Midyear Outlook 2016—Q&A

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QUESTIONS & ANSWERS

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Where are we in the business cycle, and what are the major global macroeconomic trends unfolding?

Despite the rising political risk evident in the rebellion of voters around the world against the existing political establishment and economic status quo, indicators of global economic growth have stabilized and begun a slow pickup. The proximate cause is the stabilization of the dollar and commodity prices, especially oil prices. Most of the growth drag that developed in 2015 was almost directly traceable to the dollar's big rise and the oil price collapse that began in mid-2014. Thus, it should not be a surprise that this drag has dissipated with the stabilization of the foreign exchange (forex) and commodity markets. Consequently, the most pronounced relief has been in the emerging markets (EMs), where dollar strength and commodity weakness were particularly damaging. As a result, EMs have been the big outperformers thus far in 2016.

As 2016 began, fears of further dollar appreciation and oil prices below $20 per barrel were causing a spike in recession concerns and risk-off behavior—moving to investments that are perceived to be lower risk—just when leading indicators were showing that a bottom had formed in a host of economic indicators that track global momentum.

Global central banks helped solidify that turn with additional stimulus. The Federal Reserve (Fed) backed off from its four-dot outlook—four rate hikes in the coming year—pledging more patience. The European Central Bank (ECB) and the Bank of Japan (BOJ) both moved further into negative rate territory, and ECB President Mario Draghi stepped up asset purchases. Yields plunged as a result, making even cheaper finance available to global businesses and consumers.

The panic over the dollar's potential rise turned out to be overdone. Similarly, the fears of a collapse in energy and commodity prices peaked for several reasons. First, prices successfully held to the 2009 financial crisis lows; and second, worries about financial fallout from related loan defaults mushroomed into fears of a systemic financial crisis—but after stock prices fell to bargain-basement levels, they underwent a massive rally, bringing them right back to where they started, for the third time in a year. This indiscriminate sell-off set the stage for a cyclical rise.

Aside from the dollar and oil, China was another focus for worries at the start of the year. The Asian powerhouse led the previous expansion, carrying many commodity-producing emerging markets on its coattails. The peak in China's ascendance occurred in the first two years of the global economic recovery, in late 2009 to early 2011. Global growth peaked at over 5% during China's last gasp of double-digit growth:the Middle Kingdom basically threw everything but the kitchen sink at its economy when the financial crisis hit, sparking a final growth boom. The crisis started in the U.S. and developed worldwide while EMs were still fairly healthy. They weathered the crisis once global trade came back. Their glory days ended in 2011, however, and they have been through a downturn since. EMs are now showing signs of a cyclical recovery, with lots of variation across countries. China is in a major structural transition, away from export and investment-led heavy industry, commodity-intensive growth, and toward consumer-led domestic demand focused on services and more modern intangible output growth. This has had different effects on other emerging markets: It's been good for an intellectual capital, service-intensive economy like India's, and bad for a natural-resource-dependent economy like Brazil's.

Part of China's transition has included a much stronger yuan exchange rate. The yuan was up about a third against the dollar after China let its currency appreciate, starting in August 2005. This made sense to help strengthen domestic demand and Chinese consumer spending power at the expense of export competitiveness, which dominated the old growth model. Unfortunately, when the dollar surged in 2014, the yuan went along for the ride and rose sharply against its other major trading partners' currencies. In retrospect, this was too much of a good thing. The renminbi has risen by almost half against many world currencies while China's economy has slowed during the structural transition since 2011.

Earlier this year some of the panic was focused on the massive overvaluation of the yuan and the need for a big correction in its value, which was seen to be causing a deflationary shock to an already deflating global economy. In reality, the yuan has been remarkably stable so far this year and is off only about 10% from its all-time high, in 2015.

From late 2012, when Europe began to stabilize and come out of its double-dip recession, until mid-2014, when the oil and dollar shock hit, developed economies were generally gaining momentum. Emerging markets, however, continued to slow, alongside China, a process that began after China's momentum peaked in early 2011. Lately, as China, oil, and the dollar have stabilized, EM Purchasing Managers Indexes (PMIs) have moved higher, as reflected in the three-month average's rise past 50 this year, as well as in the 12-month average downtrend. The incipient turn in EMs has caused global growth to stop declining, as is evident in the year-over-year gross domestic product (GDP) growth rate for the global economy rising for the first time since the dollar and oil shock hit in mid-2014. The leading indicator for global growth is also starting to point higher after bottoming late last year.

The Brexit vote has raised new fears about the sustainability of the global expansion. While the exit of Britain from the E.U. is still at least a couple of years away, there is concern that uncertainty about the eventual form that the "exit" takes will freeze business investment until there is more clarity. This uncertainty has heightened volatility. Nevertheless, volatility remains well within a normal range for this stage of the business cycle. In addition, the negative effect of rising uncertainty has been offset at least partially by another leg lower in real interest rates, which provides some stimulative counterweight. The outlook for further Fed rate hikes, for example, has been put on hold until it is clear that growth remains on track.

Given these offsetting forces, the key "tell" for the impact of Brexit is in the currency markets. If Europe and the U.K. were about to go into severe recession, or world economic growth was set to slow down sharply, the dollar would almost certainly surge and reignite the earnings, deflation and growth drags that scared the equity markets so much in 2015. So far, currencies have been remarkably steady on the whole. The dollar, which had surged from 80 to 100 on the DXY major currency index between 2014 and 2015, has remained around 95, the level that has prevailed for most of 2016. This is an important sign that the global economy remains in good shape despite Brexit-related fears. On balance, reflationary forces still seem to have the upper hand.

Eventually, Brexit could have a big impact on the world economy, either negative or positive, depending on its ultimate effect on the U.K.'s and European Union's relationship. Until new arrangements are set, it's purely speculative to conclude what its impact will be. For now, any impact comes primarily from uncertainty about its eventual form. The same can be said for other sources of geopolitical uncertainty, like the coming U.S. elections. This uncertainty has clearly dampened investment spending. Still, a strong consumer sector, little phased by these concerns thanks to the best fundamentals in three decades, should keep growth positive. Solid consumer demand in Europe and the U.S. will force at least a maintenance level of capital investment, if only to satisfy current needs.

The U.S. economy is the engine in this expansion. Until Brexit worries surfaced, the U.S. and the U.K. were the "steady Eddies" of this expansion. China and many EMs peaked early in the period of U.S. expansion and faded until recently. Their new recoveries are in very early stages. Europe and Japan lagged because of their cultural resistance to the monetary policies pursued in the U.S. and U.K.—namely, quantitative easing (QE) and more aggressive inflation targeting. By 2012, Mr. Draghi, who was trained in the U.S., and the BOJ, under Abenomics, adopted the Anglo-American recipe when they saw it working.

This means the U.S. is further into its expansion than Europe and Japan, and even more so than the EMs, which are just starting their upturns. The U.S. expansion turned seven years old in June. This is longer than the historical average. Expansions, however, have been much longer than average since 1960. The 1960s, 1980s and 1990s expansions are the three longest expansions in U.S. history. The current one is likely to set a new record, in our opinion. First, inflation is very low and we see little reason for tight monetary policy, which has been a feature of every recession since World War II. That's

because inflation tends to rise as the cycle matures and the Fed tamps it down. We doubt that's going to happen anytime soon.

Aside from the Fed-inflation combination, we see no evidence that expansions "die of old age." In fact, a wide variety of consumer indicators suggest that household income, wealth and job prospects are the strongest in over three decades. Finally, sentiment remains less than exuberant. In fact, we have characterized the mood as one of "irrational pessimism" for several years, as consumer surveys have shown that years into the expansion, people still thought the economy was in recession. Widely respected sources have constantly come up with (tenuous) reasons for why the ongoing drop in the unemployment rate is a deceptive indicator of economic health. Another misinterpretation claims that the 12-million-plus jobs created over the past six years are "crummy," low-paying jobs. Data suggest the opposite is the case. If we categorize jobs by whether they pay more or less than average, new above-average paying jobs outnumber below-average paying jobs by about three to one. As a result, consumers' confidence about their own situation is at fairly strong levels despite the widespread view that the economy is not doing well. Depressed sentiment about the overall economy can prolong an expansion, which usually only ends in a burst of "irrational exuberance."

Low inflation means the Federal Reserve can take its time raising rates. The latest "dot plot" economic analysis brought down the outlook for the federal funds rate to a level that is consistent with the Fed's expectation for 2% growth and 2% inflation over time. The long-run funds rate that Federal Open Market Committee (FOMC members) appear to see as consistent with those conditions has been steadily declining, largely because the Fed has slowly grasped a "new normal" rate structure similar to that we proposed several years ago. This structure is based on the notion that a heavily indebted economy needs a much lower real interest rate to foster the growth and inflation that meet the U.S. central bank's goals for full employment and price stability.

Another reason why FOMC members have been slower than the market to grasp the "new normal" was that they were looking at interest rate averages that prevailed in the 1980–1995 period, when real rates were unusually high by historical standards, having been raised in order to bring inflation back down to its new, lower range, a process known as "opportunistic disinflation." Average real rates before 1980 were much lower, with short-term money-market rates, like the funds rate, averaging closer to zero in real terms than the 2% or 3% neutral rate that many economists estimated based on data from the 1980s and early 1990s.

As the "low real rate for longer" view has sunk in, Fed Chair Janet Yellen has begun to talk about it in recent speeches. This is also apparent in the fact that the long-run average that FOMC members expect for the federal funds rate has come down from about 4% in June 2013 to about 3% in the latest dot plot. Low real interest rates are supporting global growth. Until inflation becomes an issue, that's likely to continue. As it showed at its latest FOMC meeting, the Fed continues to err on the side of extra accommodation.

Abnormal, non-U.S. central bank policy: How far does this go, and what is the end game?

Six central banks have now enacted negative policy rates as a means of reducing real interest rates and stimulating credit, consumption and investment. As these rates weigh on the level of longer-term yields across the curve, we find more than $10 trillion in global sovereign debt is currently negative yielding. There is no single lower level threshold for rates in all countries. In Switzerland the negative rate is -75 basis points (bp), the ECB is at -40bp, while in Japan it is -10bp. In the U.S., policymakers seem to rule out negative rates altogether, making the lower threshold effectively zero. Policymakers seem to recognize that negative rates punish savers, crimp banks' profitability, harm the functioning of money market funds, and potentially slow the velocity of money.

Following severe bouts of risk aversion, rates can go negative, not from policy decisions but from investors moving funds into "safe havens.". The uncertainty following the U.K. decision to leave the EU pushed German bund yields below the -40bp deposit rate. U.S. Treasury rates are declining toward historical lows around +140 bps.

There are both practical and theoretical limits to how negative rates can go. One such practical limit is the ECB's policy not to buy debt that is below its deposit rate of -40bps, so as risk-off flows drive yields lower, this will exclude that debt for eligibility in the ECB's quantitiative easing, or QE. Another limit to negative rates is the willingness of holders of paper currency to accept them. German economist Silvio Gesell pioneered the concept of negative rates as a tax on paper money. This tax only applies if money is held at the bank, however, so more negative rates are likely to drive cash out of the banks and into safes and under mattresses, as we have seen in Japan. This is one limit to negative rates, essentially where the interest rate costs exceed the carry and storage costs to the currency holder. However, as electronic currency becomes more prevalent and replaces paper money, this limit on negative rates should relax. Already, Canada is experimenting with electronic currency called CAD-COIN, which would be allocated on a distributed ledger (what does that mean in plain English?).

Another limit to negative rates is the gradual rise in inflation that we expect to see going forward. As inflation rises, central banks will have less need to resort to extreme negative rates to push down real rates; instead, they can simply allow rising inflation to push down real rates.

The end game for negative rates in this cycle is likely close. As nominal interest rates fall further into negative territory, the negative side effects tend increasingly to outweigh any benefits to stimulating credit availability and growth. Rising inflation from a recovery in commodity prices and stability in the dollar should also help keep real rates low. Ultimately, however, the most obvious alternative to ever-deeper negative rates is plain vanilla pro-growth fiscal policy.

China growth and its economic transformation: What is next, and what is the impact on everyone else?

The worst fears that surrounded China for much of the second half of last year and the early part of 2016 have now largely receded. Though it remains a year-to-date laggard within the emerging world, the mainland stock market (which plunged by close to 50% between June of last year and January of this year) has since stabilized. Central bank foreign exchange reserves—which fell by around $450 billion between August and February—have since been close to flat. And while the exchange rate continues to trend lower, there have been no further abrupt policy shifts of the type we saw last summer.

Meanwhile, China's growth rate continues to decline—it now stands at a 6.7% year-on-year rate, having dipped below 7% in the third quarter of 2015. It should be emphasized that the Chinese authorities still have plenty of policy levers available (both monetary and fiscal) to manage the downtrend in growth, and we expect it to remain gradual rather than turn into a hard landing. But we also expect the shift in the composition of China's growth to have important implications both at home and abroad.

First, we believe the slowdown in fixed investment will remain a demand-side headwind for industrial metals and energy producers. And with the Ministry of Finance restating its funding commitment to new industries, such as information technology and advanced manufacturing, in its latest five-year plan (targeting a doubling of their share of GDP by 2020), we expect competition to continue to intensify for the region's major IT hardware producers. In particular, China's increasing focus on areas like semiconductors, smart phones and PCs is likely to increase competitive pressure on other technology exporters such as Korea and Taiwan. At the same time, China's state-owned enterprises in heavy industrial sectors such as steel and cement should continue to be downsized and restructured for greater efficiency, with support for laid-off workers from state transfers and a stronger welfare state.

Is the direction of the dollar the ultimate key to the world's growth outlook and central bank policy? What's your outlook for the dollar?

We believe the stabilization of the dollar is one reason indicators of global economic momentum have stabilized and begun a slow pickup. On a trade-weighted basis against major currencies, the dollar is now off about 5% from its peak and very close to its long-term fair value. It went from extremely undervalued to roughly fair value over the 2013–2014 period, which required some hard economic adjustments as it gave up its earlier competitive advantage.

We continue to think the dollar could make incremental, choppy gains over the rest of the year on a broad trade-weighted basis, but valuations have adjusted to help rebalance the global economy and are no longer a major tailwind. Thus, gains are probably limited and there is some downside to the dollar versus the yen if risk aversion gains momentum.

Looking at valuations, the broad real trade-weighted dollar moved from undervalued to near its long-term average value as the euro depreciated from nearly 1.40 in 2014 to around 1.11 currently. And commodity currencies like the Australian dollar, Brazilian real and Canadian dollar have fallen alongside the drop in commodity prices seen since the middle of 2011. The Canadian dollar is the second-biggest weight in the trade-weighted dollar and moved from overvalued to undervalued-to-neutral during this period. These currencies have appreciated versus the dollar year-to-date on the back of more favorable valuations and stabilization in commodity prices. We think the biggest gains for the dollar versus these currencies are behind us.

The euro is the biggest component (16%) of the trade-weighted index and makes up almost 60% of the widely followed DXY dollar index. We would not be surprised to see fears of a further populism and a euro breakup rise now as politicians on the continent contemplate following the U.K.'s lead. As we saw in 2011–2012, during the first Greek debt crisis period, fears of an EU breakup coincided with a sharp depreciation in the currency that was only halted in July when Mr. Draghi pledged "whatever it takes" to preserve the euro. We think the euro will be largely range-bound over the next year, with dollar upside if global financial conditions ease substantially, clearing the way for the Fed to raise rates, or euro breakup sentiment gains momentum.

The outlook for the yen is more balanced. There is further yen upside if risk aversion picks up steam (not our base case), but risk-off sentiment has already strengthened the yen to such a degree that the BoJ may have to take aggressive steps to stem its gains and regain reflation credibility. As for China, we expect the country to manage a gradual depreciation of the yuan against the dollar as the People's Bank of China targets a trade-weighted currency basket that is likely to slowly depreciate against the greenback.

Lastly, if global financial conditions normalize, U.S. labor market and inflation data should drive the expected path of Fed rate hikes and have an outsized influence on the direction of the dollar. Because we think the underlying economic fundamentals in the U.S. are solid, we believe there is more risk that the Fed remains less accommodative than the other major central banks, which puts the balance of risk to the upside for the dollar. As mentioned, though, valuations will likely keep dollar gains more muted under this scenario.

The Fed is caught between a rock and a hard place. What are the next steps in policy direction?

The Fed has long stated its intent to "normalize" rates, but to date it has only managed one 25 bp rate hike. Market expectations for a subsequent hike continue to recede amid mixed economic data and global uncertainty that create formidable headwinds for Fed tightening. The most recent uncertainty, Brexit, has shifted our estimation of a rate hike to late 2016 at the earliest. Other global headwinds include persistently sluggish growth across the rest of the world, tepid demand weighing down inflation, and broad uncertainty around both political and geopolitical events.

This leaves the Fed with a range of tools at its disposal, but we think none of them can truly solve the problem of sluggish growth and rising uncertainty. The Fed's easing tools are additional securities purchases, adjustments to the composition and maturity of the Fed's portfolio, and forward guidance that signals a commitment to leave rates low for a prolonged period of time. Further afield are two less attractive policy options: negative rates and helicopter money. In our opinion, negative rates imply a set of likely costs to the banking and money fund sectors, without the guarantee of benefits, and are the least attractive option to policymakers. Helicopter money involves monetizing debt. Indeed, these last two options would be the most explicit form of fiscalized monetary policy yet. Far preferable to the Fed carrying out fiscal policy dressed as monetary policy would be straightforward fiscal policy by fiscal authorities. The Fed's soft but increasingly frequent pleas for a more robust fiscal policy response highlight the need for new nonmonetary policy tools to free the economy from its sluggish path.

With precious few additional rabbits to pull out of a central banking hat, the Fed's next steps should involve a healthy dose of patience. With decreasing impact from additional easing, the Fed's most prudent stance may be to stay accommodative and wait with bated breath for an improvement in the global growth cycle. Going forward, the American central bank is likely to remain between a boulder and a hard place—and to wait for the boulder to move. In our view, the recent turmoil keeps rates low for even longer and raises the stakes for a meaningful fiscal policy initiative to support aggregate demand and growth. If that fails to materialize, one possible downside risk is lower growth amid gradually rising inflation and the specter of stagflation.

What type of portfolio strategy could be most effective in this ultralow interest rate environment? Is "get paid to wait" the type of strategy you are emphasizing?

Going forward, returns from a diversified portfolio comprising traditional asset classes such as stocks and bonds are likely to be lower. Investors will therefore have to embrace income as a more substantial contributor to total returns. We recommend this "get paid to wait" income strategy be deployed with a diversified and risk-managed approach. This is because the lower-for-longer interest rate backdrop requires investors to take risks such as credit, duration, equity volatility and illiquidity to achieve decent income objectives.

A starting portfolio for investors with lower risk tolerance could include a mix of government bonds such as U.S. Treasuries, municipal bonds and U.S. investment-grade corporate bonds. We favor municipal bonds for their tax-advantaged status and investment-grade corporate bonds for their reasonable valuations and higher quality, and also they stand to benefit from foreign inflows. From here, the next step would be for investors to include strategies that provide income and growth opportunities. Our preference is for higher-quality dividend-paying stocks and especially those businesses that have the balance sheet to increase their payouts on a sustainable basis. Many stocks in the S&P 500 index have a higher current dividend yield than the 10-year Treasury bond and the prospect of growing their earnings, cash flows and payouts, which make them attractive holdings for investors willing to look beyond short-term uncertainties.

Beyond government bonds and dividend growth stocks, investors can look to a variety of special situations, depending on their risk profile. These can include selective investments in high-yield bonds, emerging market debt, traditionally higher-yielding sectors such as utilities and global telecommunications, buy-write strategies, publicly traded real estate investment trusts and even rental income from private real estate. Rising economic and policy uncertainty warrants a dynamic approach to maintaining such a diversified "get paid to wait" income strategy, with close monitoring of the changing risks and opportunities.

What is your outlook for fixed income, including credit spreads and market yields? Will yields remain “lower for longer”?

Post-Brexit volatility has led to spread widening in the U.S., but the market move has been orderly, with decent demand from real money investors on the weakness, and with limited instances of any panicked selling. Corporate spreads are still materially tighter from the first-quarter wides. Strong corporate market technicals are counterbalanced by weakening fundamentals, and by a potential continuation of volatility and ramifications stemming from Brexit. On balance, the stronger supply-and-demand technicals should be more relevant to corporate bond performance for the rest of 2016. As spreads have narrowed from the first quarter, however, our expectations for further outperformance have been tempered, and we are positioned accordingly.

Strong demand for investment-grade corporates continues from institutional investors, particularly liability-driven entities such as pension funds and insurance companies that need long-duration, high-quality assets. In addition, foreign investors have been adding to U.S. corporates over the past several years, and with 24% of the Barclays Global Aggregate Bond Index now yielding less than zero, U.S. corporate bonds look attractive on a relative basis. The flight-to-quality bid in European sovereigns post-Brexit—which has seen German 10-year government bonds hit all-time low negative yields—only further highlights this relative attractiveness. We expect the ECB’s new Corporate Sector Purchase Programme to benefit the spread environment by adding a large, price-insensitive buyer to the market, which should anchor euro corporate spreads and further increase the attractiveness of U.S. bonds. Finally, the ECB and low global yield environment are likely to incentivize U.S. companies to shift to debt issuance abroad, reducing U.S. supply and further benefiting the technical backdrop.

While the technical environment has been positive, and is expected to remain so, corporate credit fundamentals appear to be weakening, even outside the troubled energy and commodities sectors. U.S. corporations have taken advantage of low rates and favorable market conditions to issue record amounts of debt to fund mergers and acquisitions (M&As) and shareholder returns. This has led to an increase in leverage; debt/EBITDA is at or close to an all-time high, which should ultimately set the stage for an eventual turn in the credit cycle. However, we believe there is still runway left as profit margins and debt service coverage remain healthy. That being said, increased volatility can cause investors to start focusing more on fundamentals, and we will monitor the market closely for any prolonged shifts in sentiment.

The outlook for tax-exempt bonds is also generally favorable, although we believe investors should be cautious about going very long on the yield curve or lower down on the credit spectrum in search of higher yields. The technical environment has been positive; tax-exempt new issuance has been lackluster over the last few years, as taxpayers have not shown a strong willingness to fund new projects. As a result, the outstanding supply of municipal debt is actually lower now than it was at the end of 2010. On the other hand, retail demand for high-quality tax-exempt income has been very strong, as evidenced by 38 weeks of consecutive municipal fund inflows. Fundamentally, municipal credit is generally holding its own; according to Moody’s, municipal upgrades exceeded downgrades for each of the last three quarters. We do remain concerned, though, about a significant minority of issuers with large and growing unfunded or underfunded pension liabilities, as well as those oil-producing states and local governments that are disproportionately reliant on oil for tax revenues or jobs. We are also watching closely the events in Puerto Rico for signs of contagion spreading into the broader municipal market, although these appear limited so far.

What is the next phase for emerging markets? Does the underperformance of non-U.S. equities overall continue in the second half and into 2017?

After five years of persistent underperformance relative to developed markets, emerging market equities have regained ground in 2016 and remain ahead for the year-to-date. This is not the first bout of EM outperformance we have seen since relative prices peaked in late 2010, and we are not expecting it to develop into a major new EM uptrend. But in line with our position shift in May from underweight to neutral, we do think that the outlook for EM equities relative to developed markets has become more finely balanced.

What explains the improvement, and why is the worst now likely to be behind the asset class? Primarily, two major external headwinds have subsided over recent months. First, the U.S. dollar has stabilized on a trade-weighted basis, and, second, Treasury yields have slumped back to near-record lows. For most of the current cycle, dollar strength meant greater stress on external corporate debt, while periods of rising yields (most notably the 2013 taper scare) meant larger outflows of portfolio capital from the emerging world. But so far this year, the stabilization in the dollar and in yields has been more favorable. And, particularly in the wake of the Brexit vote, we expect a more benign pace of U.S. policy rate increases than was previously expected, to limit the extent of any further dollar strength or any increases in bond yields. This in turn should keep the pressure off EM assets, which are also less directly exposed to developments in Europe and are further supported by undemanding valuations.

Within EMs, we continue to favor markets that benefit most from the sustainable longer-term internal drivers of growth and reform, and we prefer to avoid those that are overly sensitive to the current uncertainties in the external environment. In terms of sectors, this means an ongoing preference for consumer discretionary, technology, consumer staples and health care. And on a country basis, our sole overweight remains in India.

We also maintain a neutral position in non-U.S. developed markets, but expect the fallout from Brexit to be a greater source of price volatility for them than for the emerging world. In the case of Japan, further strength in the yen exchange rate is likely to be a headwind for local market performance. But as with many emerging economies, direct trade and investment linkages between the U.K. and Japan are limited (exports to the U.K., for example, represent less than 1% of Japan's GDP). The most significant impact outside the U.K. itself will be felt within the rest of the European Union. Around 50% of U.K. exports go to other EU countries, while the U.K. in turn accounts for roughly 15% of total EU exports. And with a prolonged period of negotiation ahead, uncertainty around the details of the new economic and political relationship between the two markets is likely to dampen activity on both sides. On balance, we therefore expect further underperformance for non-U.S. markets overall, and we continue to favor U.S. large cap equities in particular.

What phase of the commodity cycle are we in today? What are your thoughts on oil prices and gold?

Commodity prices peaked for the supercycle in 2010–2011, about the same time as the Chinese, emerging market and global growth rates peaked. The end of the latest super-cycle in commodities is typical of other commodity booms, like that in the 1970s. It incentivized massive investments to expand capacity. As that capacity came on line, supply exceeded demand, and a two-decade secular bear market followed, from about 1980 to 2000. The latest supercycle prompted the same response, setting the stage for a new secular bear market. The new commodity price floor is the top of the old 1980–2000 range. Below that floor, supply is not adequate for the world's growing needs.

Looking specifically at oil, the indiscriminate sell-off earlier this year set the stage for a cyclical rise; and oil prices rallied from the February lows as the severe cuts in energy-related capital expenditures (CAPEX) resulted in declining U.S. production numbers. Combined with supply disruptions from Canadian wildfires, disabling attacks on the Nigerian energy complex, and ongoing instability in areas like Venezuela and Libya, the oil market rebalanced faster than consensus expectations. With stronger-than-expected global demand year-to-date, the oversupplied oil market has quickly tightened and is approaching a balanced market.

These dynamics drove crude up to $50/barrel. However, at $50, U.S. exploration & production companies (E&Ps) are increasing hedging activity and some of the best producers said they will add rigs in their core areas at $50 and higher. This is likely to establish a near-term ceiling around the $50 level and a medium-to-longer-term ceiling higher at $60–65, where a significant percentage of U.S. horizontal shale wells generate positive returns on capital. At $60 and higher, producers will look to add new rigs more aggressively.

Gold has benefited from both the broad rally in commodity prices that started in late 2015/early 2016 and elevated policy uncertainty, including Brexit, as it is viewed by many as the ultimate safe-haven asset. While gold is largely a speculative commodity, and short-term tactical calls are difficult, in our view, negative real and nominal interest rates make real assets more attractive. From an asset allocation perspective, we also think gold can act as a hedge against further spikes in policy uncertainty and related dollar strength. Global economic policy uncertainty is likely to remain elevated, in our view, and we would stress the importance of maintaining a strategic weight to gold in diversified portfolios.

Financial asset returns: What are your thoughts on the level of short-term and long-term returns given the structural issues around the globe and the valuation levels across asset classes?

Without question, recent gyrations across the global capital markets have been unsettling, reflecting growing investor concerns about the uneven, asynchronous recovery that has unfolded. So far this year there have been multiple market-moving macro events that investors have had to grapple with. In the medium term, we expect higher market volatility, which investors will have to factor into their portfolio construction processes. In this environment, how should investors allocate to manage risk but also to have enough growth to meet long-term goals?

We believe that financial asset returns from traditional assets like stocks and bonds will be lower going forward, given higher starting valuations and lower growth in an environment of lower-for-longer interest rates. We view the current environment as one in which the usual relationship between risk and return has flattened and investors typically require higher compensation in the form of returns because market volatility has increased, but investors are not getting paid for taking on additional risk.

In an environment of low returns and higher volatility, investors will need to execute on a disciplined goals-based investment process. This includes having a diversified portfolio and a periodic rebalancing plan. In addition, gaining access to a broader set of asset classes such as alternative investments if/when suitable can help with risk management (select hedge funds strategies) through portfolio diversification on the basis of lower correlations with traditional asset classes, as well as return enhancement (such as private equity). Diversified sources of income will be an important contributor to overall returns. Investors will also need to pay attention to after-tax returns by considering tax-efficient asset classes and solutions and appropriately balancing the use of active and passive strategies, with the intention of keeping costs low and taking advantage of market inefficiencies and bifurcations.

Longer-term investors should look past short-term volatility and focus on the fundamentals that drive longer-term returns. The fundamentals for high-quality equities, investment-grade bonds and municipals remain favorable. There are still opportunities for them to meet their goals, while balancing their risk tolerance. However, a flatter world with increasing volatility and greater uncertainty about the macroeconomic outlook calls for positioning that is more selective, favoring assets that are more resilient to volatility.

What does the rise of populism mean for markets/investors?

The recent U.K. referendum result highlights once again an important but somewhat underappreciated trend that appears to have emerged since the financial crisis. That is the rise of populism in many countries around the world, alongside slower post-crisis growth. This is a trend that was flagged by the International Monetary Fund in its latest World Economic Outlook, and, in line with our "government" macro theme, it will be one that bears watching alongside economic and market developments. We see two key risks here that could potentially dampen economic activity and asset price markets over time: less political and economic liberalization within countries and less economic integration between countries.

Nowhere has the erosion of cross-country integration been more visible than across the European Union (even before the Brexit vote), with an effective breakdown of the Schengen system of open internal borders in the wake of the refugee crisis, the rise of protectionism in Hungary and secessionist movements in Scotland and Catalonia. At the same time, progress on the pending trans-Atlantic and trans-Pacific trade deals has stalled, and the anti-free trade policy platforms of the leading candidates from both parties in the U.S. presidential election do not suggest that either trade pact will gain more support under the next administration. Against the multidecade trend of increasing economic and political openness since the 1970s, this all points to more nationalism and less globalization over the coming years.

The upshot is that political risk is likely to feature more heavily on the investment landscape as we move further into the second half of the decade. And general elections in the U.S. this November, as well as in the Netherlands, France and Germany in 2017, will be key events to watch in this regard. Anti-establishment political figures and political parties have grown in prominence in each of these countries recently. And should they succeed in making electoral gains at the national level, we would expect the most significant implications for investors to come from changes in trade and immigration policy, industry-specific regulation, taxation and public spending.

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