

# Adapting amid uncertainty

Multi-asset income strategies are all the more important given Brexit and the pace of US rate hikes

By Clive McDonnell

**T**HE outlook for equity markets in the second half has become more challenging in recent weeks. For one thing, investors will need to weigh the implications of the UK's decision to leave the European Union (EU). Second, the possible postponement of corporate investment decisions after the Brexit vote could weigh on economic growth – especially in Europe. Then there is the increased uncertainty over the timing and pace of rate hikes by the US Federal Reserve.

The common thread linking all these factors is uncertainty – which is to asset markets what a pin is to a balloon.

The UK's decision to leave the EU poses as many challenges for the euro area economy as it does for the UK. For this reason, we have downgraded our outlook for euro area equities to “cautiously positive” from “positive”. We remain cautious towards the UK.

Banks have been at the forefront of the uncertainty created by the Brexit vote. European-listed banks have underperformed those listed in the UK, reflecting fears over a possible fall in profits if the European Central Bank cuts rates further, pushing them deeper into negative territory. The Bank of England may also cut rates, but they remain positive for now.

The euro area was facing challenges that predate the outcome of the UK vote. Lacklustre revenue growth and an ap-

preciating euro were already weighing on the export sector. Consensus earnings growth for the Euro Stoxx 600 index of European shares in 2016 is forecast to be a mere 2.5 per cent.

Our prior optimism towards euro area equities was driven by the potential rebound in 2017 earnings which are forecast to grow 14 per cent. While that forecast remains intact for now, it is almost inevitable that it will come under downward pressure in light of recent events.

The S&P 500 has a similar pattern for consensus earnings: 3 per cent this year, rising to 14 per cent in 2017. However, we have greater confidence in the achievability of US earnings growth, as companies there are somewhat insulated from developments in the EU, and could actually be beneficiaries of increased domestic investment diverted from the EU.

Another factor supporting US earnings growth in 2017 is the recovery in energy sector profits – not just from the recovery in oil prices, but the dramatic decline in asset write-downs related to the prior collapse in oil prices.

Corporate investment tends to thrive in an environment of growth and certainty, both of which are in short supply in Europe. Companies in the transportation and communications sector have already announced reviews of future investment in light of the UK vote to leave the EU. Such news will be received negatively by investors and policymakers alike.

Slower investment will impact fu-

ture profit growth and could also weigh on economic growth in the coming quarters. If such a trend were to emerge, it could prompt policymakers to cut interest rates further, or in the case of the Fed, think twice before raising rates. Uncertainty created by the UK vote was cited by the Fed in its June meeting as a reason influencing its decision not to raise rates.

While lower-for-longer US rates do have some positive implications for high dividend yielding equities and fixed income markets, it reinforces our concern over the outlook for earnings growth and is a factor pushing equities to be our least-favoured asset class, below multi-asset income strategies, commodities and cash.

## Investment theme

Where do we invest in the second half given recent events? We believe that the Brexit vote reinforces our key investment theme for 2016: the need to adapt. We continue to emphasise the importance of multi-asset income strategies, which rank highest in order of preference among the key asset classes. Alternative strategies and fixed income, specifically Developed Market corporate bonds, should feature prominently in investor allocations. Cash, commodities and finally equities rank as the less preferred asset classes.

High dividend yielding equities are attracting renewed interest in light of the changing expectations for rate hikes by the Fed. Asian Reits have rallied strongly

in recent weeks, reflecting these changing expectations, a performance trend we expect to continue.

Within Asia we are positive on Indian equities. We believe India will be resilient in the face of uncertain growth trends in the Developed Markets. The Indian market's greater domestic focus and the increase in credibility of monetary and fiscal policies are supportive of rising corporate profits.

We note that the change in leadership at the Reserve Bank of India raises some questions about future policy. We believe that the institutional changes governor Raghuram Rajan initiated will last beyond his time at the bank. Moreover, the government has announced liberalisation of foreign direct investment laws in the retail, transportation, defence and broadcast media sectors, which emphasise the Modi administration's continued focus on reforms.

While India's high valuations relative to peers are a perennial concern among investors, we continue to focus on higher corporate margins and a superior return on equity as justification for the valuation premium.

Uncertainty looks set to remain a feature of asset markets in the second half. Nevertheless, we believe there remain opportunities in markets for investors who are able to adapt their investment strategies. **W**

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