocery shop, do laundry and order takeout. Businesses are tapping into this model as well by outsourcing delivery services to local markets to minimize cost and delivery time, while freight transporters are gaining efficiencies through mobile apps that match up shippers and carriers. Industries such as traditional retail, transportation, restaurants and autos will need to adapt to this changing environment or they could face the consequence of becoming obsolete.

THE EVOLUTION OF INVESTMENT MANAGEMENT

The investment management industry is evolving to meet the challenge of a changing investor base. These changes impact everything from investment strategy and philosophy to product development. Younger investors, among others, are seeking out investments that align with their values. Both the interconnectedness of the world and access to information have increased general awareness of social and environmental issues. This awareness flows through to the types of investments people are willing to make. For example, the increased appetite for sustainable investing strategies stems from both millennials and female investors seeking out companies that are not only fundamentally sound, but also consider corporate governance as well as the environmental and social impact of how they conduct business.

THE VALUE OF HUMAN CONTACT

As the population changes in age and preference, so does the investment landscape that individuals rely on to attempt to grow their assets and achieve their financial goals. The breadth of products and strategies is greater than ever as are the options for obtaining investment advice. The complexity of the investment industry coupled with the lack of time or desire to understand the intricacies of it has supported the traditional financial advisory relationship, and that is likely to persist going forward. ■

KEY TAKEAWAYS:

- Industries positioned to benefit from an aging population and growing middle class are health-care and information technology, among others
- Industries such as traditional retail, transportation, restaurants, and autos will need to adapt to the “sharing economy” business model that is welcomed by younger generations, or they could face becoming obsolete
- Younger investors, among others, are seeking out investments that align with their values
- The breadth of investment products and strategies is greater than ever as are the options for obtaining investment advice

Opportunities for a Post-Brexit Britain

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"Opportunity is missed by most people because it is dressed in overalls and looks like work."

Thomas A. Edison

Around about 48% of the voting UK population is feeling rather sore at the moment and it is highly likely an even higher proportion are feeling uncertain about the economic implications of the 'leave' vote. However, the world always carries on and despite the calls for a second referendum, Parliamentary blockages and other constitutional gossip now that a result has been established, the correct attitude is to concentrate on the opportunities emerging from this.

Most of us have seen the documents put together by the UK Treasury and other academic bodies highlighting various implications for economic growth rates in the UK after a Brexit vote. The methodology and assumptions used can be readily criticised, but most would agree that ripping up a trade agreement with a large economic partner always carries risks. Even just the fear of disruption can cloud consumer spending and business investment decisions. That's why you hear the recession risk talk in the UK from business groups, trade bodies and even the Bank of England.

Aside from the obvious pursuit of as many free trade centred deals, with as many countries as possible, during the two year transitional period the UK has with its current EU agreement in place, the UK has to do a lot more to offset any post Brexit impact. At first glance, the sharp downward shift in the value of the Pound, following the publication of the referendum result, appears such a policy safety valve. You know the theory: depreciate your currency and boost your exports – and given the UK's current high trade deficit position, such a move is just what the economic doctor ordered. From an overvalued position currency depreciation – as in Sterling's White Wednesday September 1992 exit from the Exchange Rate Mechanism – makes a lot of sense. The Pound is not particularly overvalued however, and

Despite calls for a **second referendum**, Parliamentary blockages and other constitutional gossip, the **correct attitude** is to concentrate on the **opportunities** emerging from this

whilst there will clearly be some competitiveness boosts, reliance on a currency depreciation as a central part of an economic recovery plan is a policy tactic straight out of the 1960s or 1970s – and it did not do much good then.

No, the newly liberated UK, which is looking to exit an EU which they believe is economically sclerotic, must go completely in the opposite direction. Not tariffs to protect domestic industries, nor restrictions on skilled citizens from other parts of the globe who can add value for the overall country or a burden of red tape that entangles business in a burden of regulation. In the global, dynamic markets of the 21st Century, the UK must adopt a mind-set that encompasses the entrepreneurial zeal of East Asia and the laissez-faire can-do-ism of the United States, mixed up with our own style and global outlook. In short, a supply side revolution not seen in this country since the 1980s.

Here's the irony. Much of what I have written in the above paragraph I would have also written in the event of a 'remain' victory. You see, some matters are much bigger than just a simple binary vote. Now the

You know the theory: **depreciate your currency** and **boost your exports** - given the UK's current high trade deficit position, such a move is just what the economic doctor ordered

question is, after all the campaign rhetoric, key issues and promises, are policymakers going to step up or not?

The EU referendum result is just the end of a beginning. The next phase is not re-making the UK in the style of some previous halcyon period, but in making sure the UK – and all of its citizens – are fully-fledged global players over the balance of the 21st Century. The challenge will be achieving this against a backdrop of lower economic growth, an evolution of the political top guard and any Brexit campaign promises that have been made.

And to put it in the terminology of the Thomas Edison quote cited above, it is going to be harder work than under the previous prevailing economic and political status quo. ■

KEY TAKEAWAYS:

- Despite uncertainty the world always carries on
- Trade deals and a positive, entrepreneurial attitude matter hugely for making the most of a post-Brexit world
- The EU referendum result is just the end of a beginning.

Now the question is, after all the campaign rhetoric, key issues and promises, are **policymakers** going to **step up?**

Is this the Beginning of the End for the European Union?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"The European Union arose on an economic foundation, and it turns out that even this is not a solid base. Cultural identity has been neglected." Gunter Grass

The European Union's current crisis cuts across economic, political and constitutional lines. Economic issues are relatively easy to spot, but waning enthusiasm for pan-European political ideals – as reflected in the rise in support for nationalist, anti-austerity or just simply alternative political parties – strikes an ultimately deeper blow. Consequently, it is easy to shift from economic to political and constitutional malaise.

Few would argue that Europe is even close to achieving its economic potential. Growth rates have been disappointing versus the United States, and the decision by one of the larger, more dynamic countries (the UK) within the European Union to exit the structure is a distinct blow, especially for the other larger, more dynamic country within the bloc (Germany).

Events however can provide opportunities. European economic history should be materially marked by the occurrences of the 23rd into the 24th of June 2016, and if this cannot induce some reaction then the European Union risks splitting further into a German-led 'hard currency' grouping, and a rag bag of arrangements for other countries unwilling or unable to follow the tone coming out of probably both Brussels and Berlin.

Such a scenario should appeal naturally to few outside of some hard doctrine orthodox economic thinkers, obsessed with balancing books and creating an economic backdrop which starts with sustained low inflation – and the better news is that it is not supported by the

It is easy to **shift** from **economic** to **political** and **constitutional** malaise

average European policy-maker (or indeed citizen). This is actually best seen not in the latest thoughts of the populist German tabloid press, but in the realities of policy-making life in the Eurozone's poorest and most troubled economy: Greece.

The election of Alexis Tsipras could have been a watershed moment for anyone highly concerned about the future of the Eurozone and European Union. His leadership of the radical, anti-euro and anti-austerity party Syriza, helped push an edgy and opinionated second or third tier player in Greek politics to a position of running the country on a platform of radical change. In the eighteen months since, the rhetoric from Mr Tsipras and his fellow Syriza politicians has continued to be radical and espousing change, but the economic decision-making has been something more conventional and conservative, manifesting itself in a series of bail-out package agreements where support from Germany, the European Central Bank and broader supranational institutions like the International Monetary Fund, were based on tangible economic reforms and changes. Whilst implementation of such plans remains patchy, the clear policy conclusion has been that when faced with a decision to leave the euro or not, even a radical political force has decided – at least for this moment in time – to stay.

Notions that the European Union is primed to split up, or that the euro single currency project is sunk below the waterline, fail to acknowledge the subtle yet important ties that bind the economic and political life of Continental Europe. The UK – and large swathes of Scandinavia – maybe struggle to feel such kinship, but such a union remains at the heart of the European Union. Of course, such allegiances and preferences cannot be taken for granted, but it is noteworthy that few of the radical parties polling strongly across Europe want to overtly leave the euro, or the European Union, or would countenance putting in place agendas if in power to achieve this, let alone achieve a political majority on such a political ticket.

| FAVOURABLE VIEW OF THE EU | |
|---------------------------|-----|
| Poland | 72% |
| Italy | 58% |
| Germany | 50% |
| Spain | 47% |
| UK | 44% |
| France | 38% |
| Greece | 27% |

Source: Pew Research (Spring 2016)

Change however is required before this situation changes, and tests such as the upcoming Hungarian vote on the pan European Union migration distribution, or next year's French Presidential election, will give an indication of any worsening in the underlying voter perception. The source of a likely change is undoubtedly a politically revitalised Germany under Chancellor Angela Merkel. Her personal intervention and agenda pushing actions, on both the latest Greek bail out deal and the creation of a migration plan with Turkey, is a reflection of the greater practical power wielding Germany has taken on. Whilst, at first glance, this appears to favour a shift towards the aforementioned German-led 'hard currency' selective membership group, it actually

The source of a **likely change** is undoubtedly a **politically revitalised Germany** under Chancellor Angela Merkel; her personal intervention and agenda pushing actions is a reflection of the greater **practical power wielding** Germany has taken on

should lead to that much anticipated of events – decisions – which benefit all. Someone, after all, has to lead and with this maybe the European Union's talking shop characteristics may start to end and the revitalisation of (as famously cited by President Bush) 'the vision thing' will begin to restart. Mix this with the deep affinity to a closer Europe, and wayward voters thinking about alternative structures, and political set-ups will start to come back to the fold. The Eurozone and the European Union have a clear opportunity to proceed positively, deepening and strengthening both institutions. The opportunity and motivation is in their own hands. At a certain level, the UK's exit from the European Union could be the best thing to happen to this economic grouping in a long time. ■

The **Eurozone** and the **European Union** have a clear opportunity to **proceed positively**, deepening and **strengthening both institutions**

KEY TAKEAWAYS:

- Economic and political malaise is apparent in the European Union
- Links are deeper than contemporary observations suggest
- Decision-making driven by Germany in Greece and on the migration crisis give some hope
- The opportunity is in the European Union's own hands

*An affiliate of Raymond James & Associates and Raymond James Financial.

Will the Pound Rebound?

Chris Bailey, *European Strategist, Raymond James Euro Equities**

"My New Year's Resolution List usually starts with the desire to lose between ten and three thousand pounds." Nia Vardalos

By far and away the most striking financial market metric emanating from the EU referendum vote has been the collapse in the value of the British pound. The 24 June 2016 saw a 7.5% plunge in the British currency against the global behemoth, the U.S. dollar, a decline that was greater than anything seen on any individual day during 2008...or even 1992, or 1981, for those with longer memories (and probably more grey hairs). Yes, it was that material.

24 June 2016 saw a **7.5% plunge** in the British currency against the U.S. dollar

The Exchange Rate Mechanism (ERM) crisis of September 1992, which is generally regarded as helping to augment legendary investor George Soros' wealth by at least a billion U.S. dollars, does not even hold the title of the month with the greatest plunge in the pound against its U.S. counterpart. The 10.6% fall seen that month is dwarfed by the 12.3% drop recorded in October 1992. By definition, momentum investing worked very nicely in the early autumn of 1992. So where does this put the 7.4% drop in the pound during June 2016? A warm-up act, or is it already reflecting a currency deep in the throes of a real crisis?

Of course, the first observation is that all the above declines have been against the U.S. dollar. Against the euro the pound may not have racked up such a magnitude of losses, but it is hardly rampant at (by early July) its lowest points against the much-maligned European single currency since late 2013. If you want to find a currency the pound has made progress against since the June referendum vote, you are going to have to burrow deep into the emerging market currency basket.

If classic currency valuation is undertaken using concepts like interest

| BIGGEST MONTHLY FALLS BY THE BRITISH POUND | |
|--|---------------------------|
| Date | Fall in the British Pound |
| October 1992 | -12.31% |
| September 1992 | -10.62% |
| October 2008 | -9.71% |
| March 1991 | -8.47% |
| August 2008 | -8.22% |
| June 2016 | -7.44% |

Source: *Fast FT*

rate differentials, plus trade balance and productivity levels, leading to some kind of indicative neutral purchasing power parity (PPP), currency appraisal over the balance of 2016 and into 2017 will require a more tactical policy insight on political change, together with perceptions as to where opaque trade negotiations are heading.

Weighing machine investors were probably quite comfortable with the Pound's level prior to the Brexit vote, at the level of \$1.50 – briefly re-attained just after the UK polls closed on 23 June – and regarded by many as being around some kind of medium-term fair value. The pound may have been a little firm against the euro, but then – as the

If you want to find a currency the **Pound** has made progress against since the **June referendum** you are going to have to **burrow deep into the emerging market currency basket**

prevailing theory dictated in the weeks and months before the referendum vote – the euro had more pressing political concerns.

Of course, this may well still be the case. The International Monetary Fund's Christine Lagarde said in early July that: 'Europe will emerge from the Brexit crisis on top', due to added flexibility from the UK not being there. Meanwhile, European Central Bank (ECB) council member, Francois Villeroy de Galhau, said that Britain will face two key challenges after Brexit, inflation and recession. In addition, Bank of England Governor, Mark Carney, made a rather unsubtle hint regarding the scope for lower interest rates in his first comments after the referendum and, in early July in the press conference for the launch of the bank's twice-annual Stability Report, noted that the UK was facing a 'period of uncertainty and economic adjustment', words that were greeted by the pound slipping to its lowest level since the immediate aftermath of the Brexit vote.

UK monetary policy is going to loosen sooner rather than later, but frankly the 8 September ECB meeting also looks primed for something to happen. My instinct is also that the political crises in the UK will have also been worked through by this point, and both the ruling Conservative and opposition Labour parties will have leaders in place who command the support of the clear majority of their parliamentary colleagues. Of course, there will then be the small issue of the now near-legendary implementation of Article 50, and the associated trade discussions. Taken together, the UK's self-voted local economic difficulty starts to look that little bit more anticipated, and certainly, on aggregate, the country faces no less of an unclear future than the rest of the European Union.

Meanwhile, rumbling away in the background, the pressure for more monetary stimulus/an overtly lower yen in Japan continues, whilst the influential Chinese Securities Journal noted the need to: 'fine-tune monetary policy in the second half of the year'. That sounds like that well-known central banking tactic of 'open-mouth operations', which is employed to try and talk down the currency, and that has already been used by other influential policy makers, such as the head of the

With any **rate rise** coming later than generally anticipated, it is not beyond the realms of possibility that one of the **better-performing larger currencies** in the second half of 2016 could well be the one that was the **weakest** during the first half of the year

Swiss National Bank in his communications with the markets.

Of course, this still leaves the U.S. dollar and the Federal Reserve. Consistent with the above, with any rate rise coming later than generally anticipated, even a few months ago, it is not beyond the realms of possibility that one of the better-performing larger currencies in the second half of 2016 could well be the one that was the weakest during the first half of the year. And this means that, unlike the September-October 1992 momentum, investors should maybe start reconsidering their positioning. In short, we expect a quiet rebound in the pound by the end of the year. ■

KEY TAKEAWAYS:

- Big falls in the value of the Pound after the referendum result
- Lots of fear about UK prospects
- Nothing exists in isolation however and pressure on other currencies is still apparent
- A quiet rebound in the Pound expected from current levels



Investing for Retirement in Today's World

Nick Lacy, Chief Portfolio Strategist, Asset Management Services, provides context for portfolio construction in the current market environment.

Of all the financial decisions investors need to make in life, choosing an appropriate portfolio that meets investment objectives throughout retirement is one of the most critical. In the past, this concern didn't exist since these decisions typically fell in the hands of the employer through pensions and defined benefit plans. These types of plans promised to pay retirees a specified monthly benefit until death. These "guaranteed" income streams meant that the primary concern of the retiree was staying under budget.

Today, it is much more common for employers to offer defined contribution plans in which the employer, employee or both make contributions on a regular basis. While some firms offer guidance, it is ultimately up to the individual to make the decisions and maintain the portfolio over time.

THE BALANCED PORTFOLIO: THEN VERSUS NOW

Today's retirees are facing a far different investment landscape than 20 or 30 years ago. Those who relied on bonds to help fund their retirement income needs are now faced with historically low yields on high-quality bonds. One of the best predictors of bond returns is the current yield, which measures the return an investor would expect if the bond was purchased and held for a year. With yields at their lowest levels since post-WWII, relying on bonds for income will not produce meaningful cash flow as in the past. Additionally, the stock market is not expected to produce the same levels of returns it has in the past, further slowing asset accumulation.

Whether investors decide to work longer and save more, or increase portfolio risk while lowering income needs, adjustments to these key inputs can increase the likelihood of achieving retirement goals.

The classic balanced portfolio is a 60/40 allocation with 60% invested in stocks and 40% in bonds*. Over the last 20 years, this type of portfolio earned an average total return of 7.3%, while for the 20-year period, ending 1996, the same portfolio earned 12.6%; a dramatic difference.

TOTAL RETURN EXPECTATIONS FOR A 60/40 PORTFOLIO OF STOCKS AND BONDS

| | | BOND PORTFOLIO RETURN | | | |
|-------------------------|-----|-----------------------|------|------|------|
| | | 2% | 3% | 4% | 5% |
| EQUITY PORTFOLIO RETURN | 5% | 3.8% | 4.2% | 4.6% | 5.0% |
| | 6% | 4.4% | 4.8% | 5.2% | 5.6% |
| | 7% | 5.0% | 5.4% | 5.8% | 6.2% |
| | 8% | 5.6% | 6.0% | 6.4% | 6.8% |
| | 9% | 6.2% | 6.6% | 7.0% | 7.4% |
| | 10% | 6.8% | 7.2% | 7.6% | 8.0% |

In order for an investor to earn 7.3% on the portfolio going forward, stocks would need to earn more than 9% and bonds would need to earn more than 4%. Can this happen? It could, but most likely won't given the near-term outlook for capital markets.

Source: Raymond James

A primary factor contributing to lower returns in the current market is lower-yielding bonds. Will interest rates rise in the future and once again provide meaningful income to investors?

Eventually, they should. The difficulty lies in predicting how long it will take and to what degree they will rise. If yields don't change from their current levels, that 40% allocation to bonds would only earn approximately 2%, a contribution of 0.8% to the portfolio's total return. If stocks were to earn 10% and bonds earned 2%, the portfolio would have a 6.8% total return.

What about the double-digit returns earned by balanced investors 20 years ago? The reality is that we are living in a different world, and there is no conceivable way to achieve those returns going forward without the stock market earning more than 15% per year; an unlikely scenario.

RETURNS: DON'T LOOK IN THE REAR-VIEW MIRROR

What should investors expect for returns going forward? Should they simply rely on history or look at current conditions to estimate future returns? There are 90 years of history one can draw on for inspiration, but is it relevant to consider data from the 1930s through the 1970s in today's world?

We know that bonds have historically returned their yields to investors. If we look back 20 years ago, the yield on the average investment-grade bond was 6.3%. Today, those same bonds are yielding around 2% or less in the U.S., which means returns on bonds are going to have a hard time earning more than that.

WHAT SHOULD INVESTORS DO?

In order to attempt to achieve the level of long-term returns experienced in the past, investors may need to own more risky assets. The traditional 60/40 portfolio may need to increase to a 70/30 or 80/20 in order to meet objectives. The danger of this allocation change is that investors will be exposed to greater downside risks compared to the original allocation, which could result in a very big difference in returns.

The downside risks for increasing equity can be very impactful. As illustrated in the following hypothetical table, if the stock market pulls back 10% and an investor owns 60% in stocks, stocks would lose 6%, with investment-grade bonds helping to offset some of those losses.

DOWNSIDE RISKS FOR INCREASING EQUITY CAN BE IMPACTFUL

| | | BOND RETURN | 2% | 4% | 6% |
|--------|------|--------------|--------|--------|------|
| | | STOCK RETURN | -10% | -15% | -20% |
| EQUITY | 60% | -5.2% | -7.4% | -9.6% | |
| | 70% | -6.4% | -9.3% | -12.2% | |
| | 80% | -7.6% | -11.2% | -14.8% | |
| | 90% | -8.8% | -13.1% | -17.4% | |
| | 100% | -10.0% | -15.0% | -20.0% | |

Source: Raymond James

The challenges retirees face today are very different from those in the past. We are now living in a lower-returning, lower income-producing world, at least for the foreseeable future. Whether investors choose more conservative income requirements or amp up risk in order to earn more from their portfolios, it is important to fully understand the implications of these actions, particularly the added downside risk associated with more aggressive allocations. Before making what could very well end up being a major shift in return or risk objectives, consult your wealth manager to discuss a plan of action.

KEY TAKEAWAYS:

- Of all the financial decisions an investor needs to make around retirement, how to invest retirement assets is one of the most critical
- We are now living in a lower-returning, lower income-producing world, at least for the foreseeable future
- Whether investors decide to work longer and save more, or increase portfolio risk while lowering income needs, adjustments to these key inputs can increase the likelihood of achieving retirement goals
- The downside risks for increasing equity exposure can be very impactful and consulting your wealth manager to discuss a plan of action is highly recommended

The performance mentioned does not include fees and charges, which would lower an investor's returns. Past performance may not be indicative of future results. There is no assurance that any investment strategy will be successful. Investing involves risks including the possible loss of capital. The market value of fixed income securities may be affected by several risks including interest rate risk, default or credit risk, and liquidity risk. There is no assurance any of the trends mentioned will continue or forecasts will occur.

*This portfolio is for illustrative purposes only. Bonds are represented by the Barclays U.S. Aggregate Bond Index and equities by the Standard & Poor's 500 Index.

Outlook for Global Financial Markets in the Second Half of 2016

Chris Bailey, European Strategist, Raymond James Euro Equities*

"Life... It tends to respond to our outlook, to shape itself to meet our expectations"
Richard M. DeVos

The events of late June inevitably hang over any outlook statement written in early July. However, the EU referendum result does matter, with a materiality way beyond UK economic growth rates and the performance of the local financial markets.

The main reason for this is that in one fell swoop the whole debate over the outlook for global monetary policy has changed, with the 'will they / won't they?' debate in the United States over interest rate tightening replaced by an acknowledgement that the new uncertainty over European economic growth rates makes it now difficult to change rates further at all. And whilst it is likely the US holds interest rates, the UK and the Eurozone appear set to loosen monetary policy in some form further. For the UK, this is in direct acknowledgement to the slowdown in economic growth rates and general disruption to the business and financial sector backdrop that is likely to be the immediate result of the Brexit decision. For the Eurozone, the need to deepen any positive influences in their economy is clear given the disruption threat from Brexit which potentially spills far wider than just the headline growth rates. My instinct is that the Bank of England loosens policy during the summer and the European Central Bank follows suit during the early autumn, probably having had in depth discussions with other leading central banks at the annual Jackson Hole summit in August.

The **slowdown** in economic **growth rates** and general **disruption** to the business and financial sector backdrop is likely to be the **immediate result** of the Brexit decision

| CONTRIBUTION TO GLOBAL REAL GDP GROWTH IN 2016 | |
|--|--------------------|
| Area | GDP contribution % |
| China | 1 |
| US | 0.6 |
| Other EM | 0.6 |
| Other | 1 |
| Total | 3.2 |

Source: Nomura

These discussions will stretch far wider than interest rates. Currencies are back in the news and uppermost in discussions will be the US dollar and the two major Asian currencies: the Japanese yen and the Chinese yuan. Both the global risk-taking environment and general financial market balance across key emerging markets like China – who are still going through their own tricky transition to a more consumer based economy - is aided by a flat-to-weak US dollar. However trying to achieve this at a time of European economic uncertainty will be a challenge for policy makers. Given the building pressures on the Bank of Japan to sanction further stimulus measures, with the secondary aim of weakening the yen in order to give a boost to their own economy, the importance of some semblance of global coordination is going to be paramount.

Which brings us back to Europe. Global balance is best served via a flat-to-weaker dollar...and hence a flat-to-stronger euro. Even the European Central Bank would privately acknowledge their own currency is a little cheap at the moment, and even though Brexit has dealt a clear political and economic blow to the region, the scope for the euro to edge up exists. The remaining key ingredient probably rests with a feeling that now is the time for the Eurozone to sharpen up their act - a reality that surely is dawning on the region's policy makers.

Now is the time for the **Eurozone to sharpen up their act** - a reality that surely is dawning on the region's policy makers

And then there are bond yields, which across many markets have compressed to record low levels on fears of sustained economic growth and risk-taking malaise. Another driver has been lower inflation, but this aspect will progressively change over the next six months or so as higher energy prices – augmented in the UK economy by the fall in the value of the Pound – filter through. Normally this would lead to pressure for a rise in interest rates...but as described above this is unlikely to happen. Put it all together and by the end of the year the perception that ultra-low bond yields are sustainable will be challenged. A rise in these depressed bond yields theoretically heightens the attraction for equities, which have globally struggled to perform so far this year.

In short, looser policy, a touch of inflation and higher bond yields have the combined scope to push up equity markets, so long as the currency markets are not overly volatile and policy makers in Europe and China, in particular, keep on making the right noises about reform and change. That suggests investors should conclude, in the inevitable bouts of volatility and uncertainty that will transitorily occur, that keeping the faith and – in the words of legendary investor Warren Buffett – being 'greedy whilst others are fearful' is the key.

As always, the future holds both challenges...and opportunities. The key is to keep in touch, active and flexible. ■

KEY TAKEAWAYS:

- Tricky backdrop but policy likely to be loosened
- Bond yields may come under pressure
- Cautiously volatility should be embraced

| CALENDAR OF SELECTED FORWARD POLITICAL RISK EVENTS | | |
|--|---|--|
| 10 July 2016 | - | Japan Upper House elections |
| 26 September 2016 | - | Spanish Catalonia confidence vote |
| October 2016 | - | Italian referendum (constitutional reform) |
| 2 October 2016 | - | UK Conservative Party conference |
| 8 November 2016 | - | US Presidential election |
| March 2017 | - | Dutch General election |
| 23 April 2017 | - | French Presidential election |
| September 2017 | - | German Presidential election |

Source: Morgan Stanley

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Each quarter, the committee members complete a detailed survey sharing their views on the investment environment, and their responses are the basis for a discussion of key themes and investment implications.

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