Multi-Asset Solutions Weekly Strategy Report

Global markets and multi-asset portfolios

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IN BRIEF

- The results of the UK's snap election—a hung Parliament—magnify risks to both the upside and downside. On the upside, the possibility of a "softer" Brexit, with an emphasis on maintaining economic links with the EU, and the potential for better growth, has probably increased. But to the downside, the fragility of the new government also increases the risk of negotiations collapsing and a chaotic Brexit—for investors perhaps the most unsettling prospect.
- Consumption and investment data have deteriorated modestly, and our base case is for further slowing in the pace of UK economic growth.
- Pound sterling remains central to our asset class views. Sterling currently looks cheap on a purchasing power parity basis, but the UK's twin deficits—in its budget and current account—are an additional drag. For the time being we see GBP/USD in a volatile range, but with a risk of further downside as Brexit negotiations advance. We are cautious on both UK equities and UK bonds as uncertainty and slower growth weigh on earnings, and real yields on UK Gilts are unattractive compared to other major government bond markets.

BREXIT BREAKDOWN? MAKING INVESTMENT SENSE OUT OF UK POLICY TURMOIL

A cloud of uncertainty has hung over the UK since Britons voted to leave the European Union (EU) in a June 2016 "Brexit" referendum. That cloud grew thicker following the UK's snap election on June 8, which ended with the collapse of Prime Minister Theresa May's bid to strengthen her Conservative Party's House of Commons majority ahead of Brexit negotiations. The Tory majority turned into a minority—a hung Parliament[1]—which, in our view, increases risks to both the upside and downside.

On the upside, there is a greater likelihood of a "softer" Brexit, which maintains a higher level of economic integration with the EU and should, in turn, be more favorable for UK growth. We expect the Conservatives to form a government supported by a "confidence and supply" arrangement with the Northern Irish Democratic Unionist Party (DUP), whose manifesto calls for a frictionless land border between the Republic of Ireland and Northern Ireland, its EU neighbor. Such an agreement would seem to necessitate, at the very least, a customs union between the UK and EU, with shared external tariffs and free trade internally—in essence a "soft" Brexit.

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[1] A Parliament in which no single party commands a majority of seats.

On the downside, the new balance of political power makes for a less stable and more disorderly government just before the start of Brexit negotiations—with long-term leadership of the Conservative Party uncertain. Comparing the pre- and post-snap election landscape, there is now a greater likelihood that the UK will fail to reach any Brexit deal by the Article 50 deadline of March 2019. For investors, that possibility—a chaotic Brexit—is perhaps the most unsettling.

An uninspiring macroeconomic outlook

Our core fundamental view on the UK economy sees growth slowing relative to other developed economies—with deterioration in potential real growth of about one percentage point per annum—as the impact of Brexit weighs on both business investment and consumption. While the weaker currency might help exporters' competitiveness, Brexit uncertainty is likely to weigh on firms' decisions to invest in new output capacity. At the same time, the higher cost of imported goods, resulting from the weaker pound, is driving up inflation and crimping household incomes in real terms. Those changes directly impact consumption, given that wage gains have not accelerated to any meaningful degree and consumer spending is already stretched relative to household incomes.

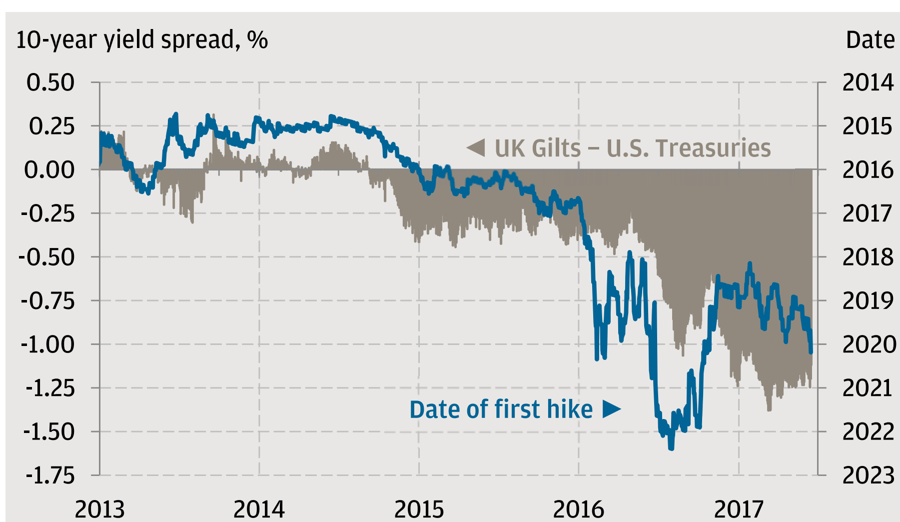
Although the post-Brexit economy has proved more resilient than originally expected, indicators of consumption and investment have deteriorated modestly, and our base case is for further slowing. Though some market participants think the housing sector is in a price bubble that is ripe for deflating, we think any declines in home values are unlikely to cause significant contagion for the broader economy since the volume of construction activity remains well-contained. But the financial sector seems particularly susceptible to post-Brexit fallout, given that it accounts for an outsized share of EU exports and is disproportionately subject to EU regulation. Changes in the overall economic outlook should be especially volatile as the contours of a Brexit agreement, or lack thereof, become clearer.

ASSET CLASS IMPLICATIONS

Pound sterling has been a major driver of both fixed income and equity markets, and remains central to our asset class views. For the remainder of 2017, we expect GBP/USD, currently 1.28, to remain in a range from low 1.20s to low 1.30s. Sterling currently looks cheap on a purchasing power parity basis, having declined about 13%

EXHIBIT 1: UK GILTS LOOK RELATIVELY EXPENSIVE

Since the Brexit referendum, nominal spreads between UK Gilts and U.S. Treasuries have expanded dramatically, from 30bps-40bps before the referendum to about 120bps today, with UK real yields now deeply negative. And since early 2016 market expectations for the Bank of England's first rate hike have been pushed out by years to 2020. Compare that timing to that of the Fed, which has delivered four rate hikes, though the U.S. is not much farther along in its economic cycle.



Source: Bloomberg, Morgan Stanley, J.P.Morgan Asset Management Multi-Asset Solutions; data as of June 15, 2017. For illustrative purposes only.

from its pre-Brexit trading range. However, currency valuations can remain distorted for many years, and the UK's twin deficits—in its budget and current account—should exert some additional downward pressure. For the early part of the Article 50 negotiations, over the latter half of this year, we expect sterling to remain in a volatile range. But as the nature of any deal becomes clearer next year, sterling has scope to break out to the downside if negotiations stall or become acrimonious, or to the upside if a "soft" Brexit deal gains traction.

These economic and exchange rate realities leave us with a cautious view on UK fixed income. The message fundamentals are sending is complicated by opposing signals for monetary policy—weaker growth and higher inflation. Still, we expect the Bank of England to allow inflation to drift higher in order to stabilize growth, notwithstanding its recent 5-3 Monetary Policy Committee vote, in which three members favored higher interest rates, suggesting less willingness to look through higher inflation. Higher inflation expectations and recovering real yields should then help steepen yield curves. On a nominal basis, Gilts look particularly overvalued relative to other developed market government bonds. The 10-year spread between Gilts and U.S. Treasuries, which was positive as recently as mid-2014 and traded at just a 30 basis points (bps)-40bps yield premium from late 2014 up to the Brexit referendum in June 2016, has since widened to about 120bps (**Exhibit 1**). Over the past year, UK real yields have turned deeply negative, offset only partly by higher inflation expectations. Further, the UK's twin deficits make the UK dependent on foreign lenders, adding potential downside risk should fiscal discipline fail, the UK's creditworthiness deteriorate, and/or foreign demand falter—all while rising yields in other developed markets attract demand away from the UK.

Turning to equities, the UK is our least preferred among developed markets. Our bearish UK equity view, however, is not especially dependent on the bearish domestic economic outlook. By our estimates, the domestic economy accounts for only about 40% of UK large cap revenues—compared with about 75% in U.S. large caps or 60% in the eurozone. However, fundamentals appear weak, as evidenced by negative and fading earnings momentum. Sector composition also looks unattractive, in light of our view on healthy global growth, to which the UK has limited exposure, given the dominance of defensive industries over cyclicals (excluding commodities). Despite weak fundamentals, meanwhile, valuations do not seem compelling. They are cheaper than the global average—based on book value, earnings and dividends—but more expensive than our preferred equity regions, Japan and emerging markets.

We are relatively bearish on UK bonds and equities for largely independent reasons. Both of these views will be affected by the evolution of Brexit negotiations and, in particular, related foreign exchange volatility. But offsetting drivers provide some reasons to focus a little less on underlying economic uncertainty. Any improvement in the domestic economy, for instance, would help domestically sourced earnings, but would probably boost the pound's value, partly via higher interest rates, and thereby come at the expense of weaker foreign earnings in sterling terms. For bonds, that same sterling appreciation would also decrease inflation expectations, offsetting the effect of higher real yields. Moreover, allowing for some modest increase in the "uncertainty premium" embedded in UK assets is probably prudent as Brexit negotiations commence.

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