Quarterly Perspectives

Europe | 2Q 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. How will the Brexit negotiations affect European markets?
2. What is the outlook for emerging markets?
3. Do higher interest rates pose a threat to the recovery and risk assets?
4. How is fiscal policy in the US and Europe affecting the investment landscape?

STRATEGISTS

Karen Ward
Managing Director
Chief Market Strategist, EMEA

Michael Bell, CFA
Executive Director
Global Market Strategist

Tilmann Galler, CFA
Executive Director
Global Market Strategist

Vincent Juvyns
Executive Director
Global Market Strategist

Maria Paola Toschi
Executive Director
Global Market Strategist

Nandini Ramakrishnan
Associate
Global Market Strategist

Jai Malhi
Associate
Market Analyst

Ambrose Crofton
Analyst
Market Analyst

J.P.Morgan
Asset Management

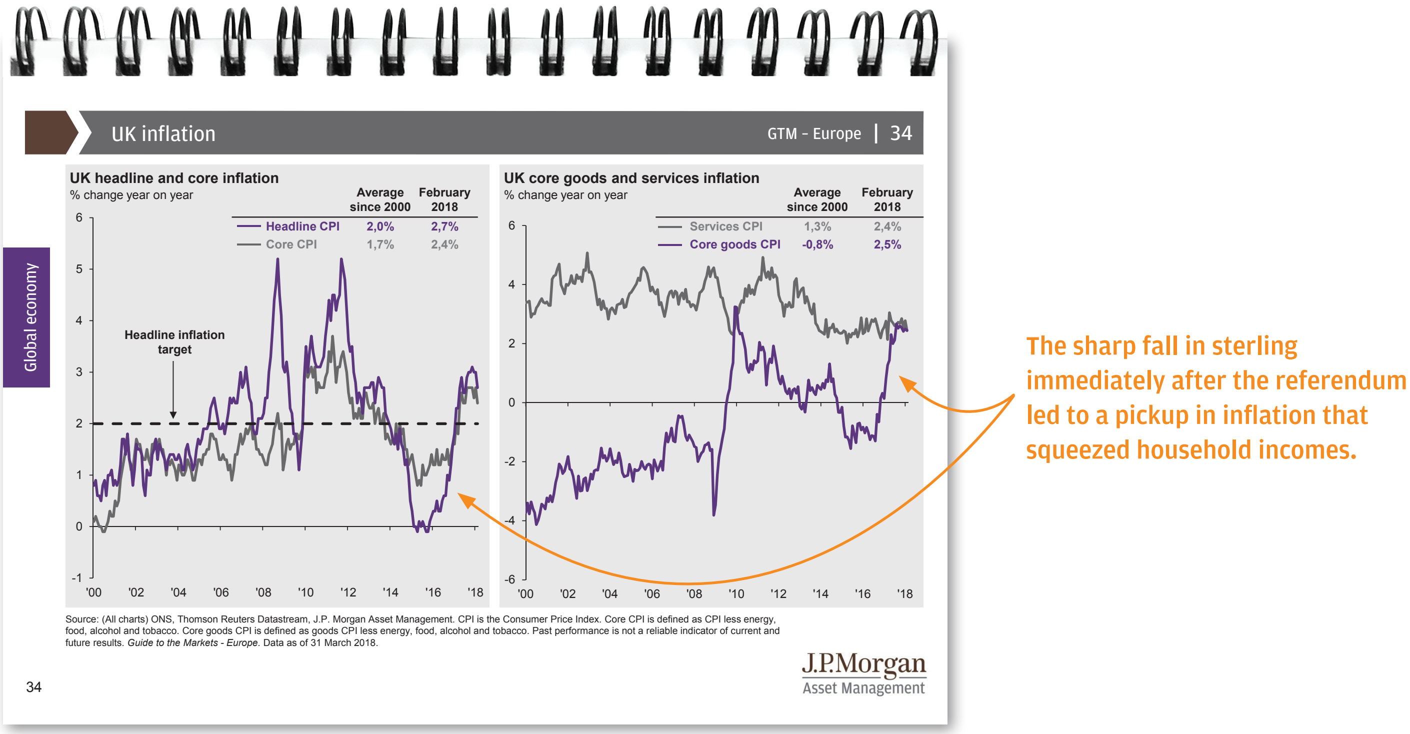
1 How will the Brexit negotiations affect European markets?

The impact of Brexit on the UK economy

Immediately following the UK referendum many forecasters cut dramatically their projections for UK GDP growth. The economy has exceeded many of these forecasts as growth has remained roughly constant in the region of 1,5%. The stability of growth in the UK however contrasts with the acceleration in activity that was seen in many other parts of the world. The UK thus slipped from joint top of the G7 league table in 2016 to second from bottom in 2017. The spike in sterling, the subsequent rise in inflation and the squeeze on real incomes was an important component of this underperformance. Lacklustre business spending, as firms postponed investment, also played a role.

OVERVIEW

- The Brexit negotiations have reached an important milestone with both sides agreeing to a period of transition between the UK formally leaving the EU in March 2019 and the new relationship coming in to force in January 2021. This has lifted sterling and UK interest rate expectations. Both could get a further boost if the next ambition is met - an agreement on the heads of terms of the final deal.



Source: ***Guide to the Markets – Europe***, page 34

Progress made: Agreement on a period of transition to December 2020

The UK will formally leave the EU in less than a year, but the EU and UK have agreed upon a period of transition between 29 March 2019 and 31 December 2020. This will give businesses time to adapt to the new trading relationship.

Attention now turns to agreeing the heads of terms for the final trading relationship. The ambition is to have broad agreement by October in order for the Withdrawal Agreement to be legally ratified by March 2019. The finer details will then be worked out during the period of transition.

Challenge ahead: Future relationship

To reach a deal on the future relationship both sides will need to compromise from their current standing. The EU's position is that there can be no 'cherry picking' and that the EU's four freedoms – in goods, services, labour and capital - are indivisible. Broadly speaking the UK's wish list includes an ambition to:

- continue trading freely in goods and services with the EU,
- have no physical border between Northern Ireland and the Republic of Ireland,
- be able to strike free trade deals with the rest of the world,
- be under the jurisdiction of British Courts rather than the European Court of Justice,
- control migration,
- and not contribute substantively to the EU budget.

Some of these 'red lines' will have to be either abandoned or seriously diluted which will bring challenges given strongly held views within the Conservative Party. Being able to strike trade deals with other parts of the world makes a customs arrangement with the EU very difficult because the EU would no longer have a clearly defined border on which to monitor the inflow of goods. If a customs arrangement is not in place then the Northern Ireland Border is difficult to solve (though the government believes that in time a technological solution can be found).

It is possible to envisage 'mutually agreeable' solutions on other issues. For example on the rule of law it has already been agreed that there will be a 'joint committee' of UK and EU representatives to oversee the implementation of the Withdrawal Agreement. This could form the basis of a more lasting arbitration panel. A compromise on migration might be that EU nationals have preferential treatment in a new migration system. And ultimately the UK may have to accept that if it wants access to the GBP 10 trillion EU ex-UK market it will have to contribute to its upkeep with budget contributions.

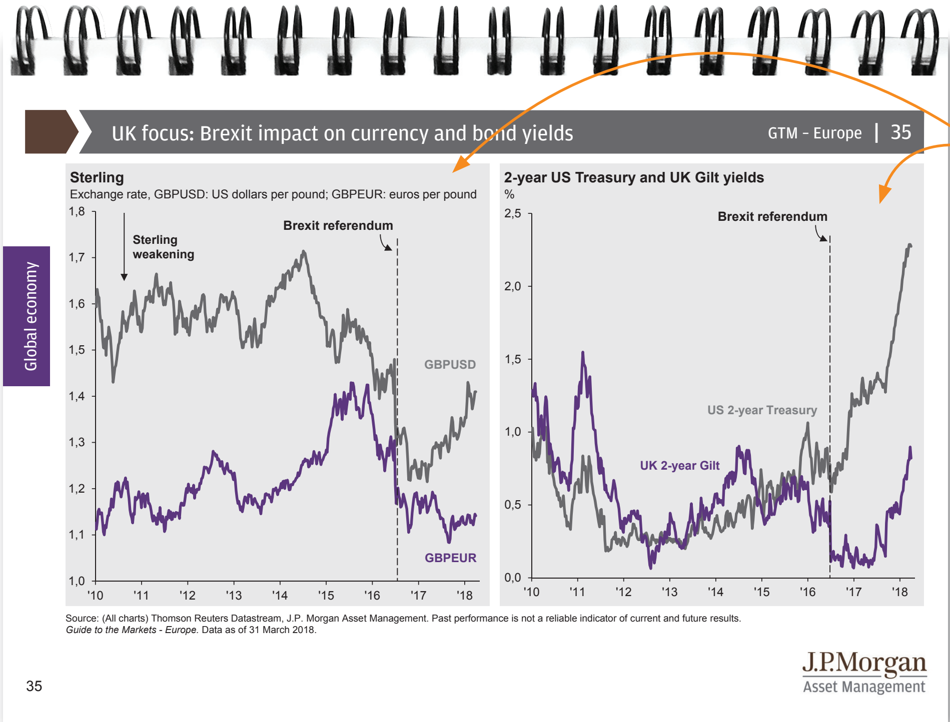
There are some reasons for optimism

There are reasons to believe that there will be a deal which means the UK and EU continue to trade in goods and services with limited frictions. It is in the EU's interest to have a deal in goods given the EU's large trade surplus in goods with the UK.

But it may also be in the EU's interest to have a deal in services. The UK's financial services industry, centred in London, is an important ecosystem that helps meet the financing requirements of businesses across the EU. The contingency plans which each bank established soon after the referendum showed that it was highly likely the financial sector would fragment to many different European countries. The loss of the ecosystem would very likely raise the cost of capital to business. In addition, many of the contingency plans identified Frankfurt as the preferred destination. Germany has in the past not seen it as desirable to have a large financial sector given the potential need for public funds in the event of a financial crisis (demonstrated clearly in 2008). Keeping the financial centre in the UK may well be in the EU's interests.

In our view the early agreement on transition signals a move in this direction, given the financial services industry was one of the key sectors requesting early agreement on transition.

At the start of the year our assessment was that there was still a significant 'hard Brexit' premium in UK markets. Sterling had risen against the dollar but that largely reflected a broad-based dollar decline. Against a basket of other currencies and the euro, sterling was still not far off the lows reached immediately after the recession.



Brexit has had a significant impact on UK markets.

Source: ***Guide to the Markets – Europe***, page 35

Expectations about UK interest rates also remained depressed. Prior to the referendum the Bank of England was broadly expected to be tracking policy at the US Federal Reserve. As a result of the referendum, policy diverged as the Bank of England deployed more expansionary policies to support the economy through a period of real wage squeeze and weak business investment.

INVESTMENT IMPLICATIONS

- The agreement on transition has already lifted the level of sterling against most currency pairs, as well as UK interest rate expectations. We now think the Bank of England will raise rates in May. If the coming months' negotiations do see compromise and agreement on the heads of terms of the deal then we may see some further gains in sterling and UK interest rate expectations.
- The impact on UK equities is more complicated. 70% of the FTSE 100 earnings are from abroad. As a result rising sterling depresses repatriated earnings and would most likely put downward pressure on the price of these stocks. However, the price of domestically focused smaller cap stocks may move higher if there are signs of a deal emerging.
- There are reasons to be optimistic that a deal will be struck. However it may be some months before this emerges, and there could well be significant political and market volatility along the way. Indeed, the headlines could get considerably worse before they get better.

2 What is the outlook for emerging markets?

The long-term growth opportunity

Over 80% of the world's population live in emerging economies. Since 1960, the populations of the developed economies have risen by about 350 million people, compared with an increase of nearly 4,5 billion people in the emerging world. Over the next 30 years, those countries that we currently term 'emerging' are forecast to see their populations expand by close to 2 billion people. Today's developed economies are expected to see an increase in their population of less than 30 million people.[2]

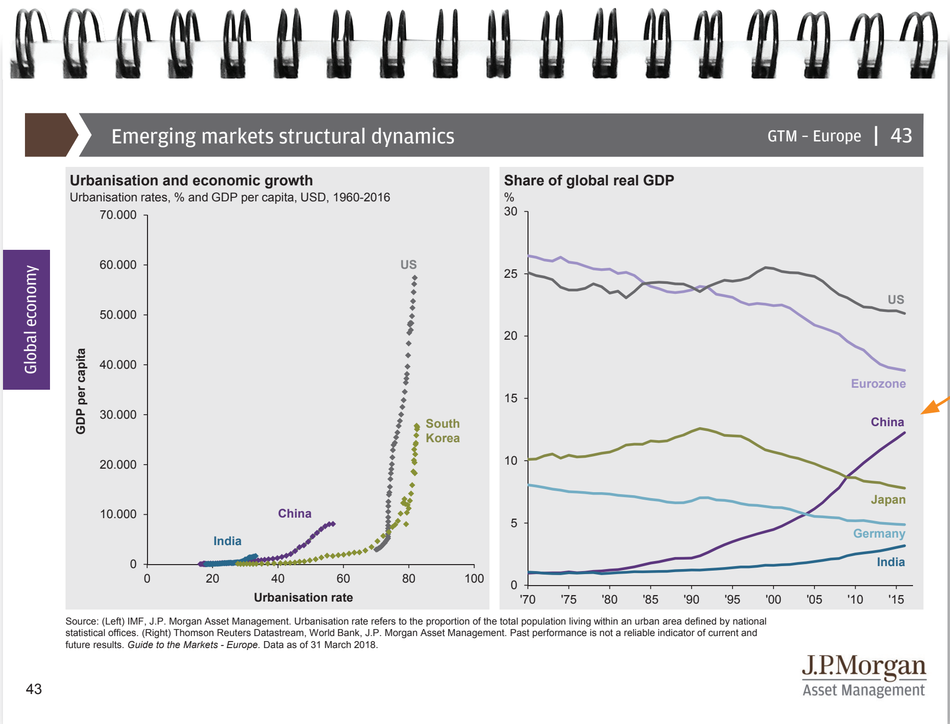
Having more than doubled its population since 1960, China's demographic boom is now largely over. China's population is likely to remain at around 1,4 billion through to 2050. In contrast, India's population is forecast to increase by a further 275 million.

While India's demographics are more favourable, both China and India stand to benefit significantly from further urbanisation. Incomes tend to rise as workers move from less productive rural jobs to more productive jobs in urban areas.

Improvements in education will also lift productivity. Significant improvements have already been made but the average number of years spent in school in India is 6,3 and in China it is 7,6. This compares to 13 years on average in the US[3].

OVERVIEW

- Over the next 10-15 years we forecast that the emerging economies will grow real GDP at an average rate of about 4,5% per year compared with only about 1,5% for the developed economies.
- Asia is a key part of this growth story. We expect the rate of Chinese growth to slow but to still average about 5% per annum over the period. India, starting from a lower base, should be able to grow at an average rate of about 7% per year.
- Higher GDP growth should lead to higher revenue and earnings growth. Over the long term we expect emerging market (EM) and Asian equities in particular to be the best performing asset class .[1]



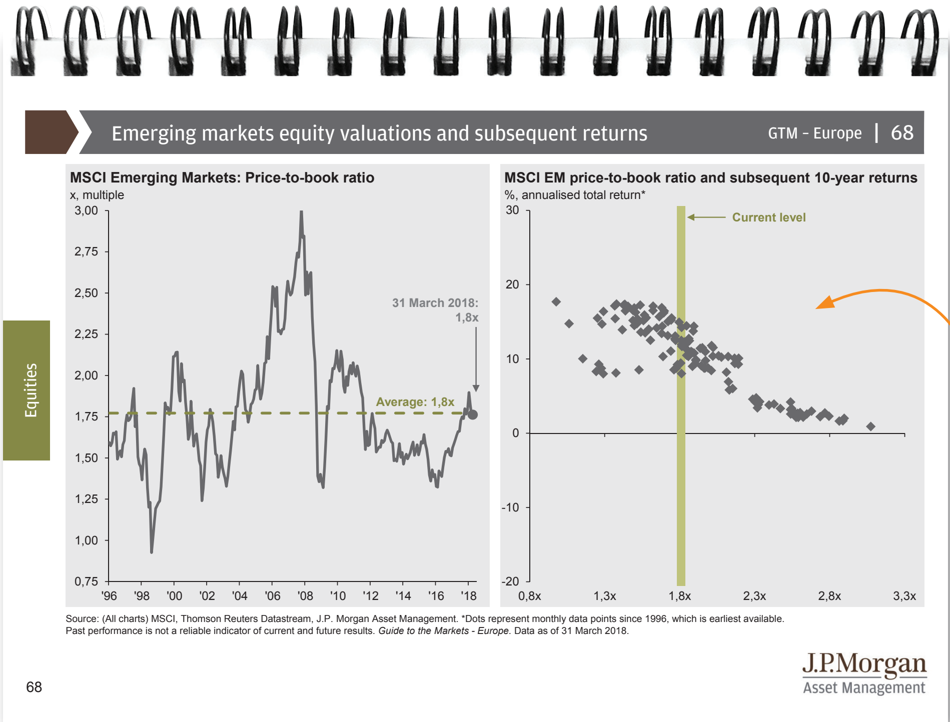
The EM share of global GDP should continue to rise.

Source: *Guide to the Markets – Europe*, page 43

[1] J.P.Morgan Asset Management, *2018 Long-Term Capital Market Assumptions (LTCMA)*, October 2017. https://am.jpmorgan.com/gb/en/asset-management/gim/adv/insights/ltcma-2018

[2] United Nations Department of Economic and Social Affairs, *World population projected to reach 9,8 billion in 2050*, June 2017. https://www.un.org/development/desa/en/news/population/world-population-prospects-2017.html

[3] United Nations Development Programme, *Human Development Report 2016: Human Development for Everyone*, 2016. http://hdr.undp.org/sites/default/files/2016_human_development_report.pdf



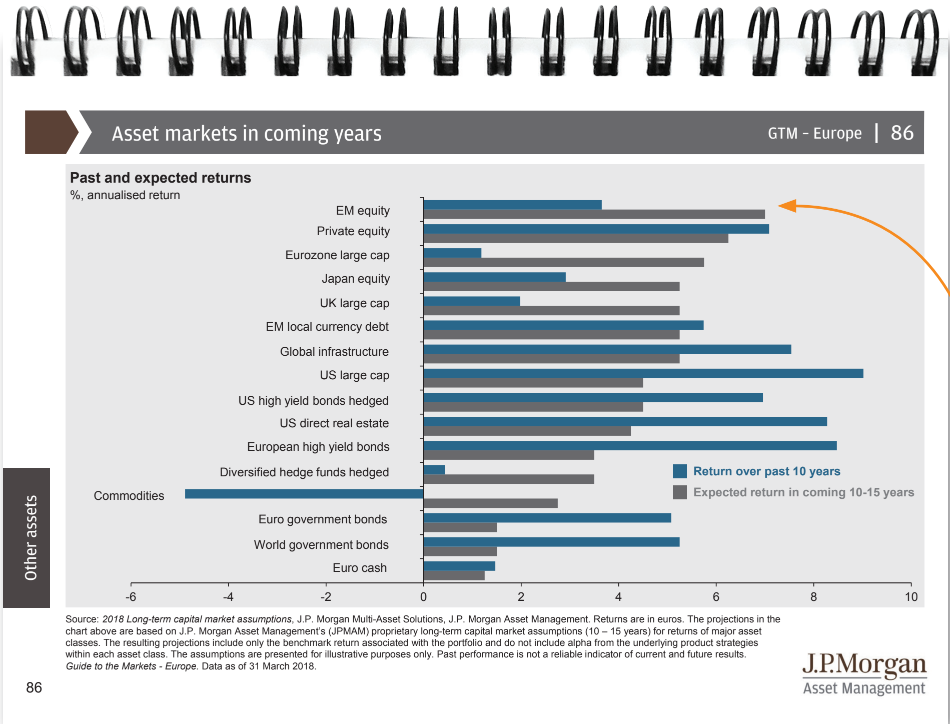
EM valuations appear supportive of long-term returns.

Source: ***Guide to the Markets – Europe***, page 68

Valuations aren't stretched

Even though emerging markets have the potential to grow significantly faster than developed markets, EM equities still appear to be relatively conservatively priced given current valuations. From these starting valuations the long-term returns on EM equities have historically been strong.

The strong fundamental growth backdrop for emerging markets argues for a decent structural long-term exposure in investor portfolios. When valuations look very stretched, as they did in 2007, investors would have been wise to reduce their exposure to EM. On the other hand, when valuations look very cheap, as they did after the Asian financial crisis, the bursting of the dotcom bubble, the credit crunch and the more recent commodity price crash, that has historically been a very good time to increase exposure to emerging markets.



EM equities are expected to deliver strong returns in the coming decade.

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

Potential to deliver strong returns in a lower return environment

We believe we are in the late stage of the US economic cycle but that there is no sign of an imminent recession. Between now and the next recession, we would expect EM equities to perform well, driven by a rebound in earnings and their cyclical exposure.

No equity market, including EM, is likely to be immune from the next bear market when the next recession does finally arrive. However, for a long-term investor, we believe that EM equities offer the most attractive potential returns from this starting point, in an environment where returns for most asset classes are expected to be lower than in the past. The potential for high GDP growth to drive strong long-term earnings growth, combined with reasonable starting valuations, gives EM equities a good chance of outperforming over the long term.

INVESTMENT IMPLICATIONS

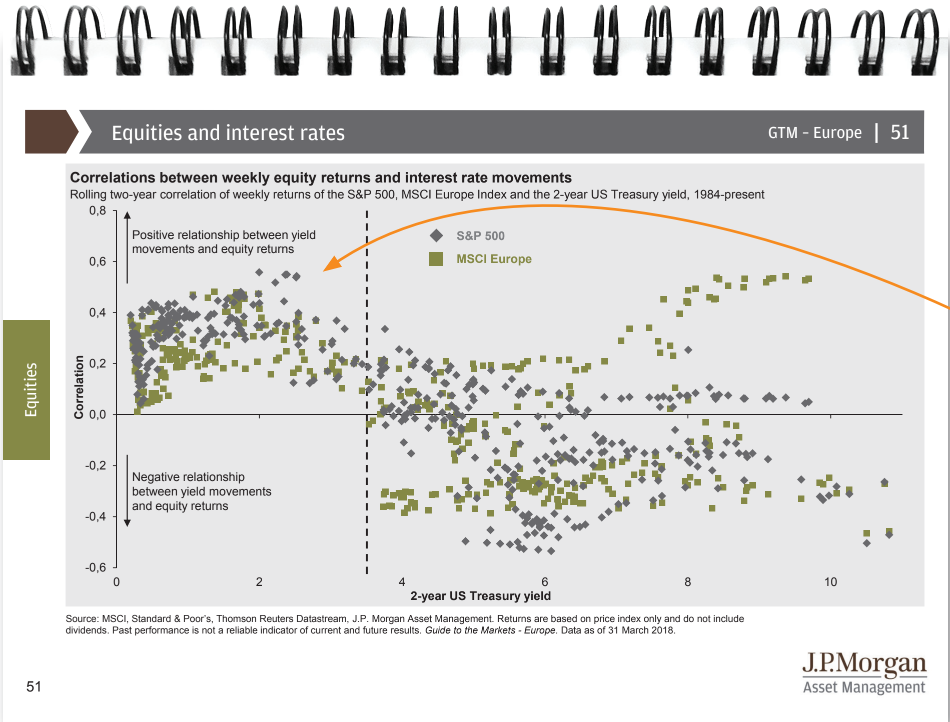
- EM equities have the potential to outperform over the long term as rising levels of urbanisation and education lead to rising incomes and faster GDP growth than in the developed markets.
- Current valuations and the economic backdrop all suggest there are significant tailwinds for EM equities this year.

3 Do higher interest rates pose a threat to the recovery and risk assets?

Central banks are easing off the accelerator

As the risks of deflation are diminishing, central banks are increasingly confident about withdrawing monetary stimulus. The US Federal Reserve (the Fed) is on a path of gradual interest hikes and is slowly winding down its quantitative easing programme.

Historically, the relationship between interest rates and equity returns is an inverted-U. When interest rates are rising from a low base equity prices have tended to rise (see chart). When the two-year rate has passed a threshold of around 4%, rising yields have tended to coincide with falling equity prices.



Source: ***Guide to the Markets – Europe***, page 51

Historically, interest rates rising from a low level have coincided with positive equity returns.

OVERVIEW

- Central banks are starting to reverse the extraordinary monetary policies in place since the financial crisis. Historically, interest rates rising from a low base have coincided with positive equity returns.
- This year we expect a very slow and gradual tightening of global monetary conditions. This is unlikely to significantly restrain corporate earnings, or equity returns.

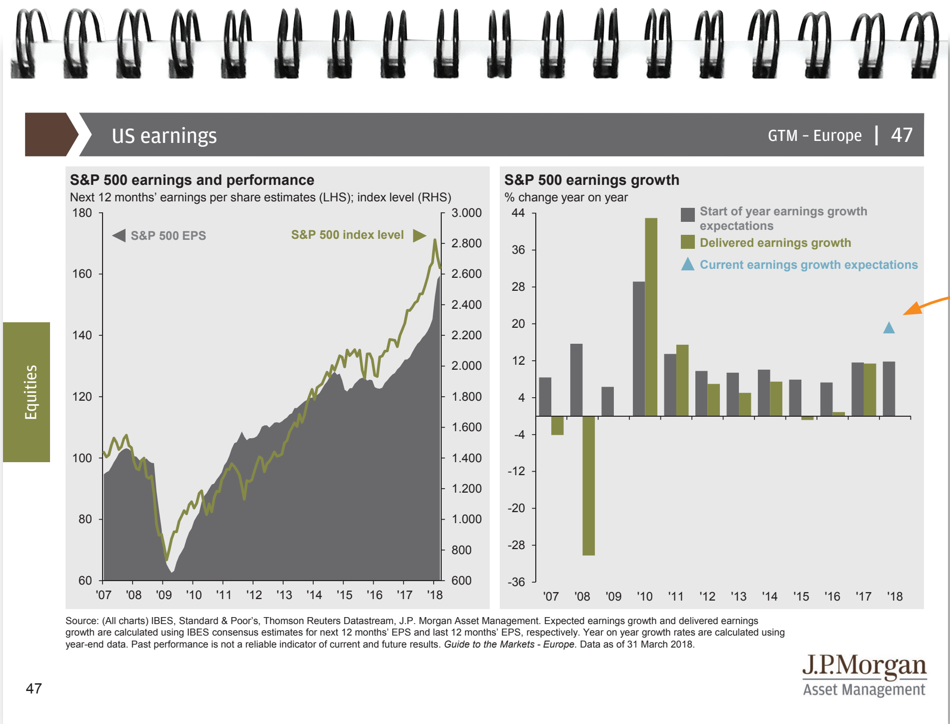
The easiest way to understand this relationship is to distinguish between a central bank easing off the accelerator (raising rates from a low level) and a central bank that is applying the brake (moving rates to a level that is restrictive for the economy).

A central bank eases off the accelerator when it is confident the economy has its own momentum. Animal spirits are rising; households and businesses feel more confident about the future and are willing to spend and invest. Companies benefit from higher sales and regain a degree of pricing power, which helps corporate margins.

A central bank is thus raising the rate at which future corporate earnings are discounted by investors, but this is overwhelmed by upward revisions to expectations of corporate earnings. That is exactly what has happened over the past year. The Fed has raised rates but earnings have been much stronger than expected, which has pushed equity prices higher.

INVESTMENT IMPLICATIONS

- The market is currently pricing around three rate hikes this year from the Fed and the US two-year rate currently sits at 2,3%.
- There is a rich debate about whether 4% still represents the accelerator/brake threshold that it has in the past. Even if it is lower this time we are still comfortably below levels that we believe will prove restrictive.
- Given we expect central banks to normalise policy very gradually we still expect equity prices to move higher this year as a rising discount rate is offset by strong tailwinds to corporate earnings.



2018 is expected to be another good year for corporate earnings.

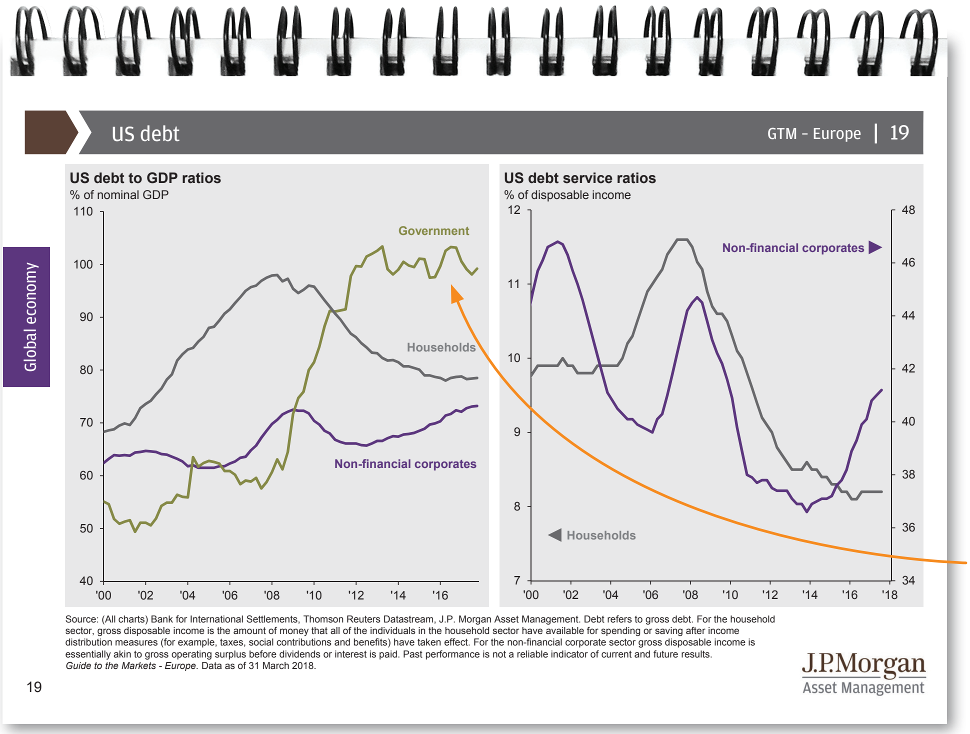
Source: ***Guide to the Markets – Europe***, page 47

At the late stage of the cycle, however, central banks start to worry about emerging inflationary pressures and will want to dampen animal spirits. In this instance the discount rate is rising but analysts simultaneously revise down their estimates of future earnings. Rising bond yields then coincide with negative equity returns.

4 How is fiscal policy in the US and Europe affecting the investment landscape?

US fiscal policy in the spotlight

The US household sector has made great strides in reducing its debt. The government sector has not made such good progress, but this has not stopped the US administration announcing a major package of government spending and tax cuts in recent months.



Source: ***Guide to the Markets – Europe***, page 19

Government debt is still high in the US but this has not stopped the administration announcing a major fiscal package

On top of the tax cuts voted through in December 2017 the government has agreed a USD 400 billion spending programme. This new spending is likely to increase the US deficit to more than 5% of GDP by 2019[1].

The International Monetary Fund estimates that the US stimulus package could add 1,2% to US GDP by 2020[2]. The US administration also has ambitions to increase investment in infrastructure. The American Society of Civil Engineers estimates that, given the current state of US infrastructure, USD 4.5 trillion of investment is required by 2025, though it is doubtful that the president will get backing for infrastructure spending at this stage.

The market has received the news of US fiscal stimulus with a mixture of joy and trepidation. On the one hand this is an additional boost to growth. But unemployment is already very low and we have never seen a fiscal stimulus this late in the cycle. There are concerns in some quarters that more fiscal stimulus will simply lead to higher inflation and tighter monetary policy.

OVERVIEW

- Government debt as a percent of GDP is still high in the developed world. But with populations increasingly overwhelmed by “austerity fatigue” governments are turning to looser policies. This is most evident in the US, but governments in Europe are also taking advantage of low borrowing costs to spend more.
- This fiscal stimulus could extend the economic cycle, although markets will remain nervous that higher government spending will ultimately result in higher inflation and higher interest rates. If inflation remains benign – our core scenario – then looser fiscal policy is likely to reinforce the global economic recovery in the coming years and support financial markets.

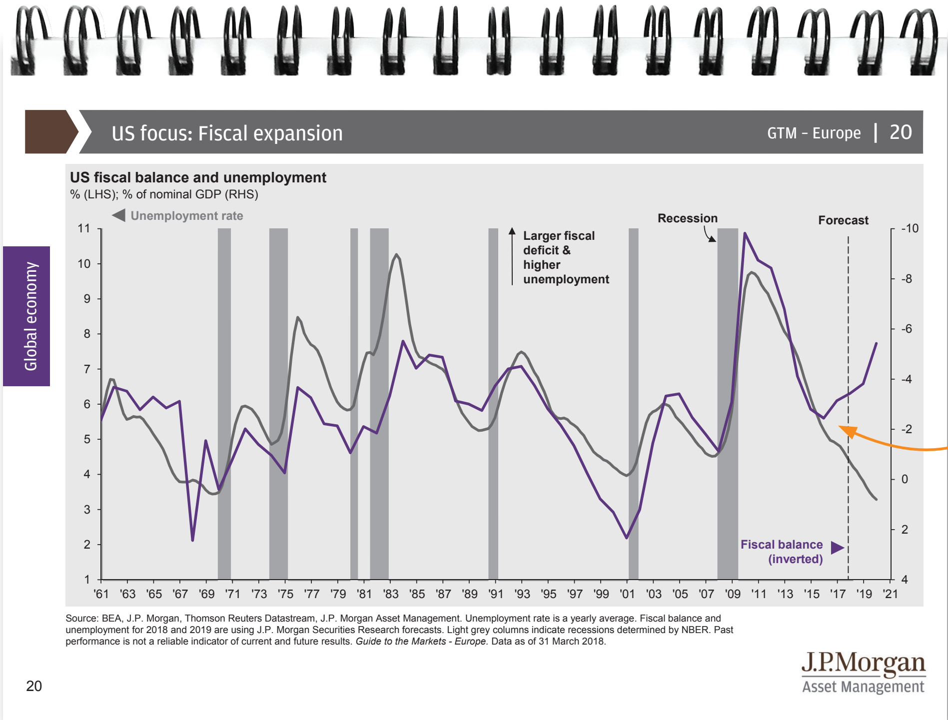
[1] US Congressional Budget Office, *An Update to the Budget and Economic Outlook: 2017 to 2027,* June 2017.

[2] International Monetary Fund, *World Economic Outlook Update: Brighter Prospects, Optimistic Markets, Challenges Ahead,* January 2018. https://www.imf.org/en/Publications/WEO/Issues/2018/01/11/world-economic-outlook-update-january-2018.

But Europe is also edging towards more expansionary policy

The 2012 eurozone sovereign debt crisis forced many European Union (EU) member states to focus on reducing their budget deficits. However, the fact that governments are having to pay such low interest rates as they roll over their debt is helping them reduce their deficits. Economic growth and falling unemployment will also increase tax receipts and reduce spending. As a result, governments will naturally be able to increase spending without seeing a corresponding increase in their deficits. Several European governments have recently announced their intention to spend more, including Germany[3], the Netherlands and Belgium.

In addition, the European Commission launched the European Strategic Fund for Investment in 2014, an off-balance sheet vehicle that, with little public money (EUR 33,5 billion) and 15 times leverage, is planning to invest EUR 500 billion in strategic projects around Europe[4] by 2020.



Source: ***Guide to the Markets – Europe***, page 20

INVESTMENT IMPLICATIONS

- The US fiscal stimulus is sizeable and should feed through to stronger economic growth and corporate earnings. Estimates of S&P 500 earnings this year have shot up to 20% following 12% earnings growth last year. In Europe, the scale of the stimulus may not be so large but many countries are now gradually moving towards introducing looser fiscal policies.
- Markets are concerned that with unemployment already low, greater spending by the US government will simply show up in higher inflation and cause the Federal Reserve to raise interest rates more rapidly. We expect inflation to increase only gradually and therefore US growth and markets should be supported by fiscal expansion through the course of the year.

It is very unusual to see such a large fiscal expansion when unemployment is low.

[3] J.P.Morgan Asset Management, *German politics: SPD members vote for four more years of Chancellor Merkel*, March 2018. https://am.jpmorgan.com/gb/en/asset-management/gim/adv/insights/market-bulletin-german-spd-party-vote-march-2018

[4] European Investment Bank, *European Fund for Strategic Investments*, March 2018. http://www.eib.org/efsi/

The Market Insights programme provides comprehensive data and commentary on global markets without reference to products. Designed as a tool to help clients understand the markets and support investment decision-making, the programme explores the implications of current economic data and changing market conditions. For the purposes of MiFID II the JPM Market Insights and Portfolio Insights programmes are marketing communications and are not in scope for any MiFID II/MiFIR requirements specifically related to investment research. Furthermore, the J.P. Morgan Asset Management Market Insights and Portfolio Insights programmes as non-independent research have not been prepared in accordance with legal requirements designed to promote the independence of investment research; nor are they subject to any prohibition on dealing ahead of the dissemination of investment research.

LV–JPM50961 | 04/18 | 0903c02a81fb92cd