Considering Brexit

Strategists and portfolio managers weigh the economic and investment implications

July 2016

THE UK'S JUNE 23 REFERENDUM TO LEAVE THE EUROPEAN UNION CERTAINLY STARTLED MARKETS and sparked a sharp decline in global risk assets, but it did not set off a systemic shock. Yet even as markets absorbed the short-term impact, investors confronted a wide range of questions about the longer-range economic, geopolitical and investment impact of the Brexit vote.

At the end of June, we assembled a panel of strategists and portfolio managers to address some of the questions that are top of mind for global investors.

How might the Brexit shock impact growth in the UK? Will it derail the global recovery?

STEPHANIE FLANDERS, *Chief Market Strategist for UK and EMEA*

The Brexit vote has produced a large shock, but a local one. Our best estimate is that it will take at least a percentage point off the UK's growth rate over the next year. The annualized pace of growth in GDP would fall from 1.6% to about 0.6% in the second half of 2016, with a similar growth rate in 2017. In the eurozone, Brexit might shave 0.4% off GDP over that period, possibly strengthening the case for the European Central Bank (ECB) to expand its quantitative easing in the autumn. Bank of England Governor Mark Carney has already signaled that "some monetary easing will likely be required over the summer."

The UK and eurozone account for 22.2% of global GDP, but we do not believe that the Brexit shock poses an immediate threat to the global recovery (**EXHIBIT 1**, next page).

Overall, what is the outlook for UK equities?

STEPHEN MACKLOW-SMITH, *Portfolio Manager, European Equity Group*

Stocks and sectors that are sensitive to UK growth, many of them mid cap names, will likely underperform. On the other hand, internationally exposed stocks and sectors could find support in a weaker sterling, which should boost export earnings. Even a small rise in inflation domestically as a result of higher import prices could help corporate earnings overall if companies can reclaim some modest pricing power. In recent years, extremely low levels of inflation have made it difficult for many firms to raise prices.

The services sector has been a key strength of the UK economy. If Britain loses uninhibited access to the European single market, we may very well see its trade surplus in services—including financial services—eroded over the next four or five years.

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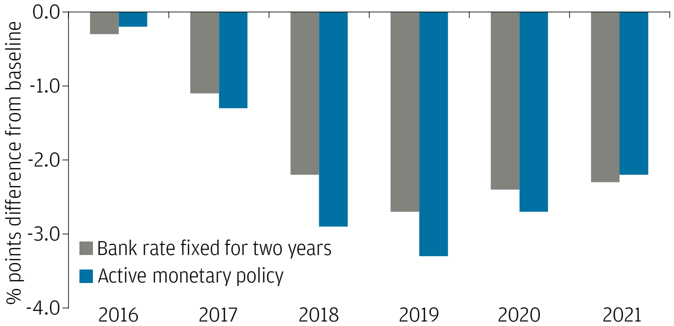
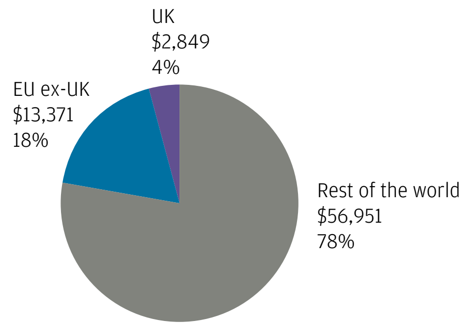
GDP will be lower—but will it be enough to derail the global economy?

EXHIBIT 1A: INDICATIVE OUTLOOK OF IMPACT ON GDP IN UK



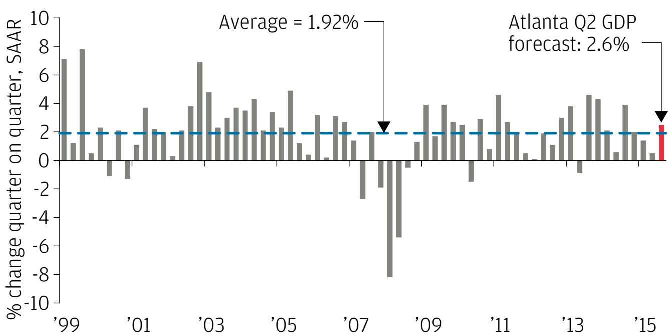
Source: National Institute of Economic and Social Research (NIESR), J.P. Morgan Asset Management; data as of June 28, 2016.

EXHIBIT 1B: BREAKDOWN OF WORLD GDP (USD, BILLIONS)



Source: National Institute of Economic and Social Research (NIESR), J.P. Morgan Asset Management; data as of June 28, 2016.

EXHIBIT 1C: U.S. REAL GDP



Source: Atlanta Fed, FactSet, J.P. Morgan Asset Management; data as of June 28, 2016.

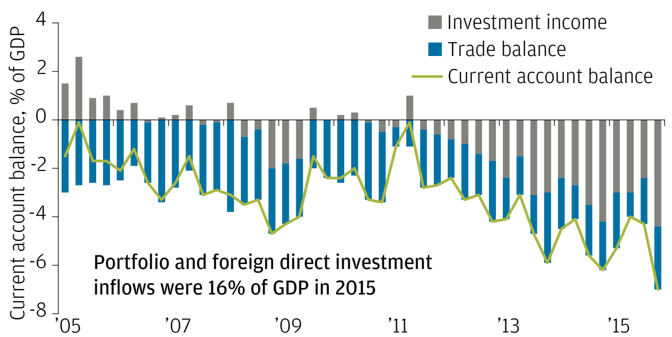
How will UK and European banks weather the Brexit storm?

STEPHEN MACKLOW-SMITH, *Portfolio Manager, European Equity Group*

Bank capital levels are substantially higher than they were in 2007-08, and UK and European banks are much better equipped to weather volatility. We'd note here that sterling could well fall further (after suffering its biggest one-day drop in 30 years), but banks look fairly well positioned to handle the impact (**EXHIBIT 2**).

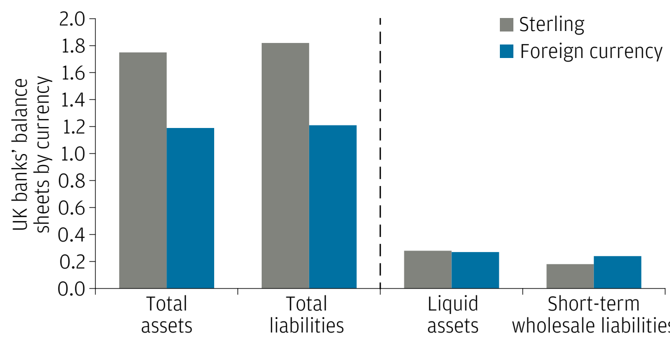
The UK needs foreign lending to plug its current account gap, and the pound could fall further, but banks look fairly well protected

EXHIBIT 2A: CURRENT ACCOUNT BALANCE, % OF GDP



Source: National Institute of Economic and Social Research, J.P. Morgan Asset Management; data as of June 28, 2016.

EXHIBIT 2B: UK BANK BALANCE SHEETS BY CURRENCY



Source: National Institute of Economic and Social Research, J.P. Morgan Asset Management; data as of June 28, 2016.

European high yield offers attractive default-adjusted spreads

EXHIBIT 3A: EUROPEAN HIGH YIELD UPGRADES, DOWNGRADES, 1990–2016

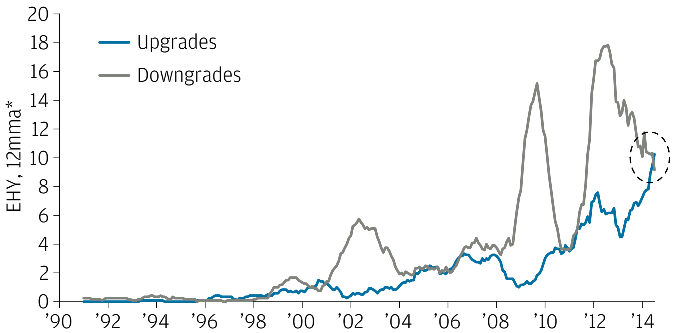
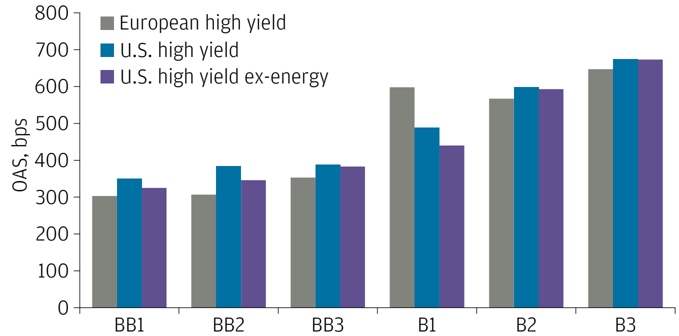


EXHIBIT 3B: U.S. AND EUROPEAN HIGH YIELD OPTION-ADJUSTED SPREAD



Source: BofA Merrill Lynch indices (HP4N, H4UN, H4XC), Barclays Research, Moody's, J.P. Morgan. Spreads as of May 31, 2016; upgrades as of September 2015.
OAS: option-adjusted spread.

*EHY: Europe high yield; MMA: monthly moving average.

Where can investors find opportunity in fixed income markets?

NICHOLAS GARTSIDE, *International CIO of Global Fixed Income, Currency & Commodities Group*

We aim high in our fixed income portfolios—we look for higher quality, higher yield and higher duration. In the wake of Brexit, nearly one-quarter of the global economy experienced a growth shock. This will probably persuade central banks to once again take action. If the Bank of England doesn't move in July, it will in August, we believe. By the end of the year, the ECB should ease aggressively again, and the Federal Reserve (Fed) is probably done hiking for this market cycle.

All that easing will underwrite credit risk, which is one reason we like European high yield. Europe is behind the U.S. in its credit cycle. Corporate fundamentals look reasonably robust, reflected in the fact that high yield upgrades have recently surpassed downgrades (**EXHIBIT 3**). As we assess the sector, we think European high yield offers attractive default-adjusted spreads.

The Brexit vote occurred amid sluggish global growth and expectations of muted asset returns. How can investors position multi-asset portfolios in such an environment?

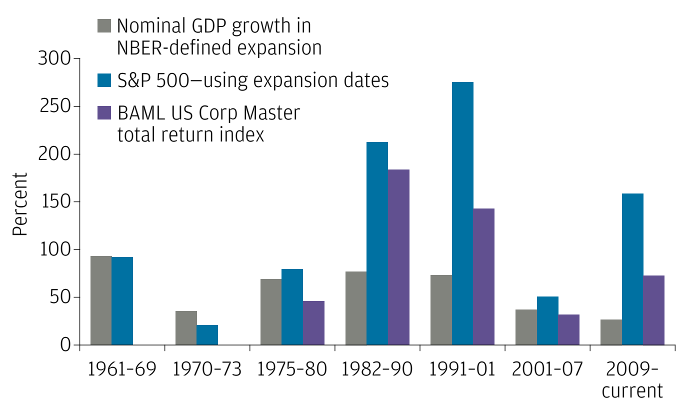
JOHN BILTON, *Head of Global Multi-Asset Strategy, Multi-Asset Solutions*

In this recovery, gains in asset markets have run far ahead of gains in the real economy. U.S. equity returns, for example, have outpaced economic growth by eight times in the current expansion vs. a historical average of about three times (**EXHIBIT 4**). This is causing some concern that valuations are dangerously extended. We disagree. But this gap does point us toward higher quality, more immunized assets.

Brexit did not fundamentally change our core asset allocation views. We maintain an up-in-quality bias, prefer U.S. assets, choose credit over equity (again with a quality bias), expect U.S. equities to outperform other global equities, and favor duration as a portfolio hedge. Even in a low return world, events such as Brexit can shine a light on relative value opportunities.

The U.S. market may be extended, but it remains the best of the pack

EXHIBIT 4: GDP GROWTH, S&P 500 AND CORPORATE BOND RETURNS DURING EXPANSION PERIODS OF THE LAST 50 YEARS



Source: Bloomberg, Datastream, J.P. Morgan Asset Management; data as of June 15, 2016.

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