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Schroders

Global Market Perspective

Economic and Asset Allocation Views Q3 2016



Schroders

Introduction

The second quarter saw a powerful rally in sovereign bond markets which took yields to new lows in many major markets. Estimates suggest that around one third of the developed government bond market is now trading on a negative yield. The bond market rally gained added impetus from the UK vote to leave the European Union on June 23rd. This event was not foreseen and investors scrambled into safe havens such as government bonds, gold and currencies like the US dollar and Japanese yen. After initially falling on the Brexit vote, global equities have subsequently rallied as investors have focussed on the increase in liquidity from central banks and the potential for fiscal stimulus in some economies.

The economic impact of Brexit will be felt most keenly by the UK and will also dampen Eurozone growth. However, the global impact is negligible as the UK only represents about 4% of world GDP and contagion effects through financial markets have been contained by the central banks. We would see the main impact from Brexit as being a warning that populist politicians should not be underestimated in the current environment where a large proportion of the population are dissatisfied with the establishment. Meanwhile, we expect the EU to pull more closely together, but there are key challenges ahead such as the need to resolve the Italian banking crisis and political risk will remain high in the run up to the US Presidential election on November 8th.

If there is a silver lining from the fall out from Brexit it may well be found in the emerging markets. Medium term prospects remain difficult as the headwinds on trade growth are likely to remain strong (see research note). However, the prospect of an easier Fed rate policy has allowed investors to refocus on fundamentals. We have yet to see the macro recovery which would accelerate emerging market growth but as inflation eases and currencies stabilise we have become more constructive on the region.

Keith Wade, Chief Economist and Strategist, Schroders

14 July 2016

Contents

Asset Allocation Views – Global Overview	2
Regional Equity Views – Key Points	5
Fixed Income – Key Points	6
Alternatives – Key Points	7
Economic View: Global Update	8
Mid-year performance review	12
Global strategy: Brexit implications and investing in an environment of rising political risk	14
Global trade research note: From feast to famine	21
Market Returns	27
Disclaimer	Back Page

Editors

Keith Wade, Harvinder Gill and Tina Fong

Asset Allocation Views: Multi Asset Group

Global Overview

Economic View Our global growth forecast is unchanged at 2.5% for 2016 with the principal impact of Brexit being felt in the UK where we have cut our growth forecasts in half for next year. Eurozone forecasts have also been reduced as a result of weaker demand from one of its biggest trading partners and the increase in uncertainty brought about by the referendum result. These effects will feed a broader slowdown in trade and activity in 2017, but the overall global effects are not great given the size of the UK in the world economy.

Global inflation is forecast to rise to 2.2% this year and to 2.5% in 2017. The forecast for next year is partly influenced by the forward profile of oil prices (the oil curve is higher but less steep). Additionally, we feel we will not see significant second round effects from higher inflation into wages, with the experience of recent cycles suggesting that wages have become less responsive to changes in unemployment.

In terms of risks around our baseline forecasts, the balance of probabilities remains skewed towards a weaker growth outcome although less compared to previous quarter. Meanwhile, with political risks rising, we have introduced a “Trade wars” scenario and a “Brexit shakes Europe” scenario. The former is based on the election of Donald Trump as president of the US, which brings a significant increase in tariffs on imported goods. Ultimately, this scenario is seen as stagflationary given that global trade contracts and global inflation is pushed higher. With regard to “Brexit shakes Europe”, this follows from the UK vote to exit the EU which galvanises anti-EU support across Europe and results in a number of similar referenda across the continent. Our models suggest global growth will be lower than the baseline in such a scenario, with higher inflation in Europe as the GBP and EUR depreciate significantly.

Central Bank Policy

We expect Fed Chair Janet Yellen and company to hike rates in December 2016 to 0.75%, which is followed by another two hikes to 1.25% by end-2017. Meanwhile, we expect the Bank of England (BoE) to cut interest rates in August as the economy weakens. The European Central Bank (ECB) is also assumed to reduce the deposit rate to -0.5%, where it stays through 2017. The Bank of Japan (BoJ) is no longer expected to take rates lower following the adverse reaction to their move into negative territory in January. Fiscal support and the further delay in the consumption tax relieve some of the pressure on the BoJ. However, we do expect them to start experimenting with helicopter money drops towards the end of the forecast period in 2017 in a renewed effort to stimulate growth in a moribund economy. The People’s Bank of China (PBoC) is still expected to cut interest rates and the reserve requirement ratio (RRR) over the forecast period.

Implications for Markets

Looking at our asset class views, we have maintained our neutral bias on equities. Valuations are generally looking fair relative to the risk free rate and even cheap on some absolute measures. However, our cycle and earnings measures continue to suggest a more cautious view on equities is warranted. We believe that earnings growth will be subdued this year given the sluggish global growth. Meanwhile, a driver of the deterioration of the global cycle has been a slowdown in manufacturing in areas such as the US and Japan. While the tightening in monetary policy by the Fed has been kinder to risk assets in this cycle, the liquidity backdrop remains vulnerable to higher interest rates. This suggests a more challenging landscape for earnings growth, which is critical for the equity call.

Within equities, we prefer the UK as the FTSE 100 not only benefits from high dividend yields but also a weaker currency supporting multi-nationals. Despite the high-quality and the low-beta nature of the US market, we have turned neutral. Equity valuations have become richer and have not adequately discounted the potential uncertainty from the upcoming US elections and the Fed’s continued path of policy normalisation. On Europe ex UK, we have stayed negative largely due to our belief that negative interest rates are likely to be harmful to the profitability of banks and be a headwind to the broader market. In comparison, we have downgraded Japanese

Implications
for Markets
(continued)

equities as we believe that consensus forecasts for earnings remain too optimistic and fail to make adequate provisions for the strength of the yen on corporate margins. We have remained neutral on Pacific ex Japan and EM equities. On the latter, we recognise that EM price-earnings multiples have adjusted a long way to reflect a subdued outlook for the global economy. Our forecasts suggest that the growth differential between the EM versus developed market is likely to increase in favour of EM, which should offer support to EM multiples and relative performance.

With regard to the duration views, we have an overall neutral bias on government bonds. Amongst the bond markets, we have retained our neutral view on US Treasuries but have turned positive on German Bunds. On UK Gilts and Japanese government bonds (JGBs), we remain neutral. We have also maintained our neutral stance on emerging market sovereign debt in USD. Instead, we prefer harvesting the carry in EMD local currency bonds given the attractive real yield.

In terms of the credit markets, we have turned neutral on both US high yield and investment grade bonds. After a period of significant spread tightening, credit is no longer as compelling from a valuation perspective. We believe the US credit sector is in the late cycle phase which means most of the returns will come from carry rather than further yield spread compression. For European credit, ultra-accommodative policy from the ECB should be positive for carry, but valuations appear to be unattractive at current levels.

We have upgraded commodities given the meaningful reduction in supply particularly in the energy market. Amongst the sectors, we believe longer-term pricing is too pessimistic on the energy sector as capital spending cuts have been dramatic and we believe that supply and demand will move into balance in the second half of the year. Meanwhile, we have maintained our neutral view on industrial metals as improvements in sentiment towards the Chinese economy are likely to support prices in the short-term. However, there remains ample supply across most base metals. For agriculture, our base case is that prices are likely to trade sideways given the tug between supply and prospects for adverse weather due to La Niña. On precious metals, specifically gold, we have retained our positive view as US real rates continue to push lower as downside risks to global growth means that the Fed is willing to tolerate higher inflation risks.

Table 1: Asset allocation grid – summary

Equity	0	Bonds	0 (+)			Alternatives	+ (0)	Cash	0(-)
Region		Region		Sector		Sector			
US	0(+)	US Treasury	0	Government	0	UK property EU property	- (0) +		
Europe ex UK	-	UK Gilts	0	Index-Linked	+(0)	Commodities	+(0)		
UK	+(0)	Eurozone Bunds	+(0)	Investment Grade Corporate	0 (+)	Gold	+		
Pacific ex Japan	0	Emerging market debt (USD)	0	High yield	0 (+)				
Japan	- (0)								
Emerging Markets	0								

Key: +/- market expected to outperform/underperform (maximum ++ to minimum - -) 0 indicates a neutral position. The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. Last quarter's GMP positioning in brackets. Source: Schroders, July 2016.

Regional Equity Views

Key Points

0	Equities	
0(+)	US	<p>We have downgraded the US market to neutral as valuations have become richer and have not adequately discounted the potential uncertainty from the upcoming US elections and the Fed's continued path of policy normalisation. The cyclical environment also presents a more challenging earnings outlook particularly given optimistic consensus expectations for 2017.</p> <p>Nonetheless, the high-quality and more defensive nature of the US market makes it attractive to hold and supports a higher than average valuation compared to the rest of the world.</p>
+ (0)	UK	<p>The fall in investment and hiring plans as companies consider the effect of Brexit will likely lead to a slowdown in UK growth, particularly in 2017 where we have markedly downgraded growth expectations. However, more accommodative policy is assumed to soften the impact with the BoE cutting interest rates. The government is set to abandon the 2020 budget surplus rule with the likelihood of larger fiscal deficits.</p> <p>Meanwhile, a significantly weaker sterling should provide tailwinds for multinationals and some relief for UK corporate earnings. Hence, we have turned positive on the FTSE 100 amid the current economic uncertainty.</p>
-	Europe ex UK	<p>Despite the ECB's ultra-accommodative policy, which could provide some support to the economy, we have kept our underweight on European equities. We believe that negative interest rates are likely to be harmful to the profitability of banks and be a headwind to the broader market.</p> <p>This market is also the most exposed to the potential spread of contagion after the EU referendum result in the UK. Indeed, political risk is likely to take centre stage in the region with the Italian referendum on the constitutional reform later in the fall and general elections in the Netherlands, France and Germany next year.</p>
- (0)	Japan	<p>We are still concerned that consensus forecasts for Japanese earnings are too optimistic and fail to make adequate provisions for the strength of the yen on corporate margins, which could lead to the potential for earnings disappointment.</p> <p>While the cyclical environment warrants more stimulus measures from the authorities, the BoJ is approaching the limits of policy effectiveness. Unless we see bold moves from the BoJ or Prime Minister, Abe honour his promises on meaningful fiscal action in the autumn, we have turned negative on the market.</p>
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	<p>We remain neutral on Pacific ex Japan equities given unconvincing valuations and weak price momentum in Hong Kong and Singapore. Although the Australian market offers high dividends and attractive valuations.</p> <p>Earnings momentum also remains relatively poor compared to elsewhere, although the more dovish stance by the Fed and scope for further policy easing in China are expected to be supportive factors in the near term. Overall, we maintain our neutral score in the absence of a medium-term growth catalyst.</p>
0	Emerging Markets	<p>The decline in EM exports suggests that the environment for EM equities remains challenging as the region is a levered play on the global economy.</p> <p>However, investors' sentiment towards the market has improved due to the weakness in the USD and the recovery in commodity prices. EM price-earnings multiples have also adjusted a long way to reflect a subdued outlook for the global economy. Our forecasts suggest that the growth differential between the EM versus developed market is likely to increase in favour of EM, which should offer support to EM multiples and relative performance.</p>

Key: +/- market expected to outperform/underperform (maximum ++ minimum --) 0 indicates a neutral position.

Fixed Income Views

Key Points

0 (+)	Bonds	
0	Government	<p>Amongst the bond markets, we have retained our neutral view on US given the balancing act between the continued dovish rhetoric from the Fed and a central bank compelled to eventually tighten monetary policy given the strengthening in the labour market. We expect the Fed to hike rates later in the year thus the short-end remains vulnerable to adjustments as yields have moved a long way. Although, we also recognise that the longer-end of the US curve could benefit from safe-haven flows from the increased political uncertainty over the next 12 months.</p> <p>After the EU referendum result, prices of UK Gilts have rallied on the back of safe haven flows and recession concerns. However, we retain a neutral view as the slowdown in the UK economy and monetary easing by the BoE are now priced in.</p> <p>We have turned positive on German Bunds as we prefer these bonds over US Treasuries given the former is particularly supported by ECB buying. The weaker USD is also likely to lift inflation expectations in the US while a stronger euro is likely to do the reverse.</p> <p>In spite of the unattractively low and negative yields, we continue to hold a neutral view on the medium to long-end of the Japanese yield curve given the aggressive support from the BoJ and low inflation expectations.</p>
0 (+)	Investment Grade (IG) Corporate	<p>We have downgraded US investment grade bonds to neutral over the quarter as we believe that this sector is in the late cycle phase where most of returns will come from carry rather than further yield spread compression. We see better technical support with investor inflows and higher quality issuance, though valuations are in-line with historic levels.</p> <p>Yield spreads have tightened considerably following the announcement of the ECB's Corporate Sector Purchase Program (CSSP), making valuations less attractive than earlier in the year. Although we believe that the CSSP effectively puts a cap on how far spreads can widen, the current elevated level of valuations means we remain neutral.</p>
0 (+)	High yield (HY)	<p>US high yield has benefitted from the recovery in oil prices and more dovish comments from the Fed. However, we have downgraded this credit sector as the valuation story is no longer as compelling as spreads have tightened significantly. In addition, there has been some further deterioration in corporate fundamentals with rising leverage and lower interest rate coverage.</p> <p>On European HY, we remain neutral. While ultra-accommodative policy from the ECB should be positive for carry, spreads remain firmly anchored around their long-term averages and valuations appear to be unattractive at current levels.</p>
0	USD-Denominated Emerging market Debt (EMD)	<p>We remain neutral on EMD USD bonds. Instead, we prefer harvesting the carry in EMD local currency bonds given the attractive real yield. With falling inflation expectations within some of the countries in the universe, there is scope for more policy easing or less aggressive rate hiking by central banks. Meanwhile, the recovery in commodity prices and improved sentiment towards the Chinese economy in the short-term has alleviated some of the downside risks.</p>
+ (0)	Index-linked	<p>We have turned positive on US and UK inflation-linked bonds. Real yields continue to fall and inflation expectations could be lifted by CPI base effects and the recovery in commodity prices. In the UK, the significant weakness in the currency and easier monetary policy is expected to feed through into higher inflation.</p>

Key: +/- market expected to outperform/underperform (maximum ++ minimum --) 0 indicates a neutral position.

Alternatives Views

Key Points

+	Alternatives	
+ (0)	Commodities	<p>We have upgraded commodities given the meaningful reduction in supply particularly in the energy market. We believe longer-term pricing is too pessimistic in the energy sector as capital spending cuts have been dramatic such that supply and demand will move into balance in the second half of the year.</p> <p>We have retained our neutral stance on industrial metals but with a downward bias. This complex is still oversupplied and should remain in surplus over the year. In particular, prices remain above the marginal cost of production given the currency depreciation in producing countries. However, prices are likely to be supported in the short term given improvements in sentiment towards the Chinese economy.</p> <p>Major grains in the agriculture sector are in abundant supply, but farmers are coming under increasing financial pressure from low prices, which may also impact supply. While prospects for adverse weather remain due to La Niña (periods of below-average sea surface temperatures), the outlook has not deteriorated sufficiently to support wheat and corn prices. We therefore remain neutral.</p> <p>We remain positive on precious metals, specifically gold. US real yields continue to push lower as downside risks to global growth means that the Fed is willing to tolerate higher inflation risks. This is supportive for gold as it reduces the opportunity cost for investors to hold this asset. At the same time, gold could be a beneficiary of safe-haven flows given the increased in political uncertainty globally.</p>
- (0)	UK Property	<p>In the investment market, the weakness in GBP could attract more foreign investors although their appetite is heavily influenced by prospects for the UK economy and for rents. We believe that both domestic and foreign investors will sit on their hands in the short-term such that there will be a significant drop in transactions until there is greater clarity over the political landscape.</p> <p>Meanwhile, office rents in central London could fall over the next 1-2 years as firms move some of their operations to the EU and attempt to sub-let the surplus space. Rental growth in other sectors could pause, as businesses put off signing leases. In addition, real estate yields could rise as investors downgrade their expectations for future rental growth and shift their attention to other countries with less political risk.</p> <p>Looking ahead, it is still too early at this stage to say how far capital values could fall. However, the UK and in particular, the London investment market is very transparent and prices tend to adjust and find a new equilibrium fairly quickly. The market is also better placed now to withstand a shock than in 2007, given the low level of vacancy in most office and industrial markets, the large premium in yields over 10-year Gilts and most recent purchases have been funded by equity rather than debt, so that there should be relatively few distressed sellers.</p>
+	European Property	<p>There are some signs that activity is moderating in the investment market as prime retail and office yields in most big cities have levelled off in the first quarter of 2016. While this could signal a negative shift in sentiment, we think it is more likely that investors are simply taking stock after a busy 2015. Despite the recent compression in yields, real estate is still priced relatively attractively, given the large yield premium over government bonds, and the prospect of steady rental growth over the next few years. Moreover, we believe investors are aware of the political risks post Brexit but are unlikely to reduce their appetite for core European property. Indeed, it could increase if some of the capital destined for the UK is now switched to the continent.</p> <p>We forecast that total returns on average investment grade European real estate to average 7-8% per year to the end-2020. The majority of performance will come from the income return of around 5%, but capital values should also be supported by a steady increase in rents.</p>

Note: Property views based on comments from the Schroders Real Estate Research team.

Key: +/- market expected to outperform/underperform (maximum ++ minimum --) 0 indicates a neutral position.

Economic View

Central View

Forecast update and scenarios: modest growth with rising political risk

After a series of downgrades, our forecast for global growth in 2016 is unchanged at 2.5%. The principal impact of Brexit will be felt in the UK where we have cut our growth forecasts in half for next year. Eurozone forecasts have also been reduced as a result of weaker demand from one of its biggest trading partners and the increase in uncertainty brought about by the referendum result. These effects will feed a broader slowdown in trade and activity in 2017, but the overall global effects are not great given the size of the UK in the world economy.

For the UK, we have revised down our 2016 GDP growth forecast from 1.9% to 1.6%. It is worth mentioning that this appears smaller than in reality due to an upward revision to second quarter GDP (pre-Brexit) due to production and construction data. The impact of Brexit is more visible from the 2017 forecast, which has been revised down from 1.6% to 0.8%. As with the UK forecast, we have lowered the Eurozone GDP forecast from 1.7% to 1.6% for 2016, and from 1.6% to 1.3% for 2017. This is driven by expectations of reduced exports to the UK as demand there slows, but also slightly lower investment growth.

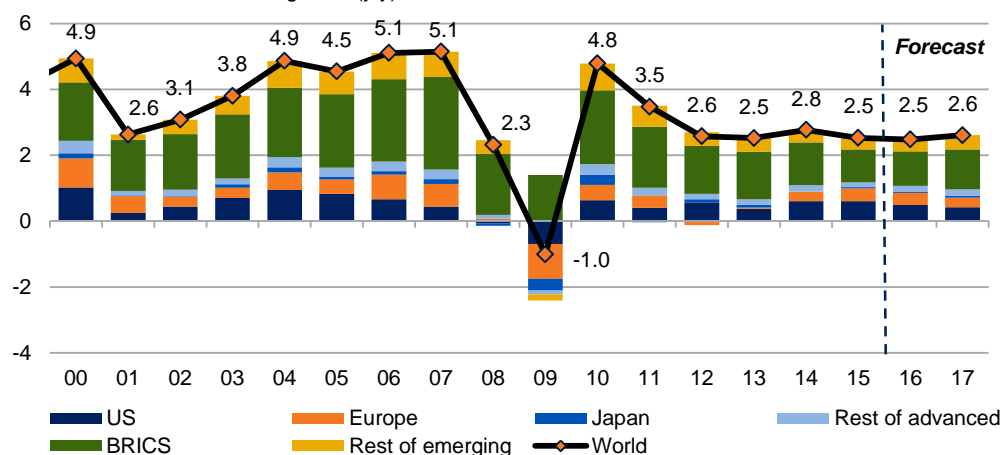
In the Emerging Markets, forecasts remain broadly unchanged post Brexit. The drag on growth looks small but there is a risk to growth for some economies, although the inflationary effects will be limited, allowing for supportive monetary and fiscal policy. The hardest hit economies are likely to be those in Europe with Asia and especially Latin America look likely to be insulated. Amongst the BRICs, the outlook is a mixed bag following a poor first quarter in Brazil, but a surprisingly strong one in Russia. A small upside surprise in China also prompts an upgrade but we remain of the view that growth will continue to decelerate this year and next. India is still the best growth story in the group and indeed of any large emerging market, though reform progress is still modest at best.

Global inflation is forecast to rise to 2.2% this year and to 2.5% in 2017. The forecast for next year is partly influenced by the forward profile of oil prices (the oil curve is higher but less steep) and by our view that we will not see significant second round effects from higher inflation into wages.

In terms of monetary policy, we expect the next US rate rise in December and Fed funds to rise to 0.75% by end-2016 and 1.25% by end-2017. Further easing is expected by the ECB, but we also see more targeting of the periphery through frontloading quantitative purchases (QE), or possibly Outright Monetary Transactions (OMT). The PBoC is assumed to cut interest rates and the reserve requirement ratio over the forecast period. In Japan, fiscal support and the further delay in the consumption tax relieve some of the pressure on the BoJ. However, we do expect them to start experimenting with helicopter money drops towards the end of 2017.

Chart 1: Global growth and forecast for 2016 and 2017

Contributions to World GDP growth (y/y), %



Source: Thomson Datastream, Schroders Economics Group, 30 June 2016.

Economic View (continued)

Macro risks: Scenario analysis

Full details of the scenarios can be found on page 11. The risks to our base case are skewed towards a weaker growth outcome versus the baseline.

We have made some significant changes to our scenarios this quarter. Political risks have risen and in response we are adding in a “Trade wars” scenario and a “Brexit shakes Europe” scenario.

“**Trade wars**” is based on the election of Donald Trump as president of the US, which brings a significant increase in tariffs on imported goods. Mr Trump has consistently targeted China and companies who have outsourced supply chains overseas. Expect a Trump administration to increase trade barriers and for rapid retaliation from those that have been hit, with the result that global trade contracts whilst inflation is pushed higher.

The second new scenario follows from the UK’s vote to exit the EU, which galvanises anti-EU support across Europe and results in a number of similar referenda across the continent. The resulting increase in uncertainty slows growth as companies postpone major investments and households delay purchases of big ticket items, much as we are seeing in the UK currently.

In terms of their impact on global activity, both new scenarios are ultimately seen as stagflationary. In the “Trade wars” scenario this is clear cut as higher inflation from tariff increases makes goods more expensive and hence reduces the volume of transactions. At a higher level, the allocation of resources will also be less efficient resulting in weaker growth and higher prices.

The impact of the “**Brexit shakes Europe**” scenario is more complex: the initial shock is deflationary as European domestic demand falls, but this then gives way to higher inflation in Europe as the GBP and EUR depreciate significantly. Softer commodity prices result in weaker currencies and higher inflation in the emerging markets. At the global level, this is mildly stagflationary, but we would see this scenario as being deflationary for economies like the US and Japan with the key takeaway being one of weaker global growth.

On the deflationary side we have retained “**China hard landing**” and “**US recession**”. The former is now driven by a wave of debt defaults and the seizing up of the banking system, rather than via an equity market collapse as before. Investors are currently focused on the extraordinary growth of debt in China and are asking how this can be unwound without a crisis. Meanwhile, the US recession scenario is still driven by the slowdown in profits growth which feeds through into weaker capital spending and employment.

We have dropped the deflationary “**Emerging markets (EM) defaults emerge**” scenario. Although the risk remains, the number of defaults has been slow to materialise as governments have intervened and the pressure on many companies is now being relieved by the rally in commodity prices.

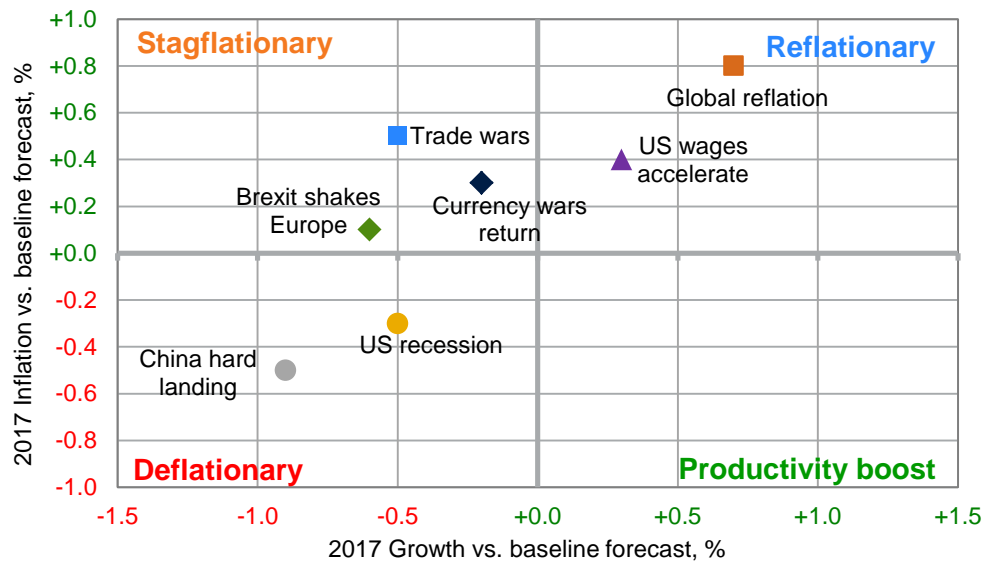
Note that the “**Currency wars return**” scenario has moved from the deflationary to the stagflationary box as a result of the change of time horizon (chart 2 on next page). Initially deflationary as a result of the increase in financial market volatility, the scenario becomes more stagflationary as inflation rises through weaker currencies. As with the “Brexit shakes EU” scenario, we would characterise this as more deflationary with currency moves generally cancelling each other out, while global activity suffers from increased uncertainty and financial market volatility as countries pursue beggar-thy-neighbour currency moves.

On the reflationary side we retain the “US wages accelerate” and “**Global reflation**” scenarios. The latter reflects a coordinated fiscal stimulus to growth by the major economies along the lines being called for by the International Monetary Fund (IMF) and Japan ahead of the recent G7 summit.

Economic View (continued)

Arguably we could have dropped the “US wages accelerate” scenario given the lack of progress in this area. However, the US labour market remains tight and higher headline inflation is likely to raise inflation expectations as we have already seen in the financial markets. We are assuming a modest wage acceleration in the baseline and this scenario pushes that further with US wages, currently running at around 2.5% for average hourly earnings, picking up to a 4% pace by end-2016 and 5% by end-2017. Note that although categorised as reflationary, this scenario is ultimately stagflationary as the Fed tighten more aggressively (raising rates to 3% by the end of 2017).

Chart 2: Scenario analysis – global growth and inflation impact

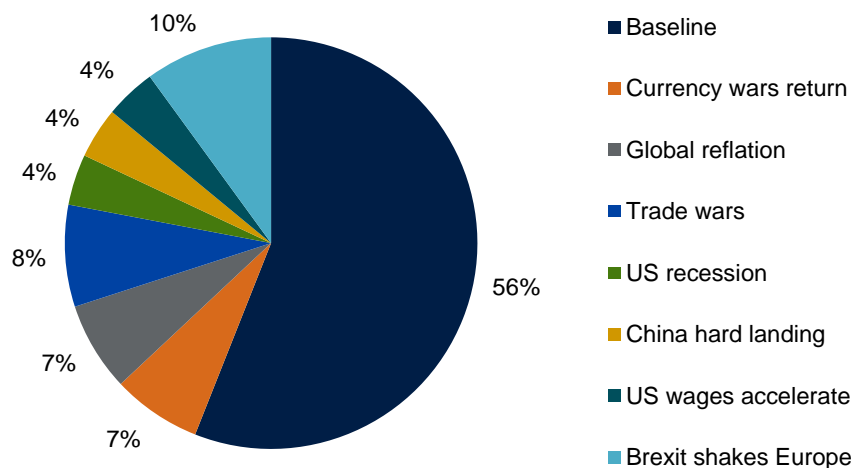


Source: Schroders Economics Group, 30 June 2016.

Chart 2 summarises the impact each scenario has on global growth and inflation relative to the baseline. There is a bias towards weaker growth outcomes with five scenarios, representing a combined probability of 33%, demonstrating growth lower than the central scenario.

Like last quarter, there are no scenarios that fall in the productivity boost category (higher growth and lower inflation than the baseline). The probability of a reflationary scenario is unchanged at 11%.

Chart 3: Scenario probabilities (mutually exclusive)



Source: Schroders Economics Group, 30 June 2016.

Economic View (continued)

Table 2: Scenario summary

Scenario	Summary	Macro impact
1. Currency wars return	After a period of truce, the currency wars return as China devalues the Chinese Yuan (CNY) by 10% in Q3 in a large one-off move. Japan, which counts China as its largest trading partner, responds by devaluing the JPY by 8%. This is likely to be achieved through a combination of rate cuts and increased QQE. Finally, the ECB responds by stepping up its own QE programme and pushing the EUR down by 10%. With financial markets unnerved, weaker equity markets result with a further knock on effect to activity through negative wealth effects and weaker investment as growth expectations decline.	Mild deflation: The impact on the world economy is modestly stagflationary with mixed results between those devaluing and those not. Inflation is pushed up in Europe, China and EM, whilst the US and UK experience weaker growth and lower inflation. Overall the global effects are not great as much of the moves in exchange rates cancel each other out. However, the USD does strengthen as a result of each devaluation thus putting deflationary pressure on the US. There is also a general deflationary effect on activity from heightened financial market volatility.
2. Global reflation	Frustration with the weakness of global activity leads policy makers to increase fiscal stimulus in the world economy. This then triggers an increase in animal spirits which further boosts demand through stronger capex. Global growth exceeds 3% in 2016 and 2017. However, higher commodity prices (oil heading toward \$70 per barrel) and tighter labour markets push inflation up by 0.5% in 2016.	Reflationary: Stronger growth and higher inflation compared to the baseline. The US Fed raises rates to 3% by end-2017 and starts to actively unwind QE by reducing its balance sheet. Higher wage and price inflation is welcomed in Japan as the economy approaches its 2% inflation target. This is likely to lead the BoJ to signal a tapering of QQE, but no increase in interest rates. Inflation concerns result in tighter monetary policy in the emerging markets with all the BRIC economies raising rates.
3. Trade wars	The election of Donald Trump as President brings a more protectionist tone to US trade policy with a significant increase in tariffs. Other countries retaliate and the world economy descends into a trade war.	Stagflationary: Higher tariffs push up inflation and reduce demand thus pushing the world economy in a stagflationary direction. Countries which are dependent on international trade are most vulnerable in this scenario.
4. US recession	Slower profits growth causes a retrenchment in the corporate sector which cuts capex and jobs. Consequently, the US economy tips into recession towards end of the year 2016. Corporate confidence and the equity market are badly hit, resulting in widespread retrenchment. Weaker demand from the US hits global activity.	Deflationary: Weaker global growth and inflation compared to baseline as the fall in US demand hits activity around the world. The fall in inflation is given added impetus by a drop in commodity prices, which then adds to pressure on energy and mining companies and producers. The Fed has to reverse course by December 2016 when rates are cut back again and the QE programme restarted. Interest rates are generally lower around the world.
5. China hard landing	A wave of bond defaults and losses for households shakes faith in the financial system resulting in capital flight and a seizing up of the lending machinery. The government ultimately acts, alongside the PBoC, to restore solvency, but not before the dearth of credit and forced devaluation have hit both the Chinese and world economies. Growth in China slows to 3% in 2016 and remains under 4% for most of 2017.	Deflationary: Global growth slows as China demand weakens with commodity producers hit hardest. However, the fall in commodity prices will push down inflation to the benefit of consumers. Monetary policy is likely to ease or stay on hold while the deflationary shock works through the world economy.
6. US wages accelerate	Tight labour markets and rising headline inflation cause wages to accelerate faster than in the base in the US, parts of Europe and Japan. Consumer spending initially accelerates compared to the base, but inflation also picks up further out.	Reflationary in 2016 and 2017: stronger growth and higher inflation compared to the baseline. Better growth in the US provides a modest stimulus to activity elsewhere, however this is likely to be tempered by a more volatile financial environment with long yields rising as inflation expectations rise and the Fed tightens more aggressively.
7. Brexit shakes Europe	The UK votes to leave the EU in June which galvanises anti-EU support across Europe. Large and widespread protests follow with as anti-establishment parties gain momentum. In an effort to head-off losses in upcoming elections, many member states (France, Germany, Italy, Netherlands) announce their own EU referendums, jeopardising the whole European Union and euro projects. Note: this is not our central view in the event that the UK votes for Brexit.	Lower growth vs. baseline. Investment across Europe stalls as political risk dents confidence. Consumers also retrench causing demand for imports from the rest of the world to fall. Both GBP and EUR fall sharply, helping to boost net trade for Europe, but to the detriment of EM and the US. Policy is loosened further in Europe, and with the currencies depreciating, inflation is higher vs. the baseline. However, this is ultimately a deflationary shock, which is felt elsewhere in the world initially.

Source: Schroders Economics, 30 June 2016.

Mid-year performance review

Marcus Jennings
Economist

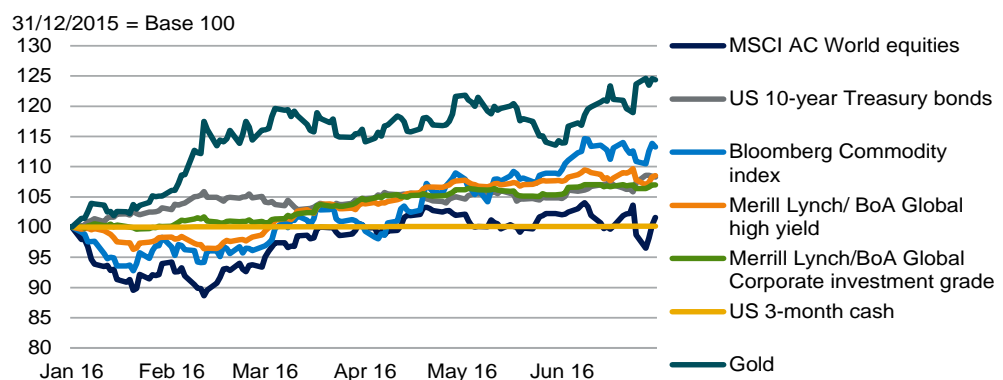
Gold rallied as
real yields have
remained
suppressed

In the first half of 2016 investors repeatedly pushed out their expectations of further rate rises in the US. Simultaneously, the ECB provided more stimulus via the launch of its corporate sector purchase program and a reduction in its main policy rate in an effort to boost inflation. This had the effect of dampening real yields, acting as a support for gold, with the precious metal ending the first half of the year up 24.4%. In addition to this, concerns over a US recession and China woes in Q1 further helped boost the price of gold. The broad commodity complex had a weak start to the year, facilitated by the fall in the oil price which originated in 2015 continuing into early 2016. The price of oil soon recovered sharply and pulled the Bloomberg Commodity Index higher to end the first half (H1) of 2016 up 13.3%. In a similar fashion, global corporate high yield debt sold off in January and February amid fears that the falling oil price would lead to a rise in defaults in the high yield sector. Spreads have narrowed more recently as the oil price has recovered, with spot WTI settling between \$40 and \$50 per barrel for much of Q2 2016. Consequently global high yield returned just over 8.6% in the first six months of 2016.

A combination of a dovish Fed, mixed US economic data and heightened global risk aversion in the lead up to the UK's referendum on EU membership underpinned the performance of US Treasuries. Ultimately, the UK's decision to leave the EU provided further support for Treasuries in late June as investors went in search for safe havens. As a result of these factors, and with the market progressively pricing out any possibility of a US rate rise in 2016, 10-year Treasuries rallied 8.3%. By comparison, global investment grade corporate debt failed to outperform either Treasuries or global high yield having gained 7% over the same timeframe.

Aside from cash, world equities have underperformed returning just 1.6% in US dollar terms in H1 2016. A falling oil price, taken by some as evidence of weak global demand, in combination with growing US recession fears weighed on investor sentiment initially in 2016. As both factors faded, together with EM economies showing some signs of stabilisation, global stock markets gradually recouped much of their early losses by April. Beyond this equities were unable to rally further, with Brexit most recently negatively influencing many developed market stock indices.

Chart 4: H1 2016 performance in key asset markets (USD)



Source: Thomson Datastream, Schroders Economics Group. 30 June 2016.

European
equities have
sold off, in part
to Brexit fears

The first half of the year has not been kind to equities as the majority of major equity indices have posted negative total returns (in USD). At the bottom end of the spectrum, European stock markets rank the lowest in terms of total return performance. Brexit fears and the further risk of a wider Eurozone breakup limited European equity performance for much of the first half of the year, with the latter risk rising post 23 June. The European core held up slightly better than the periphery in H1, as the DAX30 and CAC40 fell 7.6% and 3.4%, respectively, whilst FTSE MIB and IBEX35 declined 19.6% and 9.9%, respectively, all in USD terms. Concerns over the health of the Italian banking sector weighed on Italian stocks in particular. The FTSE All Share fared better, declining 5.0% in dollar total return terms. Although returns in local currency were positive, the sell off in sterling throughout the first half of the year was more than sufficient to lead to an overall negative dollar based return.

Mid-year performance review (continued)

Local currency returns in Japan were poor following yen strength

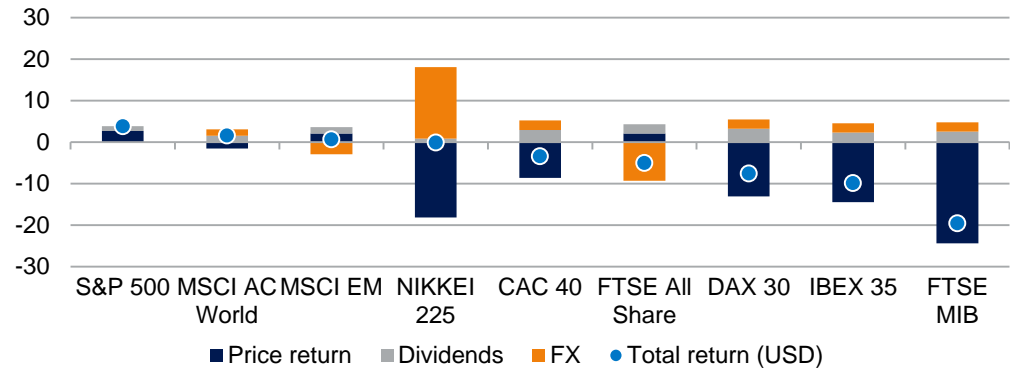
In contrast to most regions and despite the US economy being relatively rich on valuations, the S&P 500 managed to return 3.8% in H1 2016. Its tendency to be a low beta market compared to other indices provided a natural safe haven for investors wanting equity exposure but limited downside risk to global risk events such as Brexit.

In spite of additional easing by the Bank of Japan, the yen rallied against the US dollar in H1 2016, which mainly led to the NIKKEI 225 to decline 17.3% in local currency terms. For US dollar based investors however, the total return on the Japanese index was largely flat at just -0.1%.

Finally, in USD terms, emerging markets equities underperformed world equities by 0.9% points in the first two quarters of the year, returning just 0.7%. The negative contribution from the currency was more than offset by positive domestic returns, supported by a recovery in commodity prices in Q2.

Chart 5: H1 2016 equity market returns by region (USD)

Returns calculated 31/12/2015 to 30/6/2016



Source: Thomson Datastream, Schroders Economics Group, 30 June 2016.

Global strategy: Brexit implications and investing in an environment of rising political risk

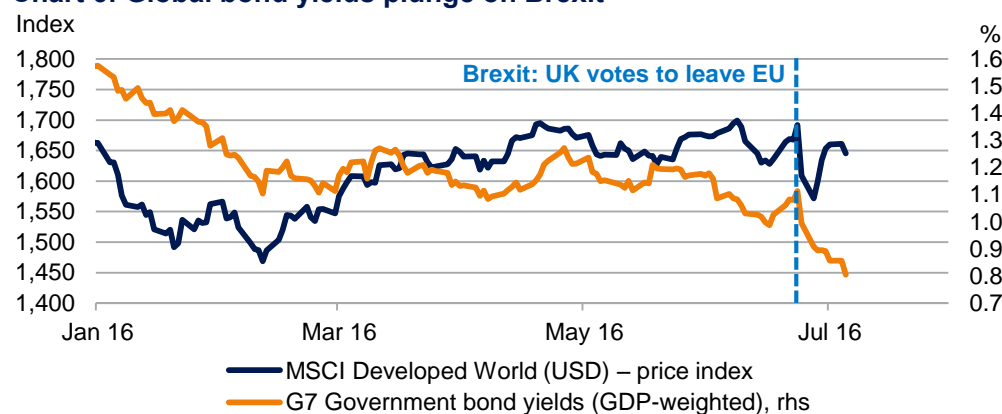
Keith Wade
Chief Economist
and Strategist

Risk aversion soars in the wake of the UK referendum vote to leave the EU

Economics seems to have taken a backseat recently as political risk has dominated markets. The UK's decision to vote to leave the EU in the referendum on June 23rd has sent shockwaves through financial markets. Although the opinion polls had been very close and actually pointed to a small majority in favour of leaving the EU just prior to the poll, the betting markets had put a high probability on a remain vote. Investors were generally wary, but many went with the betting money as they assumed that people would vote for the status quo when faced with an alternative which could materially damage their economic well being.

The outcome prompted a massive increase in volatility with the pound sterling moving more in the space of a few hours than it had in the course of the whole of last year. Risk aversion increased: equity markets fell around the world, whilst government bond yields fell sharply (chart 6). In the currency markets, the US dollar and safe haven currencies such as the Japanese yen strengthened.

Chart 6: Global bond yields plunge on Brexit



Source: Thomson Datastream, Schroders Economics Group, 6 July 2016.

At the time of writing, 10-year government bonds in the US, Germany, Japan and the UK are trading at record low yields. According to JP Morgan 31% of the developed government bond market was trading on a negative yield, equivalent to \$8.3 trillion as at 21 June. Since then the figure has increased.

Macro impact: an EU domino effect?

The Brexit vote is significant not just for the UK, but for the wider EU and for what it says about the deeper forces at work in the world economy. In terms of the immediate macroeconomic outlook, the UK is directly affected and we are sticking with the view discussed before the vote where Brexit leads to UK GDP growth being cut to 0.8% for 2017, around 1 percentage point weaker than in the event of a status quo or remain vote.

Weaker investment is the principal source of the slowdown as businesses and consumers will wait for clarity on the UK's new trading arrangements before committing themselves. This will take some considerable time given the differences between the UK and EU over free movement of labour seen as a pre-condition for any deal. More immediately, the UK needs to define its negotiating stance under new Prime Minister, Theresa May, following the resignation of David Cameron.

As for the broader impact, there is the risk that Brexit leads to a domino effect where other countries in the EU hold referendums on their membership with the result that we get a "Frexit", "Departugal" or "Czechout" (to name a few). We describe such an outcome in our "Brexit shakes EU" scenario where Brexit leads to a break up of the EU and a substantial fall in activity such that global GDP is 0.6% weaker next year than in the baseline.

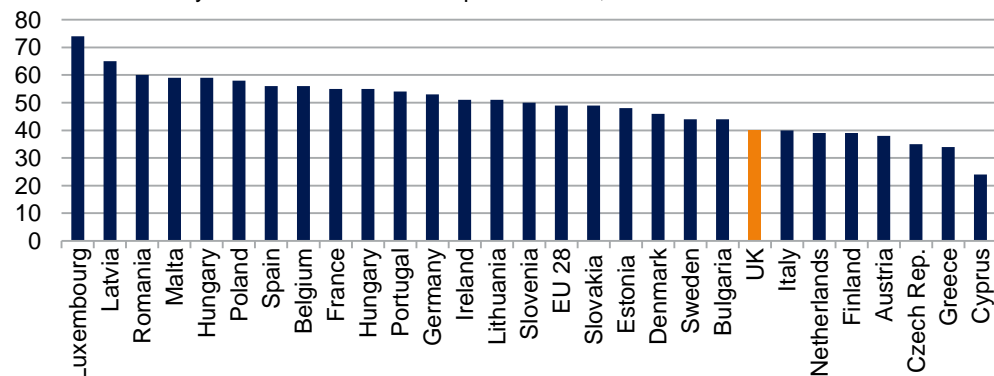
Brexit fells UK Prime Minister and UK growth forecasts

Global strategy (continued)

The threat can be seen in the regular Eurobarometer surveys undertaken by the EU, which show that the UK is not the most eurosceptic of the 28 members. The UK is below the EU average in terms of attachment to the EU, ranking alongside Italy whilst three “core” countries, the Netherlands, Finland and Austria, all feel less positive than the UK. Not surprisingly, Greece and Cyprus feel the least attachment to Brussels (chart 7).

Chart 7: The UK is not the most eurosceptic nation

How attached do you feel towards the European Union?, %

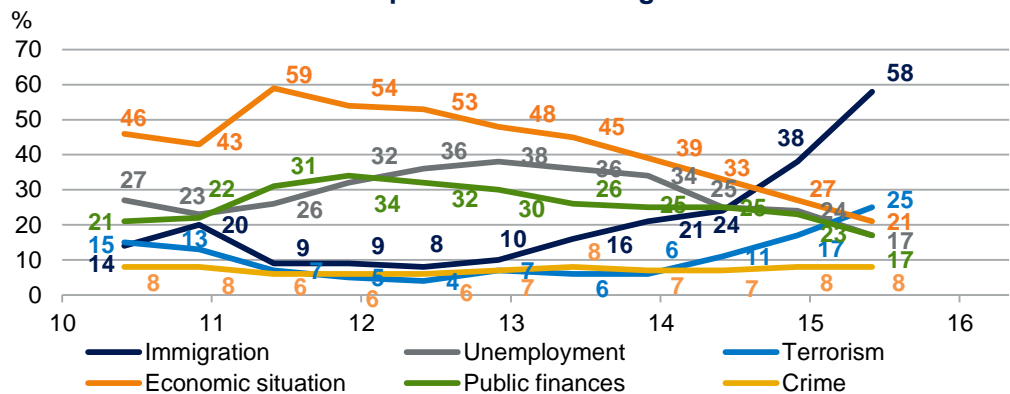


Source: Standard Eurobarometer report No.84 Autumn 2015, Schroders Economics Group.

Immigration is a major source of concern in the EU

In terms of the source of dissatisfaction, immigration is clearly the biggest concern and is cited by 58% as the most important issue facing the EU (chart 8). Many believe that this issue was decisive in the UK vote, with the leave camp emphasising the loss of border control as a result of EU membership. Clearly others could tap the same sentiment across the EU if the Eurobarometer survey is to be believed, although arguably the concern here is more focussed on asylum seekers. Hungary has subsequently announced that it will hold a referendum in October on the ability of the EU rather than its own Parliament to settle immigrants in its member states.

Chart 8: What is the most important issue facing the EU?



Source: Standard Eurobarometer report No.84 Autumn 2015, Schroders Economics Group.

So is an EU breakup likely? The risk has clearly increased but it is not our central views for two reasons.

First, we would expect the EU to react to Brexit by pulling together strongly. In particular, Germany and the core countries are likely to become more accommodative toward the periphery. Breaches of fiscal policy will be tolerated and less immediate pressure will be exerted from Brussels for structural reform. We would see the response to the recent breach of the fiscal deficit rules by Spain and Portugal as a key test in this respect with EU finance ministers expected to show greater leniency than in the past. Another test would be whether the EU allows the Italian government to use public funds to bail out its banking sector (see below).

Global strategy (continued)

EU break-up a risk, but expect the union to pull closer together

Meanwhile, pressure from the periphery for a softer stance is already building with Greek Prime Minister Alexis Tsipras quoted in a BBC article as saying that the UK vote was “either a wake-up call or the beginning of a dangerous path”. He added: “We urgently need a new vision and beginning for a united Europe - for a better Europe, more social and democratic.”¹

Second, after the UK experience, no mainstream leader in their right mind would be prepared to grant a referendum on such a complex issue based on a simple majority². The UK has learnt the hard way; others will take note.

Markets and monetary policy: central banks step in (again)

Another contagion channel from Brexit to the rest of the world would be through the market reaction. Risk assets have begun to stabilise but the decline in equity prices and widening in bond spreads will result in negative wealth effects and an increase in the cost of capital for more risky borrowers. These moves also hit confidence, and will dampen consumption and investment spending. Clearly, this represents an immediate risk and the central banks have reacted swiftly with the BoE promising up to £250 billion in liquidity whilst the Fed has made dollar swap lines available.

Interest rate forecasts cut for the UK and US

As evidence of the economic fallout increases we expect the BoE to cut interest rates in August. House builders, commercial property and the banking sector are all seen as vulnerable as investors reassess the UK’s prospects post Brexit. We still expect the ECB to cut rates again, but we also see more targeting of the periphery through frontloading QE, or possibly Outright Monetary transactions.

The Fed is now expected to duck a rate increase in September. Although the authorities have moved rates ahead of a presidential election in the past, the volatility created by Brexit alongside the current febrile political atmosphere means that the central bank will probably wish to keep their heads down. We now expect the next US rate rise in December and have lowered the profile for 2017 such that rates end the year at 1.25%, implying only three 25 bps moves over the period.

The current market turmoil could persist, but it should be noted that this is not a re-run of 2008 where high levels of bank leverage resulted in contagion as banks became reluctant to lend to each other. Despite the recent drop in bank share prices, we do not see the conditions for a systemic crisis such as that which brought down the entire financial system in 2008.

The strengthening of the financial system since the crisis with the build up of capital and reduction in leverage has enabled the banking sector to withstand such shocks better. The reaction of the central banks has also helped in preventing a funding crisis in the sector. The current episode is still problematic for banks though as it means that the period of low interest rates will persist for longer as seen in the flattening of yield curves, a factor which undermines the profitability of bank lending. For those countries with negative interest rates the problem is particularly acute with many banking models under threat should negative rates persist.

The rise of the populists

In terms of the broader implications, the Brexit vote can be seen as a warning not to underestimate the depth of populist feeling. Many voted for leave as they felt ignored and saw it as a way of changing the status quo.

¹<http://www.bbc.co.uk/news/world-europe-36618317>.

²Note that on a turnout of 72.2% only 37.4% of the UK electorate actually voted to leave the EU, one reason why important referendums elsewhere often require a supermajority so as to avoid a “tyranny of the majority”. See <http://www.ncsl.org/research/elections-and-campaigns/supermajority-vote-requirements.aspx>.

Global strategy (continued)

Plenty of opportunity ahead for voters to express discontent with the establishment

The sense of dissatisfaction has been fuelled since the financial crisis by central bank policies, which have rewarded the rich through rising asset prices whilst those at the other end of the spectrum have faced the pressures of increased competition on wages and reduced job security from a globalised labour market. These factors are not unique to the UK.

Consequently, we need to watch for more “surprise” election results and there will be plenty of opportunity for voters to express their discontent with the establishment. The next major focus in Europe will be the Italian referendum in October (no date as yet) when voters will be asked to approve a constitutional reform which will give more power to the lower house in Italy and provide a basis for more stable government by boosting the majority of the party which gains the most votes. Whilst constitutional reform hardly sets the pulse racing, the vote has been given added significance by Prime Minister Renzi’s pledge to resign in the event that his reforms are rejected. Consequently the referendum has taken on added significance with the danger that Italy is plunged into political chaos in the event of a “No” vote.

Meanwhile, Renzi is embroiled in a battle with the EU over whether he can bail out the banking system with public money. ECB stress tests are due at the end of July and unless action is taken the Italian banks will fail. Notwithstanding an adverse market reaction, failure by Renzi to strike a favourable deal would reflect badly and reduce his chances of winning the referendum.

After this we will have the US presidential vote in November. Donald Trump has been repeatedly dismissed as a contender, but he has secured the Republican nomination. As in the EU referendum, voters have a choice between the status quo (Hillary Clinton) and a radical alternative. The tensions brought by globalisation and inequality are at least as great as in the UK. Our central case is a Clinton Presidency, but do not be surprised if “The Donald” continues to gain traction.

Looking further ahead, political attention will switch back to Europe in 2017 with elections in the Netherlands (15 March), France (7 May) and Germany (late August/September).

Macro consequences: tail risks rise

Impact on global GDP is negligible, but the risk of a worse outcome has increased

The principal economic impact of Brexit will be felt in the UK where as discussed above, we have slashed our growth forecasts for next year. Eurozone forecasts have also been reduced and these effects will feed a broader slowdown in activity in 2017, but the overall global effects are not great given the size of the UK (just over 4%) in the world economy. World activity is forecast to be just 0.1% lower in 2017 as a result.

From this perspective, it might seem that investors have little to worry about from Brexit. The UK may have shot itself in the foot, but it is not significant enough to derail the world economy. Easier monetary policy also helps soften the blow and global growth is only a tad lower.

However, such a conclusion ignores the increase in tail risks following the UK’s decision. In terms of our scenarios the vote to leave the EU increased the probability on the “Brexit shakes EU” and “Trade wars” and possibly “Global deflation”.

Brexit is significant for what it tells us about political risk: voters are angry and this will result in more populist governments and populist economic policies. The target will be globalisation and we can expect more protectionism and policies to insulate workers from the pressures of the global labour market. As in the Brexit debate, advice from the International Monetary Fund, Treasury and others will be ignored with economists being dismissed as “experts”. The Washington consensus of deregulation, small government and free trade is in retreat.

Global strategy (continued)

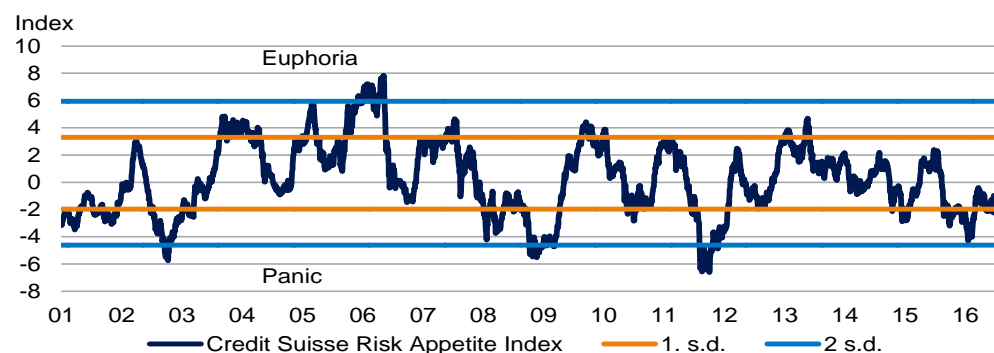
Greater political risk versus central bank liquidity and ultra-low yields on safe assets

Strategy

Investors now face a more risky political environment, arguing for a more defensive, risk averse stance. However, against this we need to weigh the increase in liquidity provided by the central banks, the extraordinary low levels of government bond yields and the cheapening in risk assets.

The Credit Suisse risk appetite index, which we have regularly discussed in past editions of the GMP, has not reached panic levels but is in negative territory thus highlighting the underperformance of equities.

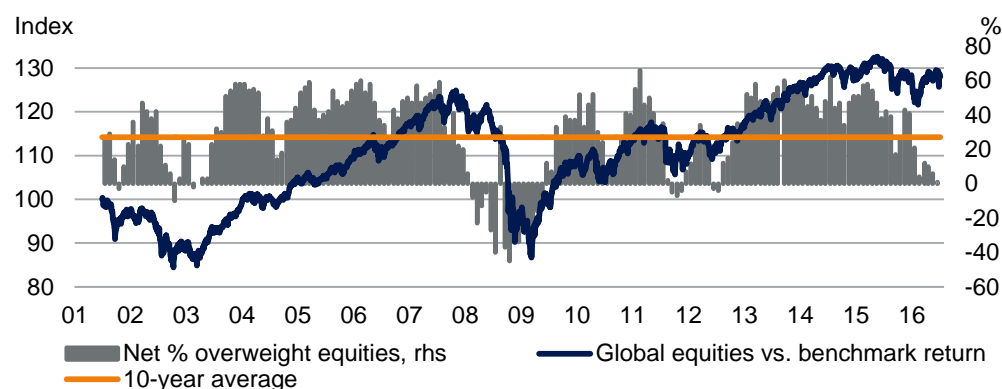
Chart 9: Risk appetite is weak



Source: Credit Suisse, Schroders, 6 July 2016.

There is also evidence that investors are already relatively cautious in their positioning with the Bank of America Merrill Lynch fund manager survey indicating the lowest overweight in equities since 2012 (chart 10).

Chart 10: Multi-asset investors are defensively positioned



Note: Global equities uses MSCI AC world (USD), benchmark is 60% equities, 30% bonds (global 10-year government bonds) and 10% US cash (3-month). Source: Bank of America/ Merrill Lynch Fund Manager Survey, Thomson Datastream, 6 July 2016.

On the macro front, as can be seen from the forecast section above, we are not predicting a global recession and the central view is for a continuation of growth, albeit at a relatively low pace compared to the past. We will see a downturn in the UK and slowdown across Europe, but more generally the activity indicators should hold up. Meanwhile, monetary policy is set to remain looser for longer.

These factors would suggest a more targeted response to political risk rather than a blanket downshift in risk appetite. Investors need to look to hedge specific risks but be mindful of the opportunities which are created elsewhere.

For example, in the current environment we would look to be short GBP as a means of playing the increased political risk premium attached to the UK post-Brexit. The view is reinforced by the significant current account deficit which was running at 6.9% of GDP in the Q1 of this year. In relying on such substantial capital inflows the UK depends on the “kindness of strangers” as Mark Carney Governor of the BoE has put it. Weak economies with large current account deficits and poor political leadership cannot expect firm currencies. Sterling has already broken through 1.40, a key low, and may now test the levels seen in the 1980’s (chart 11 on next page).

Global strategy (continued)

Brexit may have created opportunities elsewhere such as emerging market equities

Easier global liquidity helps stabilise capital flows

Chart 11: GBP may test all time lows following Brexit

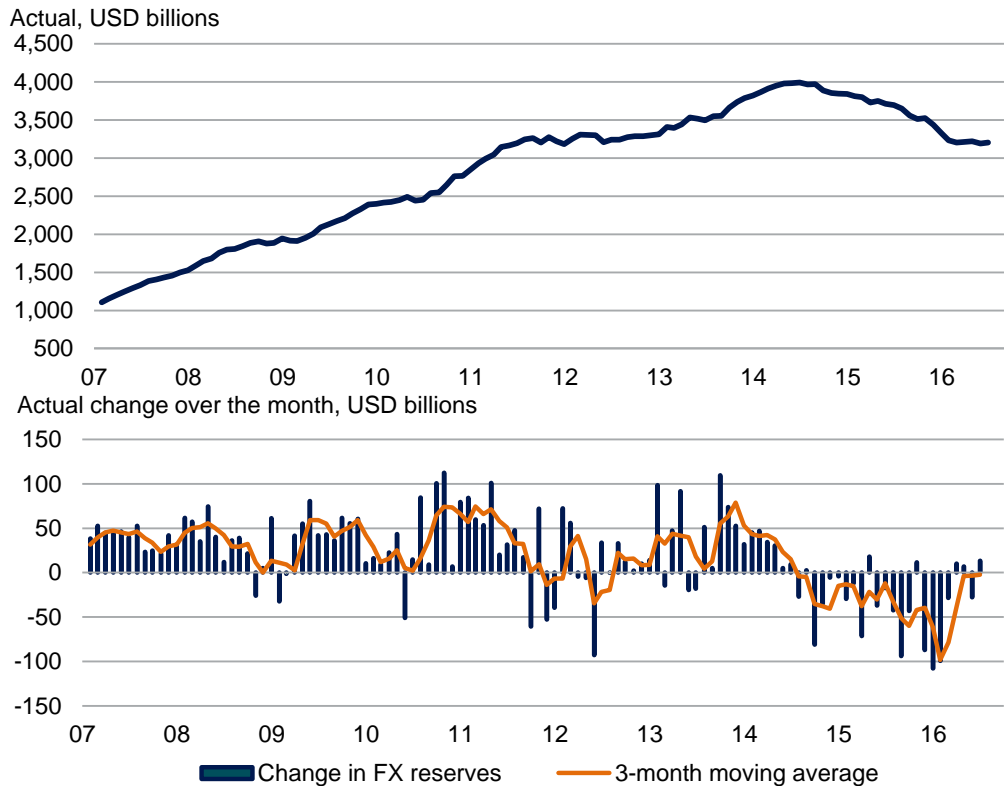


Source: Thomson Datastream, Schroders Economics Group, 8 July 2016.

Investors may also look to exploit the differential performance of large and mid/small cap UK equities in this environment with the former benefitting from the fall in the GBP whilst the latter faces the full force of the UK downturn.

In terms of opportunities elsewhere we would note that the easing of global liquidity will help the emerging markets. Emerging market bonds have already rallied strongly, but there is also scope for equities to perform. Whilst we are yet to see an upturn in global trade, commodity prices have firmed over the quarter and recent developments have helped stabilise capital flows as evidenced by the behaviour of China's foreign exchange reserves (charts 12a and 12b). On balance this makes us more constructive on emerging market equity.

Charts 12a and 12b: China foreign exchange reserves stabilise



Source: Thomson Datastream, Schroders Economics Group, 8 July 2016.

Increasing exposure to emerging markets may mean increasing risk. In the past this has often been offset with increased bond holdings. However, the ultra-low level of bond yields means they are less attractive as defensive assets and against this backdrop we will continue to hold gold and Japanese yen as hedges within our portfolios.

Global strategy (continued)

Later in the year, investor attention will switch to Italy in the run up to the referendum in October. Political risk in the US will also be in focus as the presidential election heats up and investors assess the respective merits of the candidates programmes and, critically, what a new president may be able to get through Congress. However, with the US election political risk will have global implications and unlike the Brexit, may require more than a targeted approach to hedging portfolios.

Global trade research note: From feast to famine

Craig Botham,
Emerging Markets
Economist

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Economist

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Fixed Income
Strategist

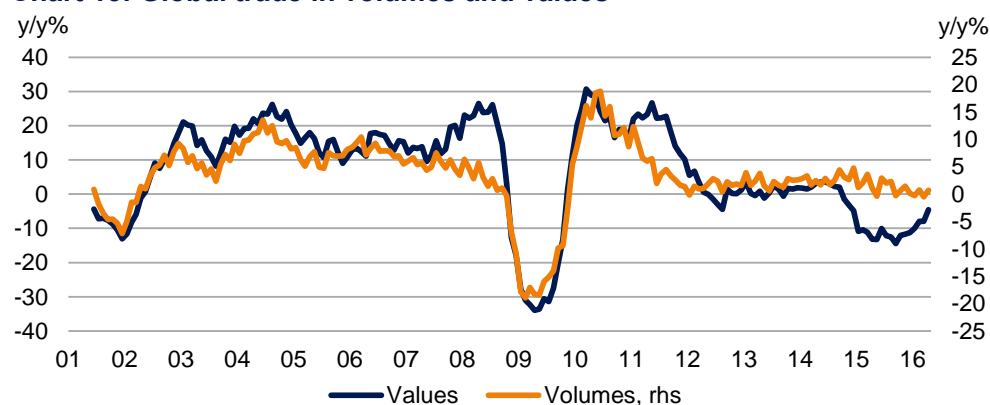
Executive summary

Global trade growth has been subdued by historical standards since 2012, and weakened further in 2015. The key question is whether this is a cyclical or structural phenomenon. We find there is undeniably a structural element, so this weaker trade growth is set to last. This has implications for asset class performance and economic growth, particularly in small, open economies, and so consequently also for policymakers. Structurally lower interest rates and a global tendency towards currency wars seem a likely outcome.

Introduction

Global trade growth has been subdued by historical standards since 2012, and weakened further in 2015. This year is looking a little better, but again relative to history trade looks to be struggling. Of course, it is important to distinguish between volumes and values. The latter, particularly in 2015, are exposed to dollar valuation effects and commodity price slumps. Trade volumes, as chart 13 shows, have held up better than trade values, but still look weak on a historical comparison.

Chart 13: Global trade in volumes and values



Source: Thomson Datastream, Schroders Economics Group, 24 June 2016.

The key question is whether this weakness results purely from weaker global demand (it is a cyclical phenomenon) or whether the relationship between global demand and trade has changed in some fundamental way (trade weakness is a structural phenomenon).

Some cyclicality, but we see long term weakness in trade

Based on our own analysis and looking through the existing academic literature, the short answer is that there is undeniably a structural element. It is important to understand whether there is hope for a reversal of the changed relationship between trade and global GDP, and in turn some investment conclusions or example, will this prompt more ferocious trade and currency wars? Is the emerging market export-led growth model dead?

Blame game: is the trade slowdown structural or cyclical?

Weaker trade growth does coincide with weaker global GDP growth; average global GDP growth 1999-2006 was around 4.5%, compared to growth of 3.5% since the crisis ended. Some cyclical effect is expected but the trade multiplier (the growth in trade generated by every unit of growth in GDP), has also fallen (chart 14 on next page). This suggests a structural element to the decline in trade.

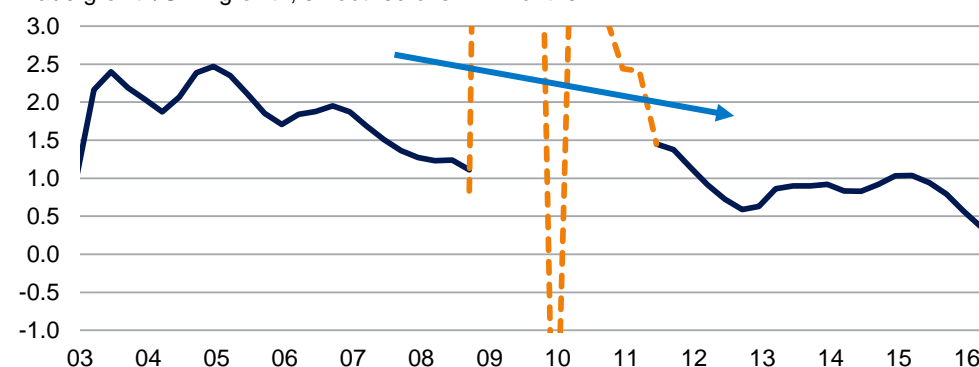
In addition, there are a number of studies which have utilised regression models to identify the relationship between trade and growth (commonly referred to in the literature as the elasticity of trade with respect to growth, or trade elasticity). These studies tend to concur in finding a reduced trade elasticity in the post-crisis period compared to the preceding 10–15 years. But, importantly, one particularly found

Research note (continued)

that trade elasticity dropped from 2.2 in the period 1986–2000 to 1.5 in the 2001–07 period, and 0.7 for 2008–13. As the authors note, this implies that the change in the trade-growth relationship was underway before the Global Financial Crisis (GFC), despite the high economic growth enjoyed in the early 2000s. The paper finds a roughly 50:50 split between structural and cyclical explanations for the recent trade slowdown. However, they also found a trade elasticity of 1.3 in the 1970–85 period.

Chart 14: Global trade multiplier

Trade growth/GDP growth, smoothed over 12 months



Source: Thomson Datastream, Schroders Economics Group. 24 June 2016.

This suggests that the 1986 to 2000 was an exceptional period, and we examine how it differed compared to the present. The post-crisis period is also exceptional, and trade weakness today is the result of more than just a faded tailwind.

What has caused the structural shift? (Blame game: is it all China's fault?)

Pre-crisis

It appears that the structural weakening of trade was underway before the crisis (chart). We believe a number of fading tailwinds were behind this decline. In particular, the boost delivered to global trade through the industrialisation of east Asia and the trend of outsourcing was beginning to fade.

Industrialisation helps drive trade because developing new industries is an import intensive process: both industrial commodities and capital goods are needed in large quantities and must usually be imported. A significant increase in demand for these goods also boosts investment in exporting countries which is more import intensive than consumption or government spending. Global growth then becomes more trade intensive, if the industrialising economies are large enough. The combined economies of east Asia, including China, would meet this qualification.

Supply chain fragmentation (or outsourcing), boosts international trade as it takes a formerly domestic process and moves it across the world. The construction of a car, for example, goes from generating no international trade to having each component being manufactured in a different country and subsequently crosses borders.

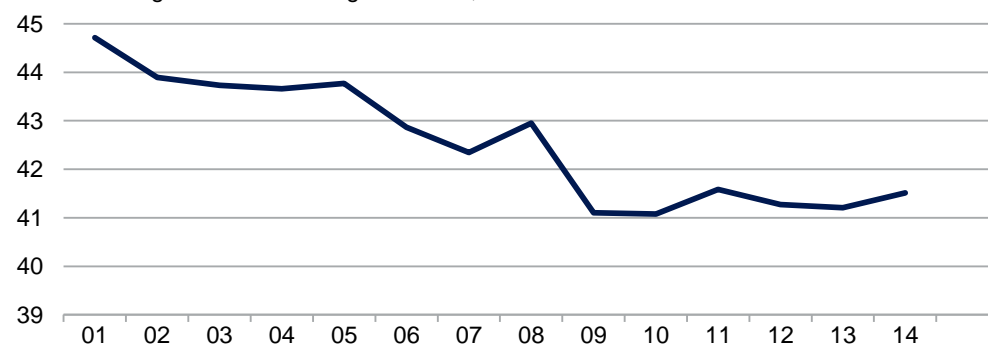
Both forces declined in the 2000s as the Asian economies matured (in the case of industrialisation) and as the scope for outsourcing diminished. While outsourcing grew over this period, it became less dominant in trade flows. Data on the topic is not plentiful, but we can get some idea of the role played by outsourcing by looking at the share of intermediate goods in global trade (chart 15a and 15b on the next page). This has become a less dominant part since the 1990s, leading to a declining trade multiplier.

Fading tailwinds even before the crisis

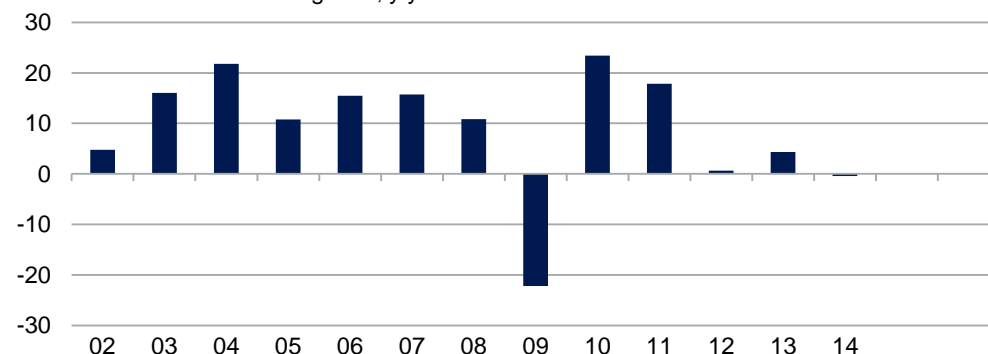
Research note (continued)

Charts 15a and 15b: The end of outsourcing?

Intermediate goods as share of global trade, %



Global trade in intermediate goods, y/y%



Source: UN Comtrade, Schroders Economics Group. 10 June 2016.

On-shoring,
re-shoring, or
just slower
offshoring?

Another suggested explanation for the trade slowdown post-crisis has been “re-shoring”, that is advanced economies are bringing production back on shore. Data on this is difficult to obtain, so we use trade in intermediate goods as a proxy. The chart above shows how growth in this trade has slowed dramatically post-crisis, essentially flat-lining from 2012. This does not support the idea of re-shoring, which would imply contracting trade in intermediate goods, but it does suggest outsourcing may have plateaued. This would be enough to reduce the trade intensity of growth, and looks a likely culprit for at least part of the trade slowdown experienced since the crisis

Financial crises
knock trade off
course

We can not overlook that the break in the trade relationship followed the GFC – it is possible the crisis itself is the cause. An IMF working paper³ found that countries which suffer a financial crisis experience a “large and persistent” decline in imports, with a much smaller effect on exports. Further, when a financial crisis occurred simultaneously with a global downturn, trade losses were larger and recovery more protracted; even 10 years after the crisis, in such cases, imports were still 10% below normal levels (compared to what an economic model would predict). A global financial crisis and downturn, to extrapolate, would be expected to have significant and long-lasting negative effects on trade.

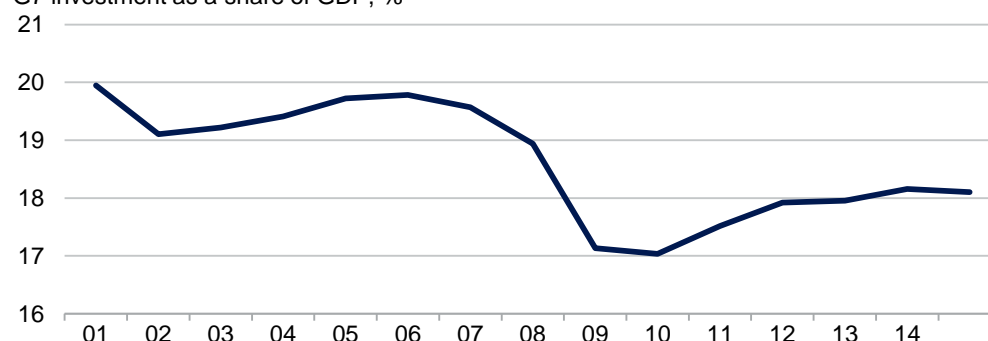
In terms of transmission mechanisms, there are a few to consider. A financial crisis increases volatility and uncertainty, which weighs on import-intensive investment in the short term. It also damages credit channels, both through a deterioration in asset quality but also in prompting tighter financial regulation, which can impact the medium term investment outlook. There is some evidence of this occurring in the G7 economies since the crisis (chart 16 on the next page). Finally, disruptive events like the GFC can force exporters out of markets as they consolidate and retrench, only to find entry costs prevent re-entering, what might be called a “reverse beachhead” effect.

³Abiad, A., Mishra, P., Topalova, P., “How does trade evolve in the aftermath of financial crises?” IMF Working Paper (January 2011).

Research note (continued)

Chart 16: Investment has fallen since the crisis

G7 investment as a share of GDP, %



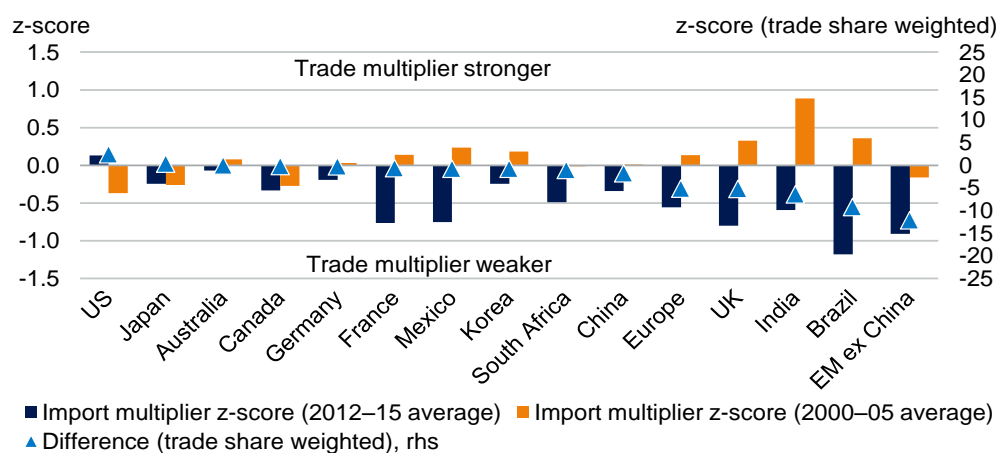
Note: Annual data from 2000–2015 using individual national accounts. Source: Thomson Datastream, IMF, Schroders Economics Group, 6 June 2016.

We should also touch on protectionism, given the recent concerns flagged by the World Trade Organisation. However, while this may be a growing concern, it does not look to have been a major driver over the pre-crisis period, which did not see a large increase in tariffs. Of course, this does not preclude an increase in the coming years, and we are already seeing large increases in tariffs on steel.

Patient Zero: is one country responsible?

Alternatively, the trade slowdown may have its roots in specific countries. We examine trade performance pre- and post-crisis by country, with a focus on imports to identify the source of demand weakness. We use real values, which will go some way towards removing price effects, though the commodity price slump will still have an impact.

Chart 17: Import multipliers have fallen post-crisis



Note: The import multiplier is defined as import growth/domestic demand growth. A z-score is taken over the period Q3/96-Q3/15, with volatile readings discounted. Readings are defined as volatile if they are more than 3 times the long term average export multiplier. The "Difference (trade share weighted)" is the difference between the 2012-15 period z-score and the 2000-05 period z-score, multiplied by the specific country's share of global imports. Source: Thomson Datastream, IMF, Schroders Economics Group, 10 June 2016.

Chart 17 looks at the trade multiplier for imports, using domestic demand rather than GDP as the denominator. Most major economies have seen a decrease in this metric in the post-crisis period, with the largest falls coming in China and the US, while EM excluding China has also seen a sizeable fall. Germany and Japan have also seen decreases, but elsewhere the change does not seem substantial.

What has driven the individual declines?

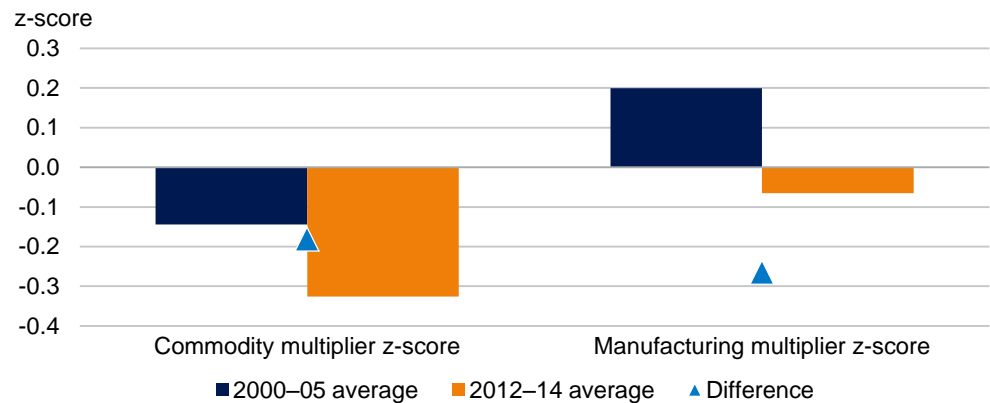
When we break down Chinese domestic demand by merchandise type, we find a fall in import intensity of both commodities and manufactured goods (chart 18 on next page). The latter, we believe, can be explained by China moving up the value chain of manufacturing and so needing to import fewer high end goods. At the same time still producing much of the lower end and intermediate goods needed domestically.

China's transition has reduced import demand

Research note (continued)

This is supported by a 2014 paper which found evidence of increasing domestic value added in Chinese firms.⁴ Meanwhile, the fall in commodities can be chiefly explained by the transition of China’s economy away from the old investment-led growth model and towards services, necessitating fewer imports of industrial commodities per unit of growth.

Chart 18: China commodity and manufacturing import multipliers using real domestic demand

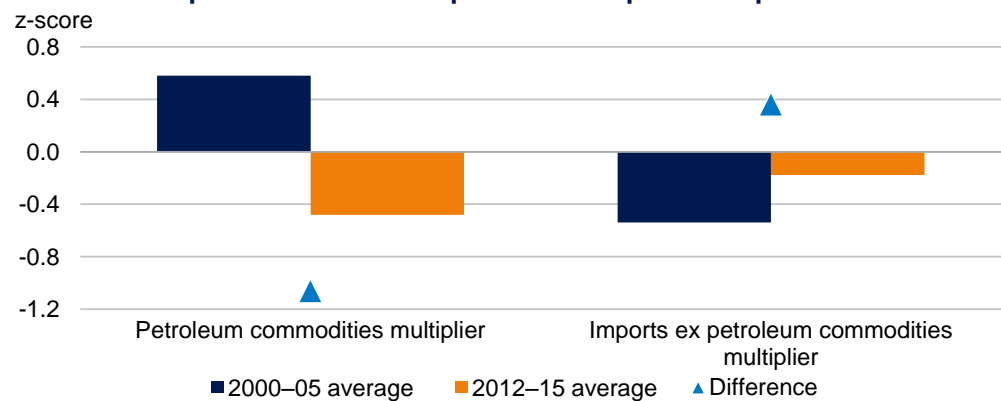


Source: UN Comtrade, Schroders Economics Group, 8 April 2016.

Fracking has disrupted US trade

For the US we might think of two potential culprits. One is the growth of the shale industry, driving down oil imports for a given level of growth, and the other is “re-shoring”, as production is brought back from overseas. It turns out that the petroleum import multiplier has fallen (chart 19), while the import multiplier excluding petroleum has actually risen. The decline in US import intensity therefore looks to be at least partly driven by the growth of the shale industry (there may also be a hit to demand such as more efficient cars and lower consumer disposable income, which we have not investigated here).

Chart 19: US petroleum and non-petroleum import multiplier



Note: Quarterly data is used from Q3 1996 to Q3 2015, with volatile readings adjusted. Data is in real terms and is seasonally adjusted before being normalised. Source: Thomson Datastream, US Census Bureau, Schroders Economics Group, 4 May 2016.

End of the commodity supercycle also hurts trade flows

In emerging markets excluding China, there are likely three factors at work. One is the slowdown or halting of outsourcing, of which they were the primary trade beneficiaries. Separate to this, but linked to China, is the end of the commodity supercycle, which means investment will generally fall in commodity exporters. Growth consequently becomes less import intensive, as the process of extraction itself requires very few traded inputs. Finally, a handful of EM economies have implemented policies aimed at restricting imports since the crisis, either through quotas and tariffs (India and Russia) or compression of domestic demand (Brazil,

⁴Looi, K., Tang, H., “Domestic Value Added in Exports: Theory and Firm Evidence from China” mimeo, World Bank (2014).

Research note (continued)

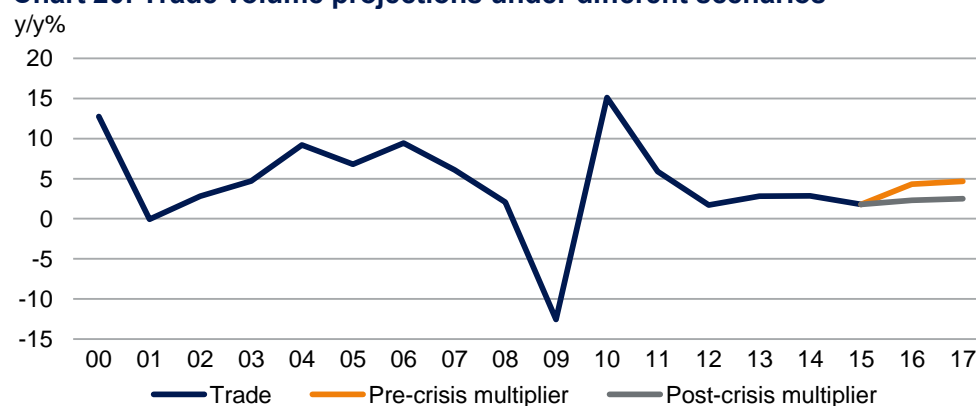
Indonesia). In addition, the fall in oil prices has seen the removal of subsidies in some EM economies, which will reduce the quantity of oil imported for a given level of domestic growth, again reducing trade intensity.

Outlook and investment implications

Overall, though there remains a cyclical component of trade growth, we have identified a number of structural headwinds to trade. Should these subside, the trade multiplier can return to its previous levels, and trade can rebound. Otherwise, trade growth is likely to remain subdued relative to its history. Chart 20 shows projections of trade (based on our growth forecasts) under the pre and post-crisis trade multipliers, for an idea of the two extremes.

However, it seems unlikely that many of the headwinds identified will fade. The impact of the GFC, based on IMF research, is set to linger for several years more at least. It is also difficult to see globalisation finding new legs; China is transitioning to a consumption led economy and moving up the production value chain. We would need a similarly large economy to go through a similar process of integration into global supply chains, and the only candidates are India or Africa. India is the closer of the two but faces significant challenges and appears to lack the desire to become a manufacturing powerhouse. A five to ten year wait seems likely, at the very least.

Chart 20: Trade volume projections under different scenarios



Source Thomson Datastream, Schroders Economics Group, 24 June 2016.

Leaner years
ahead for export
reliant
economies

We seem more closely to the lower bound in chart than the upper. Trade liberalisation could help, but if anything protectionism appears to be on the rise. This bleaker outlook for trade growth has a range of investment implications.

First, consider that economies previously highly dependent on export led growth now face structurally lower growth rates. This mainly applies to emerging market economies, though some small developed market economies could also be included in this grouping. Earnings growth is likely to be impacted, and will underperform the historic trend.

Lower growth will also mean lower policy rates and lower yields in these economies. Less export orientated economies should see a relative outperformance of growth compared to these countries. Therefore we see a case for more selective investment, particularly within EM, to take advantage of relative performance gaps.

As well as responding to a lower growth world with lower interest rates, policymakers are also likely to be tempted to resort to currency devaluation more frequently. The currency wars we have seen post-crisis therefore look set to continue, generating greater volatility in the foreign exchange markets. Related to this, currency volatility will also cause volatility in inflation. Inflation itself will face less downward pressure with globalisation running out of steam, so we face the possibility of a more stagflationary world, a difficult obstacle to overcome for policymakers.

Market Returns

	Total returns	Currency	June	Q2	YTD
Equity	US S&P 500	USD	0.3	2.5	3.8
	UK FTSE 100	GBP	4.7	6.5	6.6
	EURO STOXX 50	EUR	-6.1	-1.9	-9.5
	German DAX	EUR	-5.7	-2.9	-9.9
	Spain IBEX	EUR	-9.0	-4.6	-12.2
	Italy FTSE MIB	EUR	-9.5	-7.6	-21.8
	Japan TOPIX	JPY	-9.6	-7.4	-18.5
	Australia S&P/ ASX 200	AUD	-2.5	3.9	1.1
	HK HANG SENG	HKD	1.4	2.4	-2.4
EM equity	MSCI EM	LOCAL	1.7	0.8	3.6
	MSCI China	CNY	1.1	0.3	-4.4
	MSCI Russia	RUB	-0.2	0.5	8.3
	MSCI India	INR	1.6	5.7	3.2
	MSCI Brazil	BRL	6.3	3.0	18.6
Governments (10-year)	US Treasuries	USD	3.3	3.3	8.3
	UK Gilts	GBP	5.3	5.3	10.8
	German Bunds	EUR	2.6	2.7	8.2
	Japan JGBs	JPY	1.3	2.0	5.3
	Australia bonds	AUD	2.6	4.6	10.4
	Canada bonds	CAD	2.5	2.8	4.8
Commodity	GSCI Commodity	USD	0.1	12.7	9.9
	GSCI Precious metals	USD	9.3	8.1	25.4
	GSCI Industrial metals	USD	5.7	5.3	7.3
	GSCI Agriculture	USD	0.0	7.9	6.9
	GSCI Energy	USD	-1.2	19.0	11.7
	Oil (Brent)	USD	-0.9	24.2	39.0
	Gold	USD	8.8	7.0	24.4
Credit	Bank of America/ Merrill Lynch US high yield master	USD	1.1	5.9	9.3
	Bank of America/ Merrill Lynch US corporate master	USD	2.2	3.5	7.6
EMD	JP Morgan Global EMBI	USD	3.7	5.4	10.9
	JP Morgan EMBI+	USD	4.6	6.0	12.3
	JP Morgan ELMI+	LOCAL	0.4	1.0	2.3
Currencies	EUR/ USD		-0.3	-2.6	1.8
	EUR/JPY		-7.0	-10.5	-12.2
	JPY/ USD		7.2	8.9	16.0
	GBP/USD		-8.1	-7.3	-9.7
	AUD/USD		3.1	-2.3	3.1
	CAD/USD		1.3	0.7	7.1

Source: Thomson Datastream, Bloomberg, 30 June 2016.

Note: Blue to red shading represents highest to lowest performance in each time period.



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