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Is the New Normal High Risk and Low Returns?

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BMO Global Asset Management

08 June 2016

The agenda

- Implications of Brexit
- Global economic outlook
- Market outlook
- Two puzzles: low inflation and low productivity growth



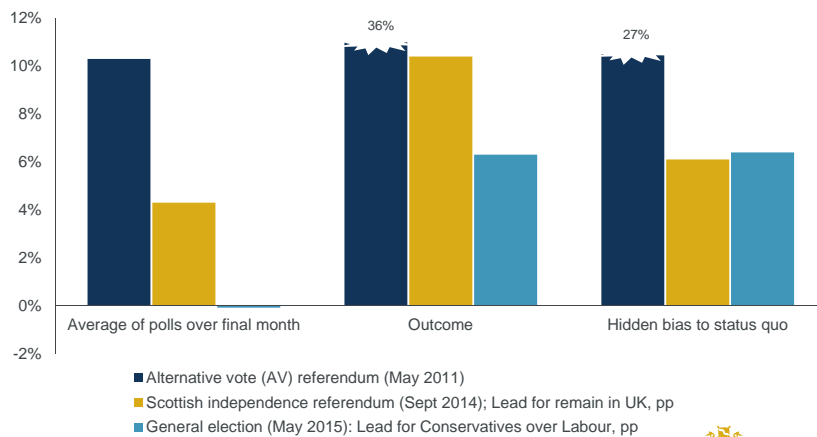


Images: <https://commons.wikimedia.org>



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6+ percentage points hidden bias to status quo

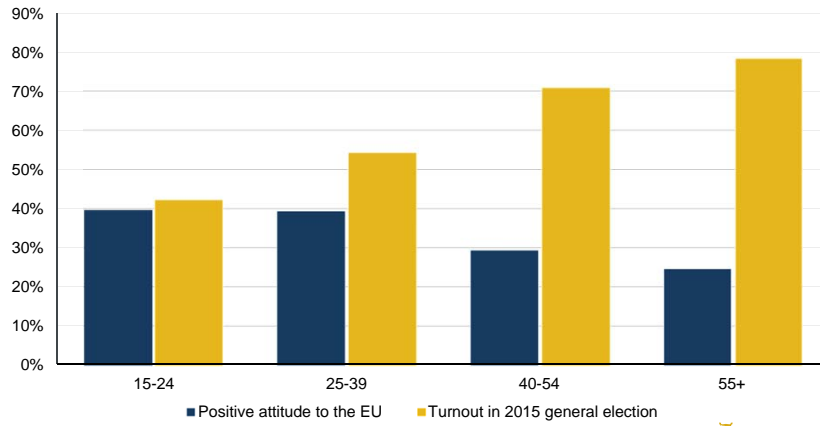


Source: ukpollingreport.com, Morgan Stanley Research. Dates of polls used: (AV: 08.04.2011-01.05.2011; Scotland: 14.08.2014-17.09.2014; General election: 07.04.2015-06.05.2015). PP = Percentage Point.



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Euroscepticism and turnout rise with age

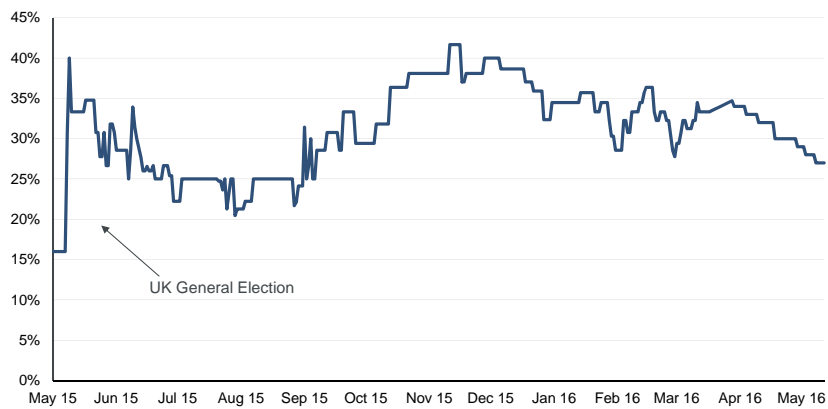


Source: Eurobarometer Spring 2015, House of Commons Library, Aliyah Dar, Elections: Turnout, July 2013, BBC; as at January 2016



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Odds of Brexit Implied probability of UK voting to leave EU

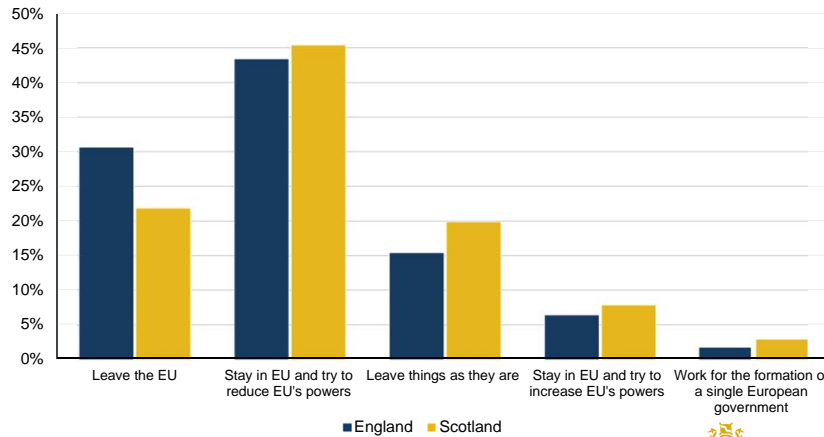


Source: Oddschecker as at 16.05.2016. EU = European Union.



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Scotland appears materially more pro-European than England

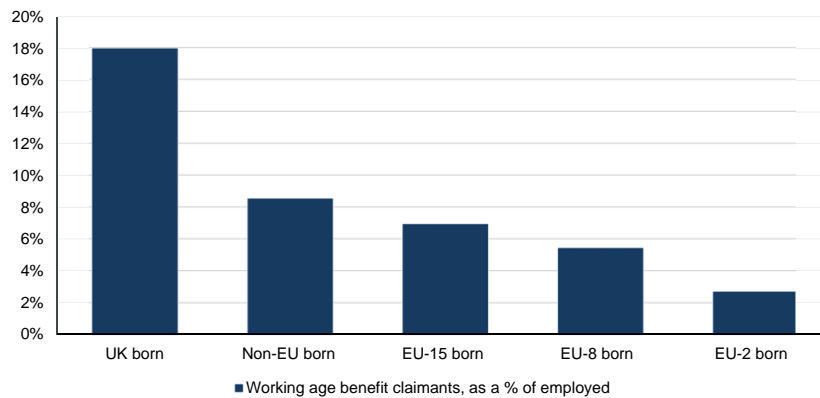


Source: University of Edinburgh, Morgan Stanley Research



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EU Migrants, particularly from Eastern Europe, have low claimant rates

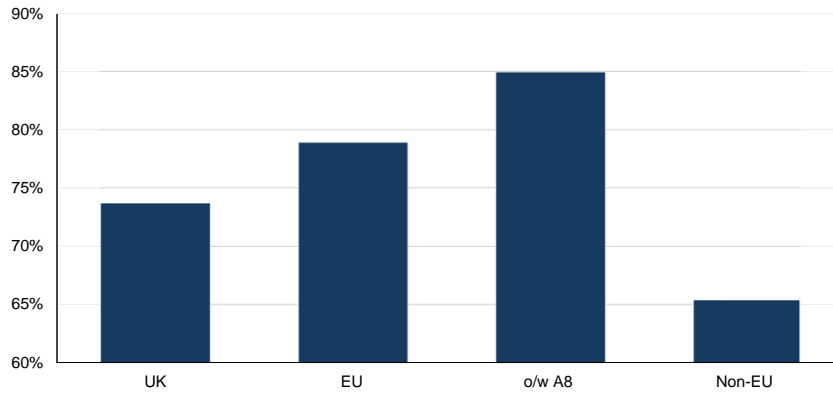


Source: Morgan Stanley Research, BMO Global Asset Management as at January 2016. EU 15 refer to EU members as at 2004, before 8 new countries, from Eastern Europe joined (EU 8). EU 2 are Bulgaria and Romania.



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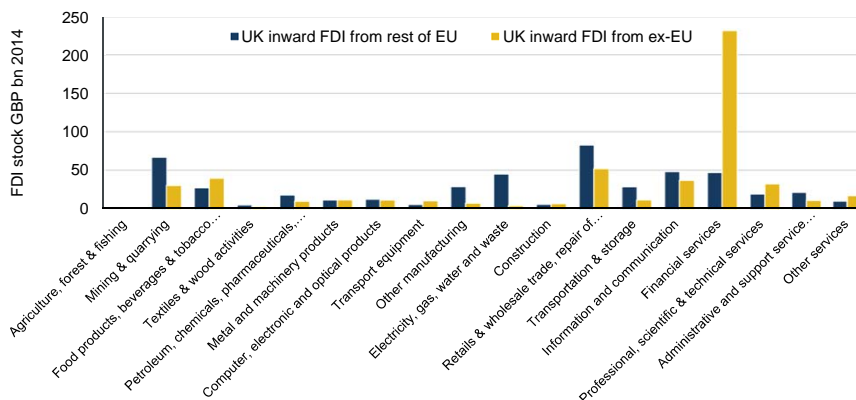
EU Migrants, particularly from Eastern Europe, have high employment rates



Source: Morgan Stanley Research, BMO Global Asset Management as at January 2016. O/w = Of which. A8 refers to the 8 Eastern European accession countries who joined the EU in 2005.



Stock of foreign direct investment (% GDP)



Source: Deutsche Bank, 14.04.2016. FDI = Foreign Direct Investment.



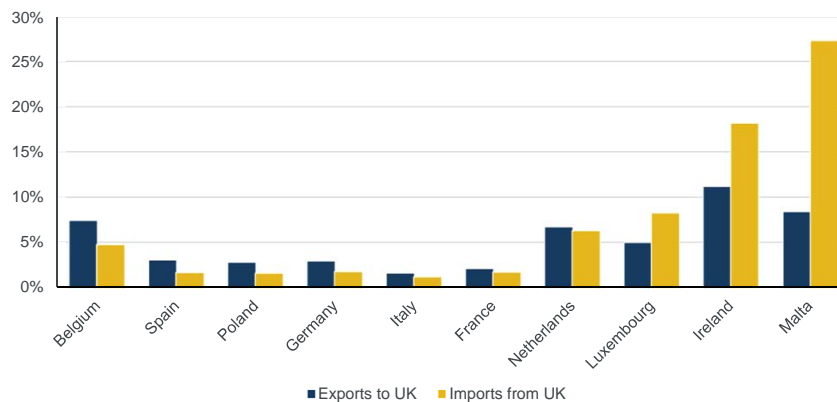
Post-Brexit trade options

	Membership	Requirements	Areas missed	Feasible
Norway model	EEA, EFTA	Four freedoms, budget contributor, 'Rules of Origin'	Limited	No
Swiss option	EFTA, widespread access to single market with bilateral deals	Four freedoms, (reduced) contributor to EU budget	Services	No
Turkish option	Custom union	Must conform to EU commercial rules and tariffs	Partial access to single market	No
Canadian option	Free trade bilateral deal	Single market rules Country of origin	Most services, including financial services	Unlikely
Default WTO option	WTO	MFN tariffs	Most services, including financial services	Highly likely initial starting position
UK customised option	EEA, WTO and bilateral deal	Conform to single market rules	Unlikely to apply to financial services	Likely eventual position

EEA = European Economic Area; EFTA = European free Trade Area; WTO = World Trade Organisation; MFN = Most Favoured Nation (Tariff Level)



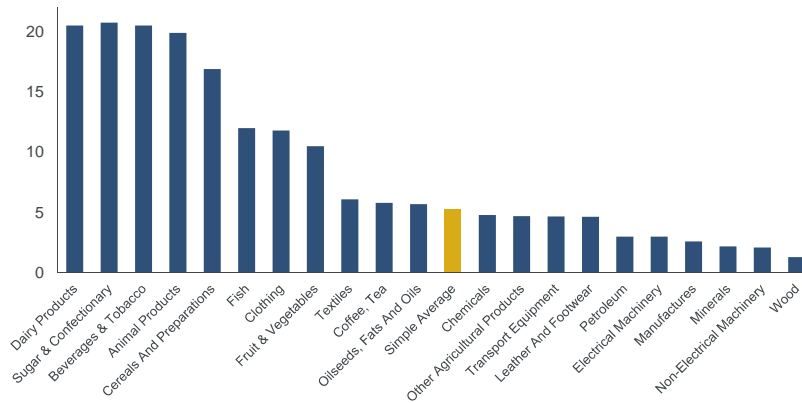
Exports to the UK (% of GDP)



Source: Deutsche Bank, 14.04.2016.



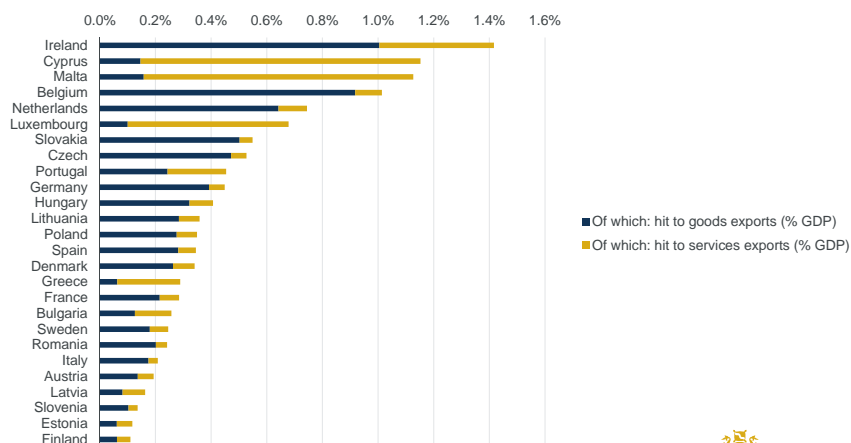
WTO tariffs vary widely



Source: WTO, Tariff Profiles 2014, Morgan Stanley Research. Most Favoured Nation (MFN) status is the trading relationship that applies to all WTO members when trading with another WTO member, and who have not agreed with each other another and more advantageous trade agreement, such as a customs union or free trade agreement.



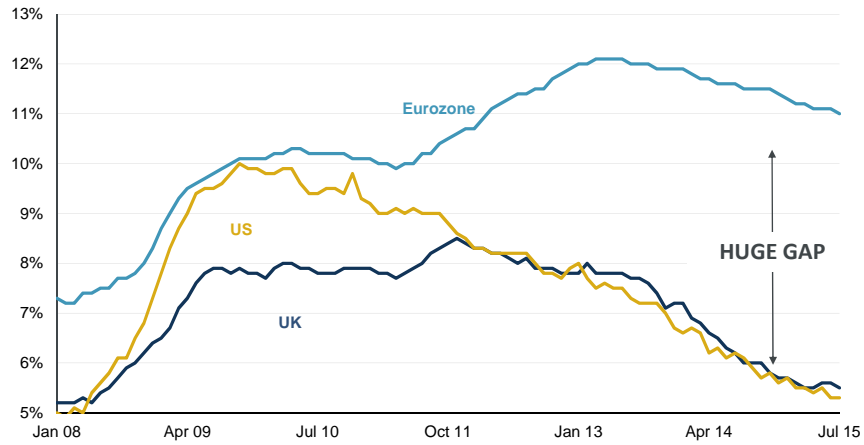
Irish exports hit hardest in WTO tariffs scenario



Source: Deutsche Bank, 14.04.2016. WTO = World Trade Organization.



Unemployment



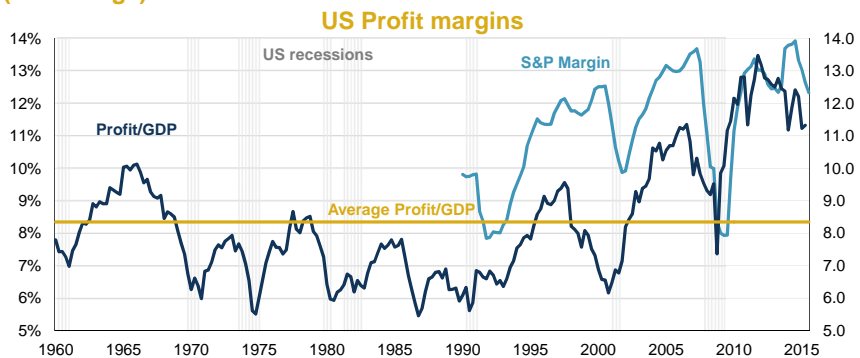
Source: Bloomberg as at 01.09.2015.



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U.S. margins are contracting so outlook bleak for S&P earnings

S&P 500 Operating margins & after-tax profits as a share of corporate GDP (Q4 average)

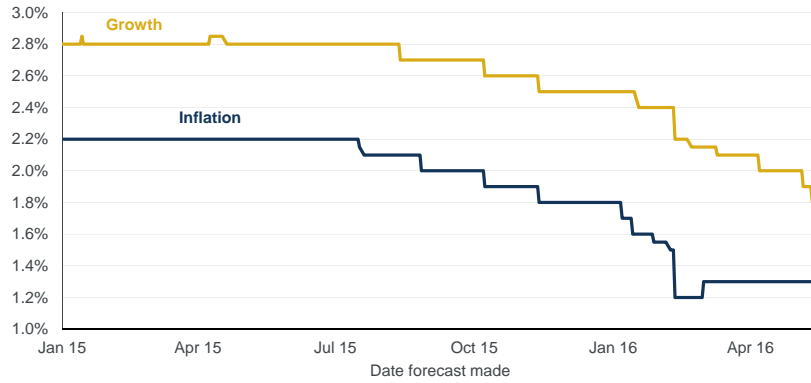


Source: Minack Advisors: S&P, Copyright 2016, All rights reserved as at 25.01.2016.



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2016 forecasts for US GDP growth and inflation

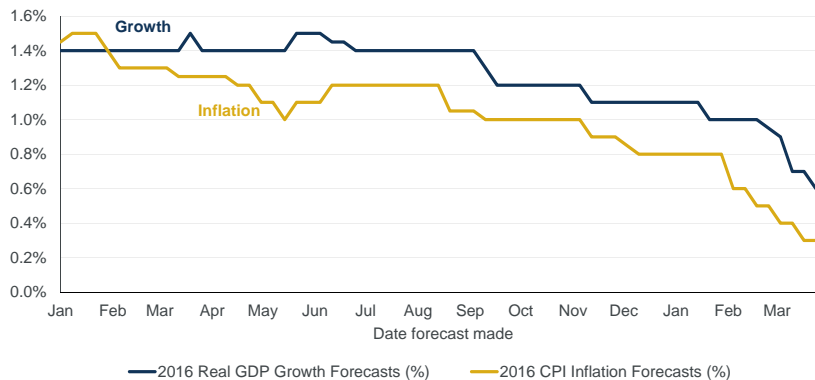


Source: Bloomberg as at 16.05.2016. GDP = Gross Domestic Product.



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2016 forecasts for Japanese GDP growth and inflation

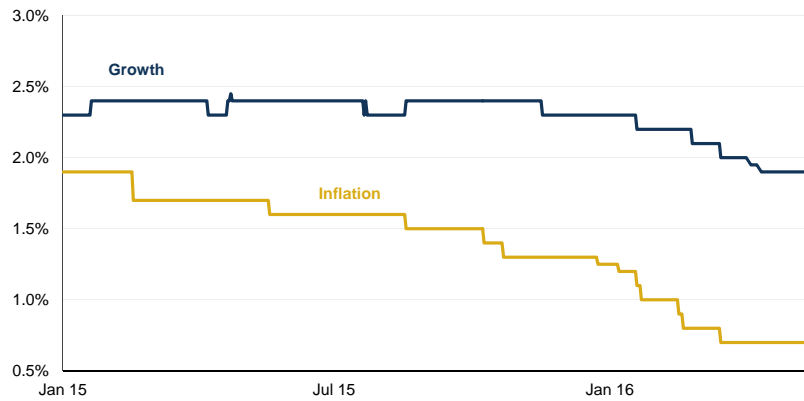


Source: Bloomberg as at 16.05.2016.



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2016 forecasts for UK GDP growth and inflation

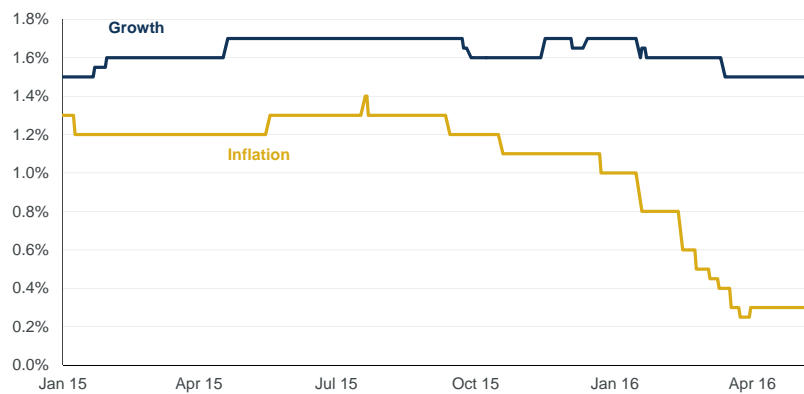


Source: Bloomberg as at 16.05.2016.



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2016 forecasts for Eurozone GDP growth and inflation



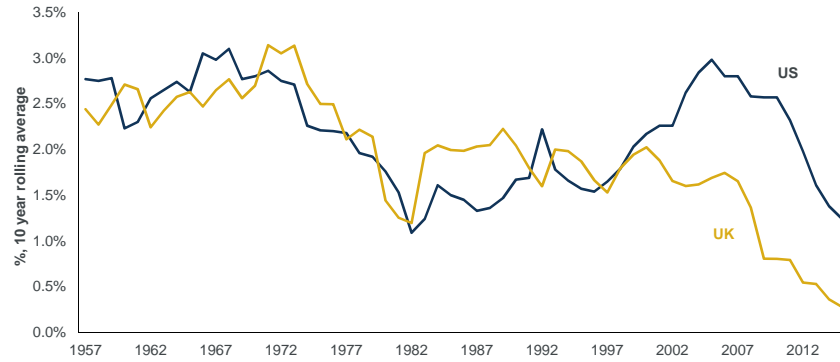
Source: Bloomberg as at 16.05.2016.



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US vs UK productivity

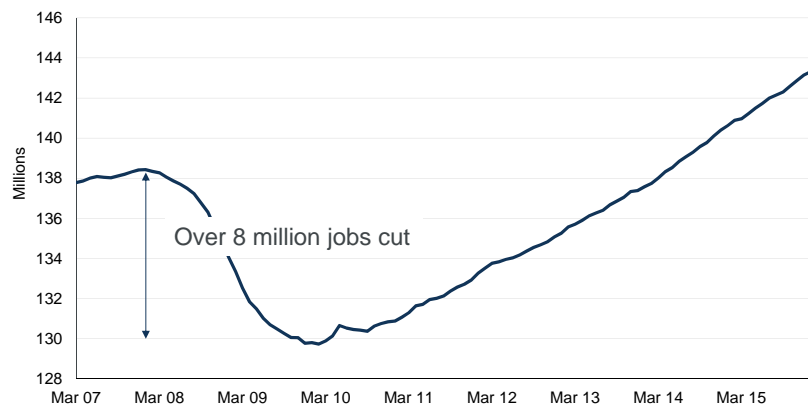
Labour productivity (UK: output per worker, US: output per hour)



Source: Office for National Statistics (ONS), Bureau of Labor Statistics (BLS), 2015



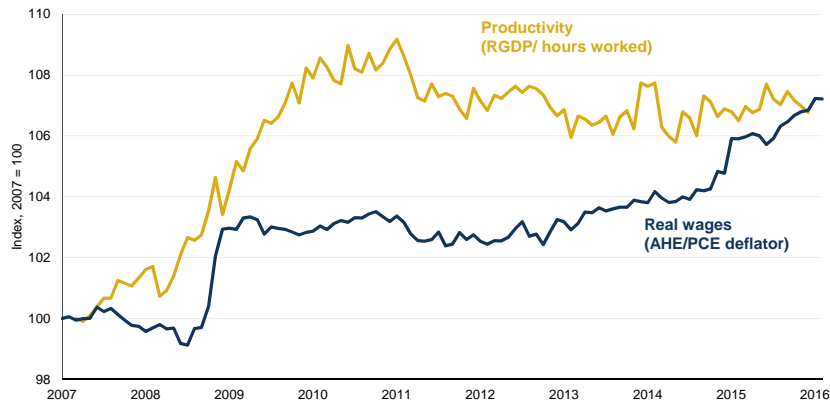
US employment (millions)



Source: Bloomberg as at 31.03.2016.



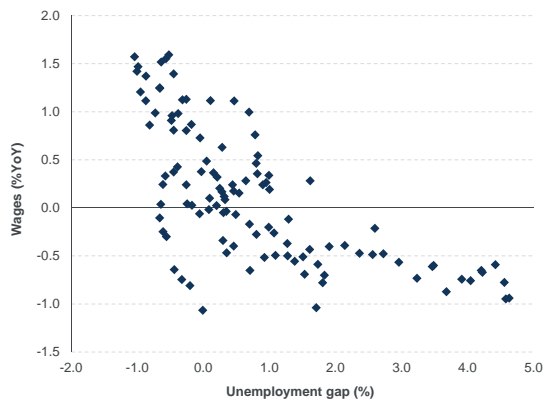
US productivity versus wages



Source: Bloomberg as at 31.03.2016. RGDP = Real Gross Domestic Product; AHE = Average Hourly Earnings; PCE = Personal Consumer Expenditure.



The US Phillips Curve: wages versus unemployment

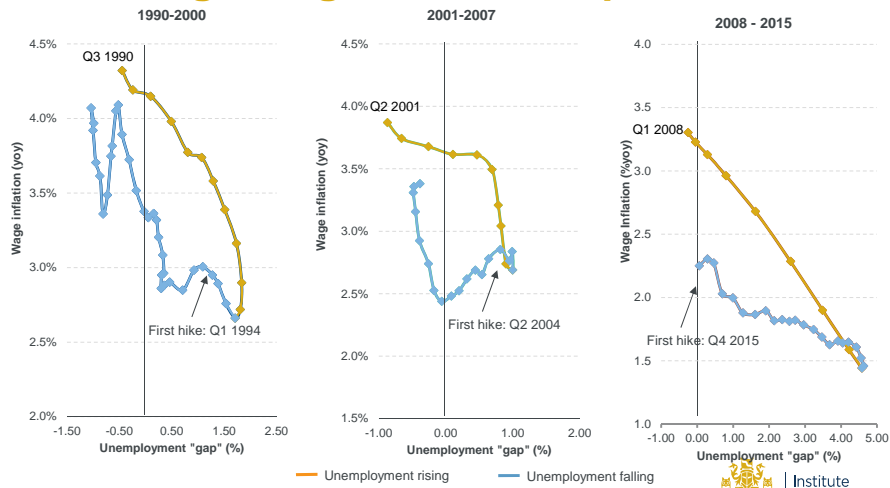


- Growth in wages and salaries of civilian workers four quarter moving average year on year percentage change
- The unemployment gap is the difference between actual U3 unemployment and the estimated non-accelerating rate

Source: SocGen, BMO Global Asset Management as at 16.09.2015. YoY = Year on Year.



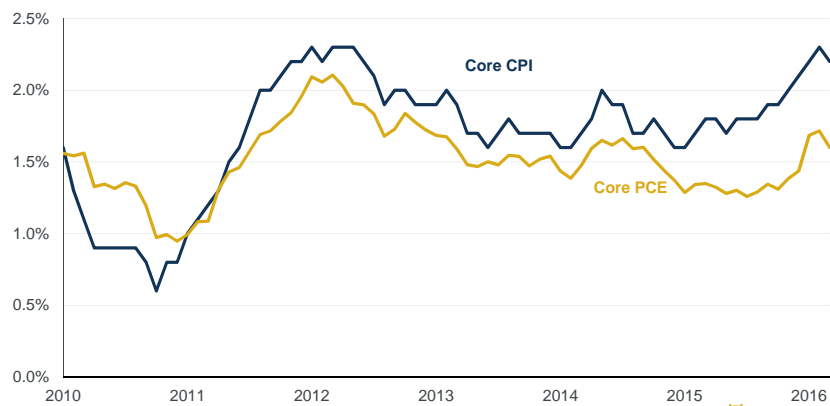
Travelling along the US Phillips Curve



Source: BMO Global Asset Management as at 20.01.2016.



US core inflation is rising

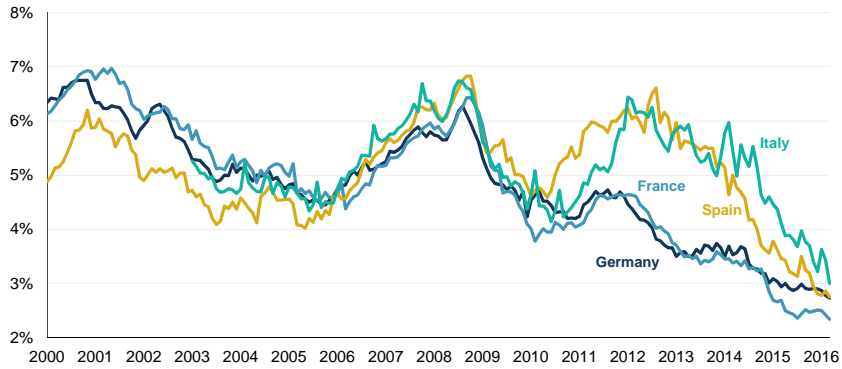


Source: Bloomberg as at 31.03.2016. CPI = Consumer Price Index; PCE = Personal Consumers Expenditure.



In Europe the credit crunch is easing rapidly

Interest rate charged on new business loans (up to EUR 1million, 1-5 years)

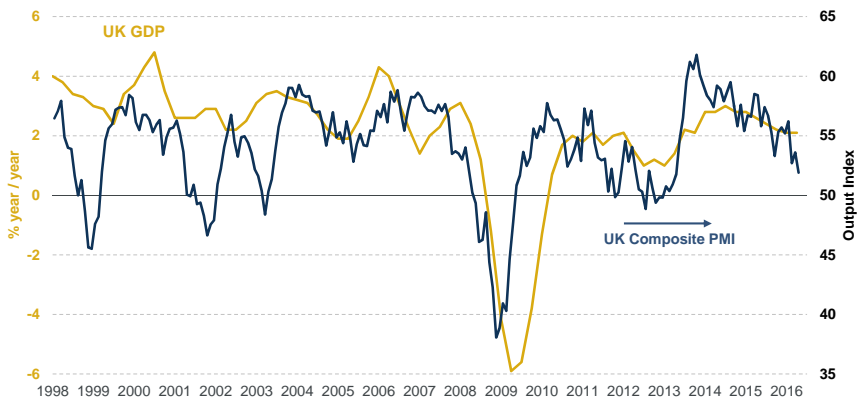


Source: ECB Statistical Data Warehouse, May 2016



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The UK slowdown has further to go



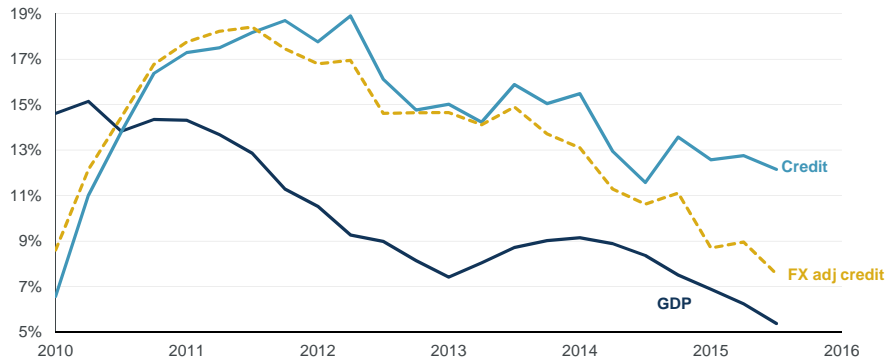
Source: Bloomberg and Markit as at April 2016. PMI = Purchasing Managers' Index.



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Emerging Markets private nonfinancial credit and nominal GDP ex China

%oya



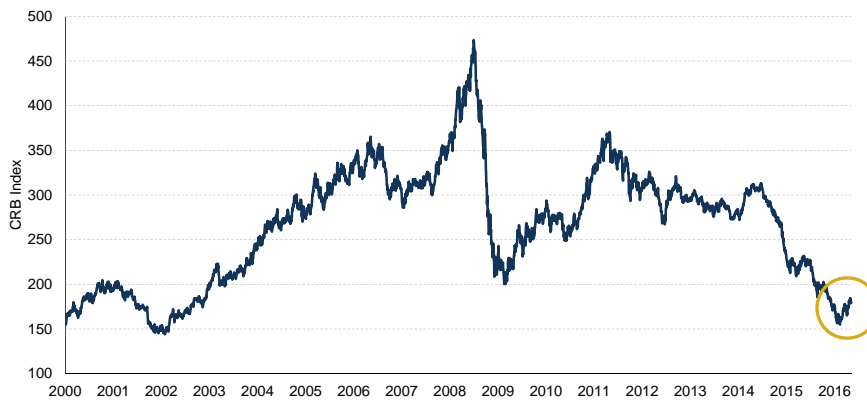
Source: Bureau of Industry and Security, J.P. Morgan, Copyright 2016, all rights reserved 25.01.2016. GDP = Gross Domestic Product; adj = adjusted; oya = over year ago, est = estimate.



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Commodity prices may have troughed

Thomson Reuters CRB Commodity Index

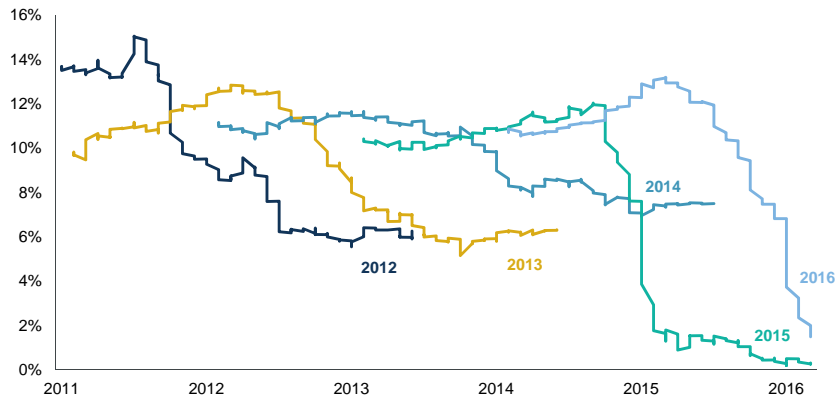


Source: Bloomberg as at 6th May 2016. CRB = Commodity Research Bureau



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S&P 500 earnings growth expectations



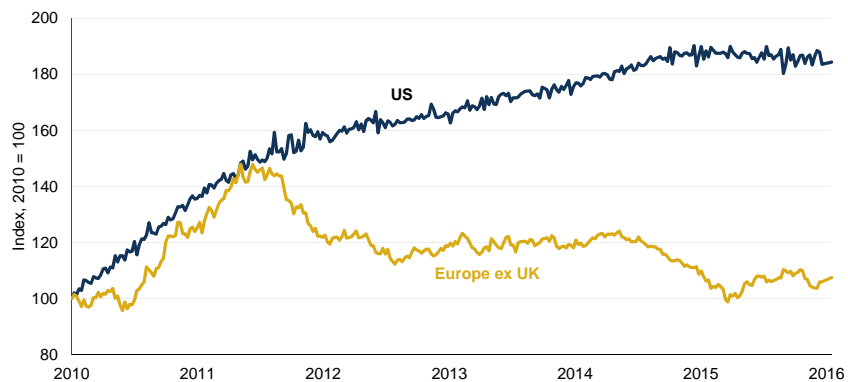
Source: Datastream as at 31.03.2016.



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European earnings prospects much better

Earnings per share (12-month trailing)



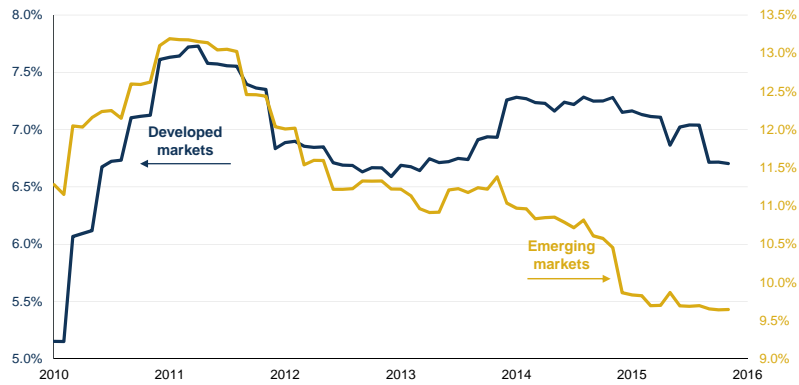
Source: Datastream, Institutional Brokers' Estimate System (IBES). As at 15.01.2016



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Emerging Market equities need margins to improve

Global profit margins (as % of revenue)



Source: J.P. Morgan, Copyright 2016, all rights reserved as of 25.01.2016.



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Conclusions

- High volatility and low returns are set to characterise markets
- Equities likely to struggle but still outperform bonds
- EM equities attractive only as a tactical trade
- Brexit uncertainty a major issue for the UK – and Europe
- Europe attractive on the medium term on a 'remain' vote

EM = Emerging Markets



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Disclaimer

- Past performance should not be seen as an indication of future performance. The value of investments and income derived from them can go down as well as up as a result of market or currency movements and investors may not get back the original amount invested.



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