Quarterly Perspectives

Europe | 3Q 2018

J.P. Morgan Asset Management is pleased to present the latest edition of ***Quarterly Perspectives***. This piece explores key themes from our ***Guide to the Markets***, providing timely economic and investment insights.

THIS QUARTER'S THEMES

1. Europe's slowdown – already in the price?
2. Can emerging markets cope with higher US rates?
3. Sustainable investing: What is it and how does it affect investment decisions?

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1 Europe's slowdown – already in the price ?

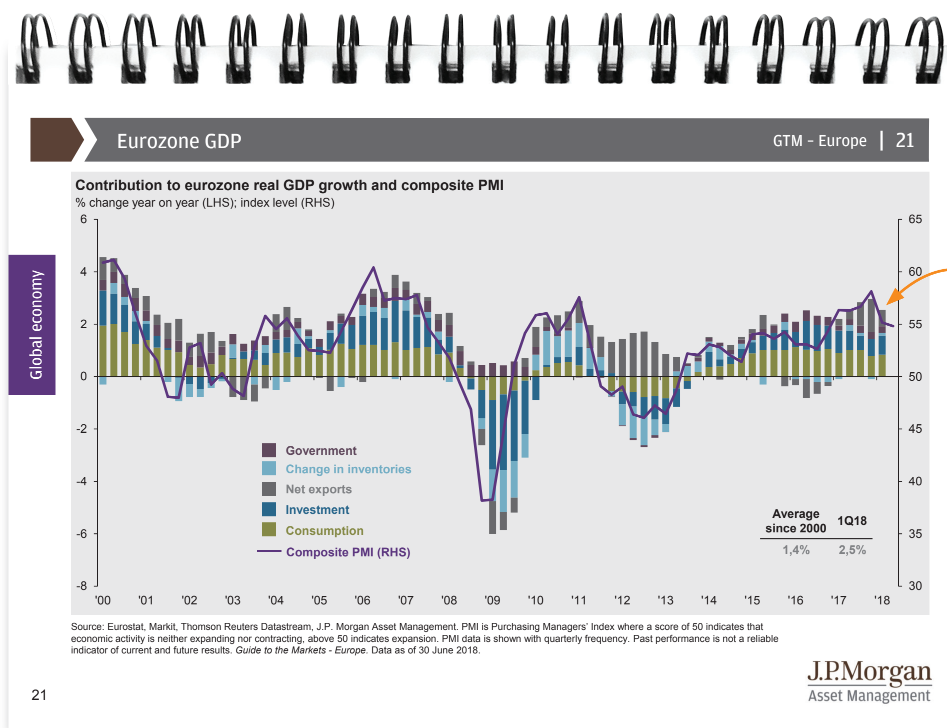
Moderation, or something more sinister?

After a strong year in 2017, growth in the eurozone has continued so far this year, but at a slower pace. The slowdown has been concentrated in net exports, which could be partly down to past euro strength. This slowdown in trade more than offset the slight improvement in consumption and investment, leading the overall pace of growth to slow from 2,8% year on year (y/y) in Q4 to 2,5% y/y in Q1.

Business surveys suggest that exports and manufacturing could have continued to be a drag on the pace of growth in Q2, and that the pace of business investment expansion could also have moderated slightly. Eurozone consumer confidence has cooled a little since January, although unemployment continues to decline and wage growth has been picking up. Overall, June's business surveys suggest a stabilisation in the pace of growth, albeit at a lower level than at the beginning of the year.

OVERVIEW

- The eurozone economy has been slowing, but if the economic data stops disappointing there is scope for eurozone equities to bounce.
- Italian politics remains a source of potential volatility, but Italy is unlikely to leave the euro.
- A mix of both upside and downside economic and political risks argues for an allocation close to neutral for European equities at this time.



Business surveys suggest growth is stabilising.

Source: ***Guide to the Markets – Europe***, page 21

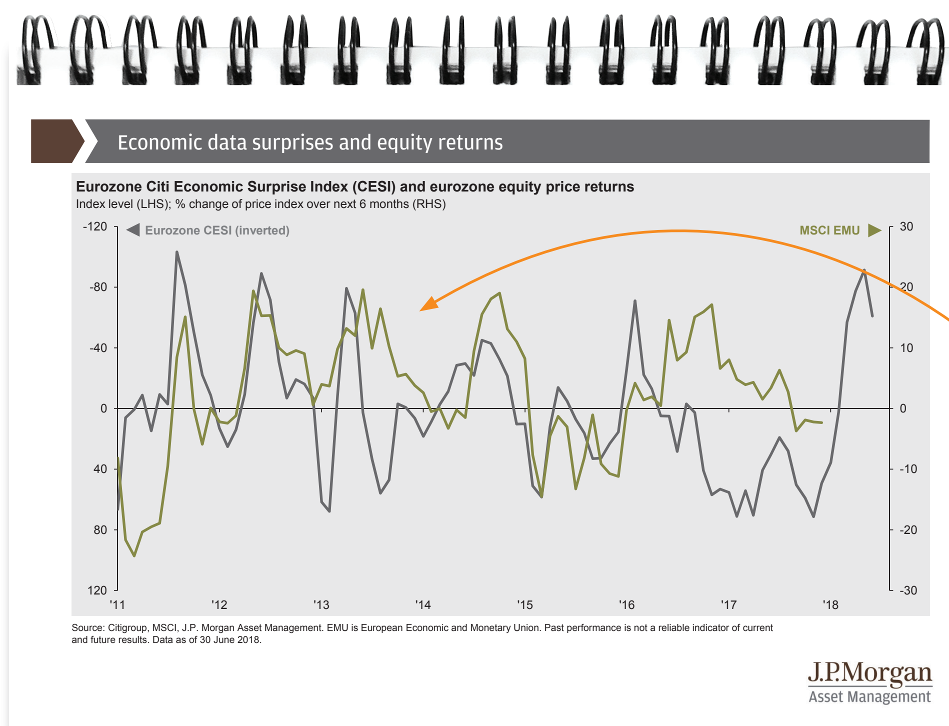
Political risk

Italian politics has also been a source of volatility so far this year, and we expect this to remain the case. The new government appears keen to challenge the European status quo on both fiscal policy and immigration. Importantly though, they have expressed a desire to stay in the euro, reflecting growing popular support for the single currency in Italy. The latest Eurobarometer survey in March showed 61% of Italians want to remain in the euro, with only 29% keen to leave and 10% undecided. We think the probability of Italy leaving the euro anytime soon remains very low.

Perhaps a more concerning source of political risk stems from US trade policy, with the potential for tariffs to be levied on European auto exports. This has dampened optimism that the current boom in US consumption (US retail spending was up 6,4% in May) will contribute to a revival in eurozone export growth.

Are the risks already in the price?

Despite these economic and political concerns, there are also upside risks now that a fair amount of bad news has already been priced in. Eurozone economic data has disappointed relative to consensus expectations since the start of March. As a result, expectations have been revised downwards, making them easier to beat. In recent years, when the economic data has been as disappointing as it has been recently, equity returns over the next six months have been positive (as shown in the chart).



Source: J.P. Morgan Asset Management Market Insights Team

Periods of data disappointment tend to be followed by strong equity returns over the next 6 months.

INVESTMENT IMPLICATIONS

- Political risk could cause the road ahead to remain a bumpy one for eurozone equities.
- However, with economic data having already surprised to the downside, history suggests equities may rally as the data gets less bad relative to now-lower expectations.
- A mix of both upside and downside risks to the outlook argues for a neutral view on European equities.

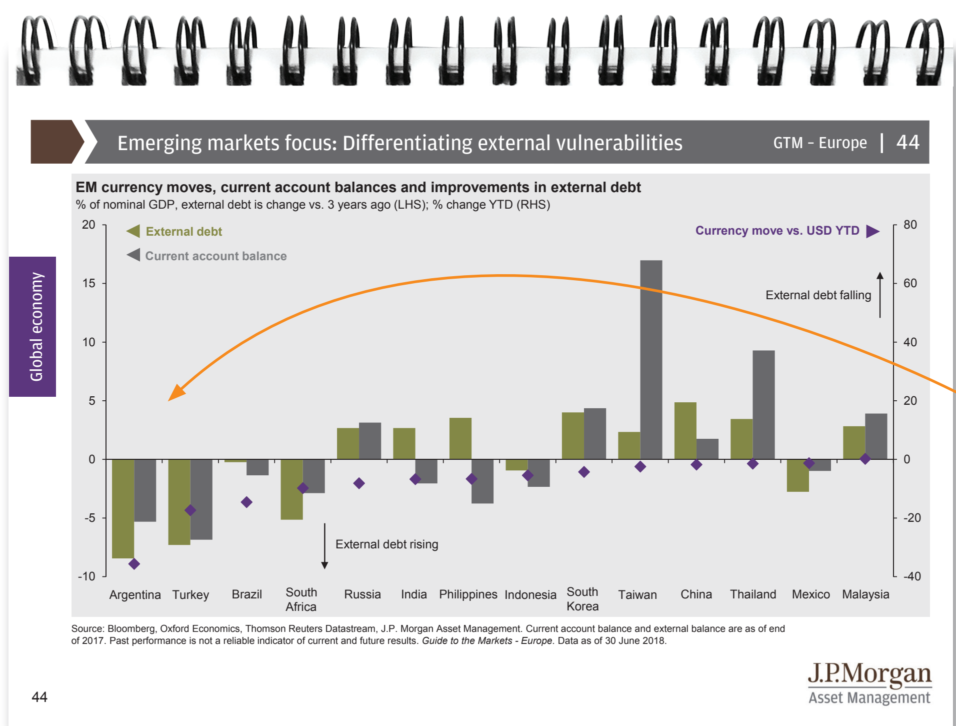
2 Can emerging markets cope with higher US rates?

Why are emerging markets concerned about higher US rates?

The big EM crises of the past had one thing in common – they were all preceded by a sharp rise in US interest rates. The problem is linked to how EM governments and corporations often finance themselves. Due to the lack of market depth and liquidity in many local markets, governments and corporations often issue debt in US dollars. Rising US interest rates therefore increase the cost of US dollar debt financing, while any rise in the value of the US dollar will swell the size of dollar-denominated debts relative to the domestic economy of the issuing government or company. This is the situation many emerging markets experienced in the second quarter of 2018. A booming US economy and tighter Federal Reserve policy caused US bond yields to rise and the US dollar to strengthen. At the same time, growth momentum in emerging markets and the rest of the world started to weaken. Against this backdrop, emerging economies with current account deficits have faced difficulties due to their dependency on external financing.

How big is the risk today?

After the Asian crisis many emerging markets focused on developing their local currency bond markets. In recent years there has been a trend towards issuing in local currency which has reduced the direct dependence on US interest rates. Nevertheless, the total amount of US-dollar denominated debt has increased substantially (+150%) in the last 10 years, as governments—and particularly corporates—have taken advantage of historically low US interest rates. But it would be wrong to assume that external risks are equally distributed across emerging markets.



Source: ***Guide to the Markets – Europe***, page 44

Argentina, Turkey and South Africa look to be more vulnerable than other emerging markets to higher US rates.

OVERVIEW

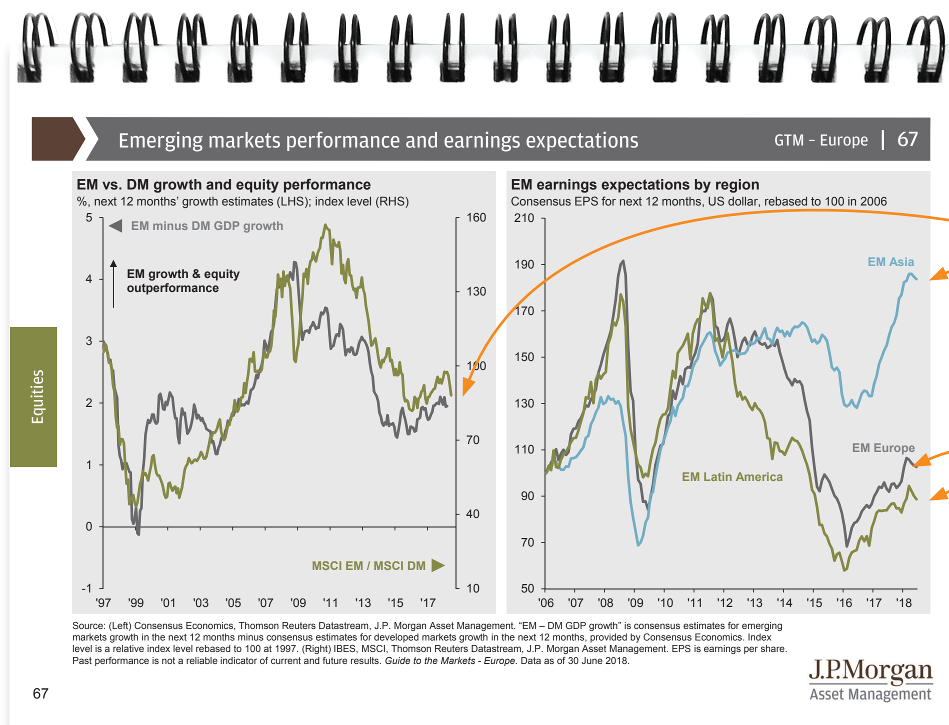
- Five years after the taper tantrum, the external vulnerabilities of emerging markets are back in focus. Investors are concerned that rising US yields and a strengthening US dollar could undermine emerging market (EM) financial stability.
- EM countries with high current account deficits and rising external debts relative to the size of their economies are particularly vulnerable. Currently only three major countries screen poorly on these metrics. We do not view this as a broad EM concern.

Two metrics often considered to assess a country's vulnerability to rising US rates are the current account position and the three-year change in external debt. On these metrics we can see that many countries in emerging markets look sound. However, Turkey, Argentina and South Africa may be vulnerable to a sudden stop in external financing. All three countries have large current account deficits and all have significantly increased their external debts. On the other hand, several Asian economies have a large current account surplus and have been reducing external debts.

If a country's balance of payments is vulnerable to a withdrawal of external financing it doesn't necessarily mean that a crisis is inevitable. As long as the growth outlook for the economy and corporate earnings remains healthy, a crisis can be avoided. Although there has been a moderation in the pace of growth in the first half of 2018, in many emerging markets the absolute level of growth remains healthy.

INVESTMENT IMPLICATIONS

- Despite the short-term headwind of a stronger dollar and rising US rates, emerging markets as a whole do not look vulnerable to a crisis. In the medium-term emerging markets still look attractive.
- Asian equities appear least exposed to rising US rates and any balance of payment risks.
- Corporate earnings are expected to grow in 2018 and equity valuations should give emerging markets support.



A slowdown in EM economic momentum relative to developed markets explains the recent relative weakness of EM equities.

Earnings growth is strong but recent data shows the first downward revisions in earnings estimates. Asian earnings look to be the most resilient.

Source: ***Guide to the Markets – Europe***, page 67

3 Sustainable investing: What is it and how does it affect investment decisions?

What are E, S and G?

Environmental: Issues relating to the quality and functioning of the natural environment and natural systems, such as carbon emissions, environmental regulations, water stress and waste.

Social: Issues relating to the rights, well-being and interests of people and communities, such as labour management, health & safety and product safety.

Governance: Issues relating to the management and oversight of companies and other investee entities, such as board composition, ownership, shareholder rights and pay.

Types of sustainable investing

ESG integration

ESG integration is the systematic and explicit consideration of ESG factors in the investment decision-making process. Often, portfolio managers can ascertain details about a company's plans for the future, resiliency, and business practices by asking direct questions, through in-depth research, or active engagement, which can feed into the investment decision. ESG integration does not limit the investment universe or exclude sectors or companies unless required by client guidelines or local regulations. Investment teams consider the idiosyncrasies of each strategy in their development and approach to ESG. These considerations can provide an additional layer of risk mitigation that could lead to increased risk-adjusted returns.

For example, ESG integration can help an investor avoid buying securities of a manufacturing company that fails to adequately prepare for resource shortages that impact longer-term business viability. Or it can help a portfolio manager choose a company that screens positively on privacy and data security concerns versus other companies that may face challenges in that realm.

Best in class

Best in class, or positive screening, actively seeks to invest in those companies with positive ESG performance relative to peers. For example, if a business has adequate planning for future environmental regulation and policy initiatives due to out-of-favour or climate-disruptive sources of energy, it may be selected as "best in class" compared to others in the sector. Another example of a best in class company is one where the compensation of senior management is well aligned with long-term company viability, or where the board of the company is diverse and independent versus peers. Like ESG integration, best in class screening does not always limit the investment universe.

OVERVIEW

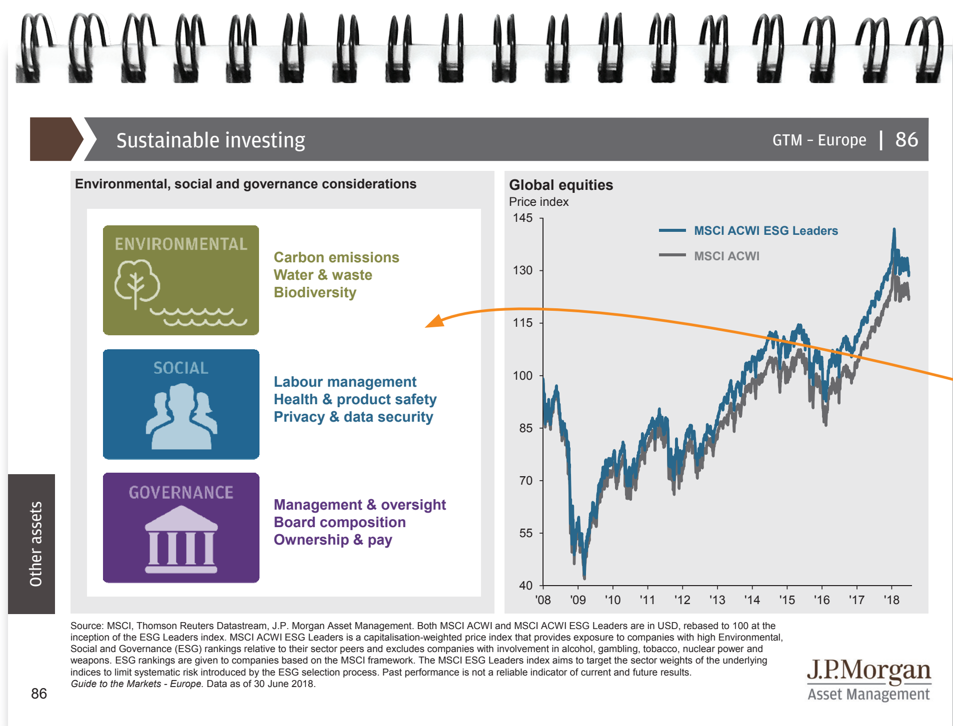
- While sustainable investing is a broad term that can mean different things to different people, it is becoming an increasingly important consideration across investor groups and asset classes.
- Environmental, social and governance (ESG) topics can be part of broader investment goals, or a specific requirement. Investment strategies that consider ESG can be aligned with client objectives in different ways.
- As page 86 of *Guide to the Markets – Europe* shows, considering ESG as part of an investment strategy need not cost investors returns, and may even improve risk-adjusted returns in some cases.

Values/norms-based screen

Screening avoids certain companies or industries that do not align with investor values or meet their norms or standards. For example, certain investors may have hard rules on excluding tobacco, nuclear power, weapons, alcohol and gambling or other industries. Others may wish to exclude companies which breach an international standard on human rights. The selection of exclusionary investment strategies is evolving to meet investor demand.

Impact/thematic investing

Thematic investments are those that are based on specific environmental or social themes or assets related to sustainability, such as green bonds, public services bonds and private equity in enterprises that have social objectives. For example, a strategy dedicated to alternative energy or low carbon investments would be classified as an environmentally focused fund.



Source: ***Guide to the Markets – Europe***, page 86

ESG considerations can span a variety of topics and industries

Page 86 of *Guide to the Markets – Europe* shows MSCI ACWI ESG Leaders, a capitalisation-weighted price index that provides exposure to companies with high ESG rankings relative to their sector peers and excludes companies with involvement in alcohol, gambling, tobacco, nuclear power and weapons.

ESG rankings are given to companies based on the MSCI framework. The MSCI ESG Leaders Index aims to target the sector weights of the underlying indices.

Relative to the MSCI ACWI, the MSCI ACWI ESG Leaders Index outperforms since inception of the ESG index. However, this is just one example of combined "best in class" and norms-based screen from one data provider. There are many types of third-party ESG screening and rankings. Notably, this index outperforms the MSCI ACWI in periods of drawdown.

INVESTMENT IMPLICATIONS

- ESG can apply across asset classes and types of strategy, and need not cost an investor returns.
- Rather than being a consideration that limits an investment universe or portfolio manager's process, ESG can be thought of as an additional screen to consider when making an investment as it can often provide a layer of risk mitigation. This can potentially lead to sustainable stronger risk-adjusted returns.

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