The future doesn’t suddenly get more predictable in December. The shelf life of forecasts made now is no longer than that of those made throughout the year – there are just lots more of them.

Despite the plethora of end-year projections, the investment outlook also doesn’t suddenly change at midnight on New Year’s Eve. Portfolios shouldn’t need adjusting just because the calendar does – particularly if you believe, as we do, that tactical tweaks should be kept to a minimum, and that “time in the market” is more important than “market timing”.

So as in 2014, this December/January Market Perspective is only a little longer than usual, and avoids (we hope) spuriously precise or dramatic analyses and projections.

But if the calendar doesn’t warrant a shift in investment views, what about the traumatic and immensely sad geopolitical backdrop? It seems wrong for so much human suffering to have little apparent economic impact. However, while the sheer scale of the population movements under way may yet give today’s geopolitics more lasting economic significance, as yet the impact is limited, and sympathy, tolerance and aid is needed, not altered investment advice.

We offer some thoughts on what we learned in 2015, and why we still think a muddle-through, glass-half-full scenario best describes the investment climate. By way of balance, however, we do so in the context of a quick look at the next financial crisis. A little more parochially than usual, we also review the “Brexit” debate, which is about to get a lot louder.

Market Perspective will next be published in February. We wish readers a peaceful and prosperous New Year.

Kevin Gardiner
Global Investment Strategist
Rothschild Wealth Management
Cyclical and secular risks

“I have learned from my mistakes, and I am sure I can repeat them exactly.”
– Peter Cook

The next financial crisis? Wait for it...

There will surely be another financial crisis at some stage. But while many assert that the global financial system is a house of cards and a collapse is imminent, we disagree.

For one thing – and at the risk of tempting fate as we move further into the seventh year of the current US expansion – we think the next cyclical downturn may lie still on the other side of the visible investment horizon.

Regular readers need not worry: we are not about to start making explicit short-term forecasts. We just think the global “muddle through” can continue for a while longer. It is too soon to call the end to the current business cycle.

For another, we think the next crisis, whether caused by a US recession or not, will be about liquidity, not solvency – just like its predecessor, and the one before that. We do not see the financial system as secularly challenged.

In this context, taking avoiding action might prove premature, and costly. If you’re invested already in a diversified, balanced portfolio, best to sit tight. If not, we’d still advise taking advantage of any setbacks to climb aboard.

The current cycle: lessons from 2015

Among other things, we were reminded that emerging markets remain relatively risky, and that commodities are not that scarce. We saw the Greek government’s bluff called by its euro partners. But a particularly important lesson (re)learned in 2015 was the importance of not being dogmatic about interest rates and bond yields.

Yet again, expectations of higher interest rates were postponed for much of the year as the Federal Reserve (Fed) and Bank of England held fire (figure 1). Meanwhile, the European Central Bank (ECB), Swiss National Bank (SNB), Bank of Japan and People’s Bank of China actively loosened monetary policy. Allowing for exchange rate movements, local monetary conditions tightened in the US, and were not as loose as they seemed in Switzerland and China – but overall, the monetary climate was more lenient than we’d expected.

Low inflation – thanks to oil prices and still-subdued pay – and China’s slowdown helped explain the postponement at the Fed. That said, higher US rates now seem imminent as we write, and it’s unlikely to be a case of “one and done”. We expect the Fed to start a long process of normalising rates, with the Bank of England eventually starting to follow in 2016.

We continue to doubt that the initial moves will have a lasting impact on stock markets. Increasingly, we wonder whether even bonds will be quite as hurt as we might have thought a year or two back. With central banks owning a big part of the global market, and little hint of an upturn in core inflation even as headline rates rebound in the New Year, bonds may not sell-off dramatically. When some inflation does arrive, history shows it can take yields a long time to respond – even when central banks haven’t been buying bonds.

Seven-year itch?

We’ve expected US policy rates to start to normalise at some stage because we think US economic growth can continue, even though we’re now in the seventh year of expansion. With America’s private sector – consumers and businesses together
– still running a cashflow surplus, and effectively supplying liquidity to the rest of the economy, there is plenty of fuel still in the tank, and some modest inflation risk.

Meanwhile, those low oil prices are boosting developed consumers’ spending power, and the fading of fiscal austerity removes a further headwind. Cyclical indicators point to trend-like growth in most big economies (figure 2). Even China is showing little sign of collapse (whether you believe the official targets for growth or not).

**Investment conclusion**

Trend economic growth, and levels of inflation and interest rates that are likely to remain historically low even in the US and UK, is not a bad investment prospect. As weak oil company earnings move into the rear-view mirror, total profits can stay resilient, leaving stock market valuations unremarkable (figures 3 and 4).

A dramatic sell-off in bonds may be avoided, but we still doubt they offer inflation-beating returns at today’s low yields. The same is true of most investment grade corporate bonds, although they look a little less expensive after underperforming in 2015. High-yield (or speculative grade bonds) probably now offer inflation-beating returns as yields have risen, but not yet compellingly so. We continue to advise that the best prospects for multi-year inflation-beating returns come from stocks (with the US and continental Europe currently most favoured on a top-down, “macro” view, and the UK, developed Asia ex-Japan and emerging markets least).

We are not rash enough to predict one-year market returns – even knowing that US stocks have tended to do relatively well in Presidential election years (they are supposed to fare even better in the previous year). If pushed, we’d suggest referring again to the four possible profits/valuations scenarios (figure 5). We suggested a year ago that in 2015 valuations might stay the same, but earnings would grow – consistent with a position on the borderline of the “best of both worlds” and “nervous reflation” scenarios, in blue market territory. The outcome was an oil-related fall in earnings, but higher trailing valuations, with market returns currently (just) in blue territory in the “benefit of the doubt” quadrant.

For 2016, earnings might rebound as the oil effect fades, but trailing PEs could fall back, as the “benefit of the doubt” is called-in. This places us somewhere in the “nervous reflation” scenario. We suspect that investor relief at 2015’s feared risks not materialising may push us into the blue segment – but it could be another close call.

Exchange rate conviction has to remain low, and we do not advise trading currencies (or routinely hedging equity positions). On a one-year view, we’d continue to rank the majors in descending order of attractiveness as dollar, sterling, yen, euro, Swiss franc and yuan. Higher US interest rates should be priced in, but the US’ underlying strength may still not be – and the dollar is not yet especially expensive (figure 6).

**The next crisis?**

Like the business cycle, more severe financial crises may be unavoidable – not because capitalism is fundamentally flawed, but because consumers, managers and investors are prone to contagious, extrapolative moods of (irrational) exuberance and despondency.

Suppressing such waves entirely might stifle growth and innovation. And sheltering in cash can be damaging to investors’ long-term real wealth, because the clear message from history is that however shocking they are at the time, their long-term impact has been swamped by routine, ongoing growth.

A crisis threatens the financial infrastructure, which since 1971 has been built wholly on paper (or electronic) monetary foundations. The absence of a more tangible form of money has made many commentators wary. But all money, whether backed by metal, paper or bytes, is ultimately founded on confidence. And while some forms might be more vulnerable than others, the gold standard epoch was not always noted for stability.

In 2008’s Global Financial Crisis (GFC), many asserted that the system was insolvent. However, while individuals, companies and banks can be insolvent – and very traumatically so – the same...
Figure 3: Developed world corporate earnings, by sector
Analysts’ expectations for next 12 months, dollar indices

Figure 4: Developed world stock valuations unremarkable
Cyclically adjusted PE ratio and 10-year moving average

Figure 5: Valuations and earnings – the four possible outcomes for return assets in 2016

- **Benefit of the doubt**: Earnings fall, but investors view it as temporary and choose to “look across the valley” – valuations rise.
- **Best of both worlds**: Growth boosts earnings, and more optimistic investors push valuations higher.
- **2008 redux**: Earnings fall, and investors worry about renewed recession/crisis – valuations fall too.
- **Nervous reflation**: Growth boosts earnings, but wary investors value stocks more cheaply.

Source: MSCI, IBES, Datastream, Rothschild
can’t be meaningfully true of the system as a whole. The GFC was about aggregate liquidity, not solvency, as are most crises.

How best to spot the next crisis in advance? Not all US recessions are accompanied by financial crises, and not all crises are accompanied by US recession. That said, the US private sector’s behavior generated two massive liquidity squeezes in the noughties. So far, as noted above, there are few signs of cyclical, let alone secular, US excess.

Despite fears of excessive dollar borrowing, and of the impact of low oil prices on oil producers’ economies, the emerging world may not be sufficiently central to the global money supply process for its difficulties – not yet that extreme – to have a systemic effect. China’s capital markets, for example, are still not open (though the yuan joining the IMF’s special drawing rights currency basket is another staging post on that long march). Meanwhile, the liquidity accumulated through its ongoing current account surplus, its still-massive stock of foreign currency reserves, is under government control.

The public sector is also unlikely to be the cause of the next crisis. Government spending is less driven by emotion, and a post-quantitative easing world is perhaps one in which governments may feel a little more willing to create extra liquidity on their own account.

We can imagine a big natural disaster having a systemic impact; so too a more dramatic geopolitical crisis. But if we had to stick our necks out, we’d expect the next crisis to follow another surge in developed-world confidence and borrowing by consumers, businesses or investors.

It may be accompanied by more expensive valuations than we see today. It will almost certainly be accompanied by more apocalyptic commentaries. And – the crucial point perhaps – it will surely occur at higher levels of global living standards than the last one. Remember that per capita GDP is already an eighth or so bigger than it was at the pre-GFC peak in 2008.

We will hope and strive to see it coming. If we do see it looming, our portfolio managers might make an exception to our wariness of market timing: a change in the economic climate, as it were, rather than the weather, could be worthwhile trying to avoid.

But what if one strikes unannounced – perhaps if a sudden liquidity shortage breaks out in the emerging world after all, or within the leveraged investment community?

Routinely holding some safe haven, “diversifying” assets in portfolios can help – if chosen carefully, such assets don’t just spread risks, but can rise when other assets fall. Otherwise, the lesson from history has been to ensure that we do not get sucked into the likely spiral of gloom.

On a long-term view (figure 7), market peaks and troughs have trended higher because growth is the norm. And it is ultimately driven by the availability of labour, natural resources, technological innovation and the learning curve – not by finance.
Breaking bad? Brexit and UK markets
Not good news – but probably not a game-changer

“The best lack all conviction, while the worst
Are full of passionate intensity” – Yeats

An obvious talking point in 2016 will be the UK’s relationship with the European Union (EU). The referendum on EU membership will be held at the latest before end-2017, and perhaps as soon as summer 2016. Recent polls suggest it will be close (though they said the same about the 2014 Scottish referendum and 2015’s general election).

This short essay sketches our current view of the main issues. It may seem a rather parochial topic to non-UK and EU readers, and if so we apologise. However, a vote for “Brexit” could have a wider impact on international risk appetite for a while at least, and on the EU’s evolving economic footprint.

The issues are frustratingly but unavoidably unquantifiable. We judge Brexit would likely be bad news for business – both Britain’s and the EU partners’ – but not on a game-changing (or portfolio-restructuring) scale. In or out, we expect the UK to remain the most dynamic (or least sluggish if you prefer) big European economy. If pushed, we’d guess that British voters will choose the status quo.

Caution: dramatic views ahead

The European integration project arouses strong opinions. British voters are about to be told loudly and repeatedly that both staying in the EU and leaving it would lead to economic disaster. We doubt it matters that much.

From its inception the EU project has been primarily, and understandably, politically motivated. Germany and France had been to war three times in 70 years, catastrophically so in 1914 and 1939. But that political impetus initially had to express itself economically.

The political dimension was always visible in the 1958 Treaty of Rome’s oft-cited stated goal of “ever closer union” – usually ignored or downplayed by pro-Europe British politicians. Loss of national sovereignty is what arouses the strong feelings – but the economic debate has to bear them.

Recap: the EU today

On some measures, the 28-member EU bloc is arguably the largest single economy in the world, with the “four freedoms” of movement in labour, capital, good and (most) services. Its $16 trillion GDP represents 21% of the world economy in current dollars. It has just 7% of the world’s population, so its 508 million consumers are both relatively prosperous and productive – a magnet for would-be high value-added suppliers.

EU states are involved in three quarters of global cross-border direct investment, and most cross-border banking and portfolio flows. The EU has become the UK’s biggest customer, supplier, and direct investment partner. At the risk of stating the obvious, it is very important to the UK. But would Brexit imply disengagement?

The threat to trade, FDI – and the City

The pro-EU lobby – like the pro-euro lobby in the early noughties – is unafraid to stoop to conquer with its headline-grabbing suggestion that Brexit would cost millions of jobs. Around 45% of UK exports, or 13% of UK GDP, are bought...
by the EU, directly supporting roughly 4 million jobs. But they would not all be at risk from Brexit.

UK–EU trade would not suddenly stop. The EU trades with non-EU countries as a matter of course, on terms that are subject to negotiation (see below), and the UK is itself a significant customer of the EU.

The economic advantage of being inside the single market is that UK exporters don’t face the tariffs and constraints faced by many other suppliers to the EU. But successive rounds of General Agreement on Tariffs and Trade talks, and then the efforts of the World Trade Organisation, mean that such protection is much smaller than in the early 1970s.

Data are difficult to obtain – if you’ve ever had to look at the product-specific detail of international trade statistics you’ll understand why. But “typical” EU protection faced by a non-EU manufacturer without a trade agreement in place might be of the order of 5% (say), compared to perhaps twice that in the early 1970s. The advantage in being sheltered by a common external wall is smaller if that wall is much lower than it was.

Moreover, modern trade is less price-sensitive than economists like to think. Germany did not become an export powerhouse by selling cheap cars, for example. A one-off loss of UK competitiveness, in those markets subject to EU trade agreements, of the order of 5% might result in an impact on GDP of perhaps half a percentage point.

This would be a significant dent in an annual growth rate – the UK’s trend growth rate is perhaps 2–3% – but such volatility would be little more than business as usual. The loss would be quickly made good by ongoing growth, and some reduction in competing imports (though UK imports are even less price-sensitive than its exports). UK producers would likely step up their marketing efforts elsewhere.

This assessment overlooks the wider economic advantages of membership – including the enhanced “dynamism” that the Bank of England’s recent report (“EU membership and the Bank of England”, October 2015), for example, attributes to EU membership. As a relatively liberal economy in a less liberal EU market (free labour movement has not yet brought equal
flexibility in national labour markets), the UK might be well-placed to exploit potential EU economies of scale.

Another important consideration is the potential impact of Brexit on foreign direct investment (FDI). The UK’s EU partners are its biggest co-investors, and their UK-based operations create many jobs. Third-party FDI might also be at risk – if, say, Japanese car makers decided that an “out” UK was no longer an attractive base.

These risks – foregone opportunities perhaps – are impossible to quantify even approximately. Much of the UK’s “dynamism” may be home-grown, reflecting some hard choices made several decades ago, and the fact that its population is expanding relatively quickly, and seems set to continue to do so, in or out of the EU.

When the UK joined the “Common Market” in 1973, trend GDP growth lagged Germany’s: it now exceeds it. The UK population is projected to rise by 14% in the next quarter century, compared to 3% across the wider EU (and a shrinkage of 3% in Germany, though this projection pre-dates the recent absorption of refugees). The UK’s attractiveness as an investment destination may be sufficiently high to withstand Brexit: World Bank rankings show it scoring highly in terms of the ease of doing business, at 6/189 – in the EU, only Denmark ranks higher.

Even the impact of Brexit on the City is not a foregone conclusion. The UK’s financial services sector is the largest in Europe, half as large again as Germany’s, and London’s position as a financial hub might be threatened. But there are difficulties associated with continuing EU membership – the regulatory burden and a possible transactions tax – and the City might prove resilient.

London was a vibrant international trading, banking and insurance centre long before the industrial revolution – it provided a vigorous home market and plentiful supplies of raw materials for that revolution. The empire that fostered its growth is long gone, but substantial competitive strengths remain.

London’s time zone and culture – its mid-Atlantic, English-speaking common-law traditions – can make it an attractive location. As yet there is no clustering of financial activity elsewhere in Europe that offers a plausible alternative. London has global, not just EU, strengths: for example, it is the leader in cross-border lending, foreign exchange, and specialist derivatives; the second-largest (after the US) fund manager; and has a strong position in specialist insurance.

Generally, leaving the EU does seem to pose more difficulties than opportunities, a conclusion reached by most published studies. Free trade tends to raise living standards for the parties concerned, and re-introducing some frictions seems more likely to hurt than benefit the UK. It would also not be a costless change for our EU partners, though the impact would be spread across a bigger area. The UK’s relative economic liberalism, and its faster growth, make it an attractive ally and market for the more progressively minded members, such as Germany.

But the rest of the world is steadily liberalising, growing faster than the single EU market, and the relatively dynamic UK might be able to maintain greater access to the EU than feared. We judge that the costs would be manageable.

What would “outside” look like?

Nobody knows what the UK’s “outside” status would be. There seem to be four likely models – none involving autarky.

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### Brexit: possible costs and benefits

<table>
<thead>
<tr>
<th>Costs of Brexit</th>
<th>Benefits from Brexit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced market access...</td>
<td>Net contribution to EU budget: approx £10bn (0.5% GDP) pa</td>
</tr>
<tr>
<td>...and fewer economies of scale</td>
<td>Reorientation to faster-growing partners?</td>
</tr>
<tr>
<td>Slightly higher real interest rates...</td>
<td>More flexibility in rates and sterling</td>
</tr>
<tr>
<td>...and greater financial volatility</td>
<td>More liberal markets...</td>
</tr>
<tr>
<td>Financial services exposed</td>
<td>...and less red tape – “coiled spring” effect?</td>
</tr>
<tr>
<td>Foregone FDI</td>
<td>Greater political independence</td>
</tr>
</tbody>
</table>

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Nobody knows what the UK’s “outside” status would be. There seem to be four likely models – none involving autarky.
The “Norway” model, with the UK enjoying European Economic Area membership and continuing single market access. Yet this would also mean a continuing budgetary contribution (which admittedly is negligible in macroeconomic terms) and compliance with – but no representation in deciding – EU legislation. What would be gained politically compared to the status quo?

The “Switzerland” model, an extensive cherry-picking bilateral arrangement that might deliver most of the economic advantages of EU participation, greater independence from legislation, and a more significantly reduced budgetary contribution. However, there is no guarantee that such an arrangement could be negotiated.

The “Turkey” model, a narrower customs union that retains access for non-agricultural goods trade, though probably not services, and perhaps without free movement of labour or capital. There would be no budgetary contribution, and EU legislation would not apply. But again, the model may not be on offer.

A clean break, with the UK reverting to the global trading rules agreed by the WTO (what is called “most favoured nation” status).

Meanwhile, as noted, the rest of the world is moving towards (even) lower barriers to trade and closer integration. The EU and the US are negotiating a Transatlantic Trade and Investment Partnership, while the US “pivot to Asia” has helped foster the Trans-Pacific Partnership. China might eventually join the TPP, but in the meantime is in the Regional Comprehensive Economic Partnership.

An “out” UK could end up ploughing a lonely furrow – but whether this would matter in practical terms is moot. Being excluded from the big blocs may not hurt a relatively-dynamic, flexible UK – whose home market is of course itself an enticing opportunity for their exporters. A case of “Billy No-mates” – or everybody’s best friend?

Even larger uncertainties include the UK’s ability to make its views heard as effectively on such non-economic issues as foreign policy and climate change. Brexit is widely seen as making Scottish secession more likely.

Investment conclusion?

The combination of strident views with institutional uncertainty is a recipe for financial volatility – which in practice means likely setbacks for risk assets and sterling. The possibility of a credit downgrade – suggested by at least one of the rating agencies – might seem to pose a risk to gilts too, but in practice their “safe haven” appeal might dominate.

However, the long-term prospects for an “outside” UK may not change significantly: its trend growth, profitability and inflation rates might be little affected. Moreover, the UK’s capital markets are largely “global” in nature to begin with: its largest companies make most of their profits outside the UK, and its interest, profitability and exchange rates correlate as closely with the US markets as with those in Europe (figures 12–15).

As with so many other event risks, the appropriate response for far-sighted investors may be to look for opportunities amidst those setbacks – and to remember that a portfolio containing a large weighting in international equities carries with it some implicit protection against local economic risk and a weaker exchange rate.
Figure 12: Interest rates
Policy rates, %

Figure 13: Credit spreads
Investment grade corporate bond yields less government yields, basis points

Figure 14: Corporate profitability
Return on equity, %

Figure 15: Exchange rates
Real, trade-weighted exchange rate indices

source: Datastream, Rothschild
source: Barclays, Rothschild
source: MSCI, Datastream, Rothschild
source: JP Morgan, Datastream, Rothschild
Contacts

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