Schroders

Global market perspective

Economic and asset allocation views

Q3 2017

For professional investors or advisers only

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Introduction

Risk assets continued to perform well in the second quarter with strong gains to be found in Europe, particularly the peripheral equity and bond markets such as Italy and Spain. These returns were enhanced for international investors by an appreciation in the euro as capital flowed back into the region. The catalyst was the election of Emmanuel Macron as president of France, an outcome which quelled concerns of a populist revolt in a country seen as a bastion of the European Union (EU). In practice France chose not to follow the UK out of the EU and risk political and economic isolation.

Meanwhile, we have seen the further demise of the "Trump trade" as although the US economy would seem to have bounced back in the second quarter, progress on policy has been painfully slow. We ended the second quarter in much the same way as we ended the first with Congress delaying a vote on the critical healthcare bill, seen as a prerequisite for tax reform. Nonetheless, with a change in sector leadership, US equities have performed well led by technology and the more defensive quality stocks. We look at the performance of a broad range of assets in our mid-year review (see *page 15*).

These gains have been accompanied by an unusually low level of volatility and with the VIX index remaining close to all time lows many have argued that investors are ignoring risk. We examine the key drivers below and the importance of central bank policy and liquidity (see Are investors complacent? *page 20*).

Political uncertainty has diminished in Europe, but is alive elsewhere. Rumours continue to dog President Trump and whilst it is unlikely that a Republican Congress would impeach one of its own, this may change after the mid-term elections next year, especially if policy gridlock persists. Brazil has also run into problems with President Temer and we take a look at the behaviour of markets during periods of presidential impeachment (see *page 25*).

In terms of asset allocation, we have moved to a more neutral stance over the quarter by closing our overweight on equities and our underweight on bonds. Within equity markets we remain positive on Europe ex UK and the emerging markets. Within bonds we have a preference for emerging market local currency debt and remain wary of Bunds and investment grade corporates.

Keith Wade

Chief Economist and Strategist, 7th July 2017

Asset allocation views: Multi-Asset Group

Global overview

Economic overview

The recovery in global activity remains intact, whilst inflation appears to have peaked following the stabilisation in energy costs. We continue to forecast global growth at 2.9% this year after 2.6% in 2016, but have trimmed our inflation forecast to 2.4% from 2.7%. On inflation, we have reduced our forecasts across the board to reflect a lower oil price profile and subdued core readings. Looking into 2018, global growth is expected to stabilise at 3% with modest downgrades to developed markets offset by a small upgrade to Japan. In the emerging world, our forecast for China has not changed and the downgrade to our growth forecast for 2017 reflects cuts to Brazil and Russia.

Meanwhile, we are passing the peak in inflation globally with the turn in commodity prices. Headline inflation rates are now expected to decline as the increase in energy prices fades from the annual comparison. The UK may prove to be an exception to this trend as weaker sterling is likely to push inflation higher.

In terms of our scenarios, the risks around our central forecasts are more deflationary with the return of hard landing concerns over China and secular stagnation, which are both our highest risk scenarios. On the former, the risk is that monetary tightening in China goes too far and sparks a seizure in the financial system which chokes off the supply of credit to the real economy. With regard to "secular stagnation," growth and inflation continuously underperform.

Central bank policy

For the US, we still expect the Fed funds rate to rise to 1.50% by end 2017. Moving into 2018, the Fed is expected to tighten further as fiscal policy supports economic growth and with US core inflation rising modestly, policy rates are expected to end the year at 2%. In comparison, interest rates are expected to be kept on hold in the UK, Japan and Eurozone. Moreover, the European Central Bank (ECB) is assumed to begin to taper quantitative easing (QE) further in 2018. Over in the emerging market region, there is further policy accommodation expected in Brazil and Russia this year. Despite the divergence in monetary policy between the US and key developed markets, we still expect the USD to weaken following its very strong appreciation of the past two years.

Implications for markets

Looking at our asset class views, we have downgraded equities from a positive to neutral over the quarter. Global valuations appear on the expensive side of fair value when we compare the equity risk premium relative to history. We recognise that this is being supported by the low interest rate backdrop. Nonetheless, our analysis suggests that the equity risk premium can absorb moderately higher bond yields in this environment. Importantly, in the short-term, we believe that the softer momentum behind the cyclical data could weigh on consensus earnings forecasts such that analysts' earnings revisions grind lower in the coming months. However, over the medium-term, the economic fundamental backdrop should provide support to equities and we will view any correction as a buying opportunity.

Within equities, we remain positive on the emerging markets as this region stands to benefit more from the recovery in global growth and trade. This market also offers a valuation discount versus their developed peers. Furthermore, we believe that the headwinds from a stronger US dollar environment have eased, which provides an opportunity for EM to outperform.

Meanwhile, we have remained positive on Europe ex UK as earnings have markedly improved with analysts revising up their expectations of this market despite a stronger euro. This has also been underscored by the improvement in the macro data. Monetary policy remains very accommodative and political risks have receded compared to the start of the year. Over in Japan, we have upgraded the market as it stands to primarily benefit from an environment where the yen weakens, as a result of the BoJ retaining ultra-accommodative monetary policy.

On the UK and Pacific ex Japan we have retained our neutral stance. Over in the UK, there have been signs that the data is starting to deteriorate with analysts already revising down their earnings prospects for this market. However, UK multinationals, which dominate the FTSE 100 index, could benefit from a revenue boost from sterling weakness. By contrast, we have downgraded US equities to a negative. Despite the high-quality nature of the US market, valuations have become richer compared to the rest of the world. Moreover, the normalisation of monetary policy by the Fed will put a squeeze on corporate profit margins and earnings growth.

With regard to duration, we have upgraded the government bond market to a neutral position over the quarter. The pace of improvements in global activity has continued to recede from robust levels. Inflation has also been trending downwards with the reduction in the base effects from lower commodity prices and lack of second round effects from wages. Against this backdrop where bond yields are struggling to move higher, we are likely to harvest a positive carry.

With the exception of German Bunds, we are neutral on US Treasuries, UK Gilts and Japanese government bonds (JGBs). We have also maintained our neutral stance on emerging market sovereign debt (EMD) in USD. Instead, we prefer the carry in EMD local currency bonds given more attractive valuations along with supportive inflation and growth dynamics

Turning to credit markets, we have stayed neutral on high yield and negative on investment grade (IG) bonds. While valuations for both sectors are no longer compelling, investment grade spreads are more sensitive to shifts in interest rate expectations with a lower carry cushion compared to high yield (HY). For European IG credit, spreads are highly correlated with the US such that we are also negative on this segment. Moreover, we continue to hold a cautious view due to unattractive valuations and the prospect of tighter liquidity conditions with the ECB tapering of QE next year.

We have turned neutral on commodities, despite relatively robust global growth, the pace of improvements in the data has ebbed and price momentum in the commodity universe has turned negative. For agriculture, we have stayed positive as future supply of major grains may be impacted from low prices. Meanwhile, we have turned neutral on industrial metals given the recent monetary tightening in China. However, the supply side is more constructive, with most sectors likely to move into deficit next year. Similarly, the energy sector has been downgraded to a neutral position as the rebalancing in inventories is occurring slower than expected given the strong recovery in US shale production. For precious metals, we have remained neutral as gold and real rates could remain range bound with the Fed committed to a gradual normalisation of monetary policy.

Table 1: Asset allocation grid – summary

Equity	0 (+)	Bonds	0 (-)			Alternatives	0 (+)	Cash	+ (0)
Region		**Region**		**Sector**		**Sector**			
US	- (0)	US Treasury	0 (-)	Government	0 (-)	UK property EU property	- +		
Europe ex UK	+	UK Gilts	0 (-)	Index-Linked	+ (0)	Commodities	0 (+)		
UK	0	Eurozone Bunds	- (- -)	Investment Grade Corporate	-	Gold	0		
Pacific ex Japan	0	Emerging market debt (USD)	0	High yield	0				
Japan	+ (0)	Emerging market debt (local currency)	+						
Emerging Markets	+								

Key: +/- market expected to outperform/underperform (maximum ++ to minimum- -) 0 indicates a neutral position. The above asset allocation is for illustrative purposes only. Actual client portfolios will vary according to mandate, benchmark, risk profile and the availability and riskiness of individual asset classes in different regions. For alternatives, due to the illiquid nature of the asset class, there will be limitations in implementing these views in client portfolios. Last quarter's GMP positioning in brackets. Source: Schroders, July 2017.

Regional equity views

Key points

0 (+)	Equities	
- (0)	US	We have downgraded US equities to a negative. Despite the high-quality nature of the market, which makes it attractive to hold, valuations have become richer compared to the rest of the world. Moreover, the normalisation of monetary policy by the Fed will put a squeeze on corporate profit margins and earnings growth. Meanwhile, there is still the prospect of US fiscal expansion, such as corporate tax cuts, which is likely to provide a substantial boost to corporate earnings. However, investors have continued to reassess their expectations on the ability of the Trump administration to push through these policies.
0	UK	We continue to expect a slowdown in the UK driven by weaker business investment and higher inflation hitting consumer spending. Recently, there have been signs that the data is starting to deteriorate with analysts already revising down their earnings prospects for the UK. UK multinationals, which dominate the FTSE 100 index, could benefit from a revenue boost from sterling weakness.
+	Europe ex UK	Despite the strengthening in the euro, corporate earnings have markedly improved with analysts revising up their expectations of this market. This has also been underscored by the improvement in the macro data which has led us to upgrade the Eurozone growth forecast this year. From a valuation perspective, the region offers better value compared to other markets. Meanwhile, monetary policy remains very accommodative with the ECB unlikely to hike interest rates until 2019 with tightening in policy contingent on inflation expectations. At the same time, political risks have not gone away, but have receded compared to the start of the year.
+ (0)	Japan	The Japanese economy is expected to remain well-supported this year from the fiscal stimulus. In turn, this should benefit top-line earnings growth in a market where valuations are still attractive compared to history and other markets. Importantly, Japanese equities stand to benefit from an environment where the yen weakens, as a result of the BoJ retaining ultra-accommodative monetary policy.
0	Pacific ex Japan (Australia, New Zealand, Hong Kong and Singapore)	We are neutral on Australia, Hong Kong and Singapore. While Australian equities provide a high dividend yield compared to other markets, the index is vulnerable to headwinds in commodity prices particularly given the recent monetary tightening in China. Elsewhere, the strong momentum behind Hong Kong equities has been overshadowed by less compelling valuations. In comparison, the decent dividend yield and attractive valuations offered by the Singapore market is balanced against weak price momentum.
+	Emerging Markets	Emerging equities continue to offer a valuation discount versus their developed peers. While momentum behind the emerging market growth premium remains in favour of the developed market, the recovery in global growth and trade should benefit the emerging world particularly the Asian manufacturers. Furthermore, we believe that the headwinds from a stronger US dollar environment have eased, which provides an opportunity for EM to outperform.

Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.

Fixed income views

Key points

0 (-)	Bonds	
0 (-)	Government	Over the quarter, we have upgraded government bonds to a neutral position. Bond valuations are still unattractive at current levels with real yields for the key developed markets either close to zero or negative. However, the pace of improvements in global activity reflected in measures such as the business surveys have continued to recede from robust levels. Inflation has also been trending downwards with the reduction in the base effects from lower commodity prices and lack of second round effects from wages. Against this backdrop where bond yields are struggling to move higher, we are likely to harvest a positive carry. On US Treasuries, we have moved to a neutral position. With a positive sloping curve, the cost of carry makes it expensive to short the market particularly against a backdrop where both inflation and growth dynamics in the US have continued to ease. Similarly, we have turned neutral on UK Gilts. There are signs of a slowdown in the economy with households likely to get hit by the rise in inflation. Despite more hawkish comments by the BoE, the central bank is expected to keep interest rates on hold until there is greater clarity over Brexit negotiations. Meanwhile, we have increased the positioning on German Bunds to a single negative (from double negative) given that yields at the long-end are still vulnerable to more hawkish rhetoric from the ECB and receding in political risks. However, the central bank is expected to continue with a very loose monetary policy until there is evidence of a strong recovery in inflation expectations. On JGBs, we have kept our neutral positioning as the BoJ is expected to keep rates on hold and yields at the long-end well-anchored.
-	Investment Grade (IG) Corporate	We remain negative on US IG bonds given uncompelling valuations and deteriorating fundamentals, which are exposed to greater sensitivity to higher rate expectations. Leverage also continues to rise and interest coverage has been falling. European IG spreads are highly correlated with the US such that we are also negative on this segment. Moreover, we continue to hold a cautious view due to unattractive valuations and the prospect of tighter liquidity conditions with the ECB tapering of QE next year.
0	High yield (HY)	Valuations have continued to be eroded with the tightening in US high yield spreads. At the same time, fundamentals such as an elevated leverage ratio and strong M&A activity are pointing towards a credit market in late cycle. However, US high yield spreads have been relatively resilient during the recent energy sell-off, which suggests a strong global bid for carry. Moreover, there is still good debt affordability amongst high yield corporates. Overall, we are neutral, as high yield offers less rates sensitivity with a higher carry cushion. On European HY, we remain neutral. Europe is in an earlier stage of the credit cycle compared to the US, and fundamentals are in a more favourable position such as share buybacks are at the lowest level in more than a decade. Nonetheless, valuations appear to be unattractive at current levels.
0 +	EMD USD-denominated EMD local currency-denominated	We remain neutral on emerging market debt bonds denominated in USD as valuations have continued to turn less compelling with spreads trading within fair value range based on a 10-year comparison. Instead, we prefer harvesting the carry in EMD local currency bonds given more attractive valuations along with supportive inflation and growth dynamics.
+(0)	Index-linked	While inflation expectations have eased with the fall in the oil price, underlying inflation trends should remain supported by the recovery in growth and the prospect of higher wages. Meanwhile, disappointments over Trump's reflation policy have meant that there is better valuation support for breakeven inflation rates.

Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.

Alternatives views

Key points

0 (+)	**Alternatives**	
0 (+)	Commodities	While global growth remains relatively robust, the pace of improvements in the data has ebbed and price momentum in the commodity universe has turned negative. However, there has been evidence of a meaningful supply adjustment in some of the sectors after a prolonged period of weak prices. On balance, we are neutral on commodities. On agriculture, consumption growth has been strong but prices continue to reflect high levels of global stocks. We expect supply to gradually reduce this year, due to prices falling below production costs. Moreover, record short positioning suggests that a weather event could cause a rapid re-pricing in the market. Overall, we remain positive on the sector. The recent monetary tightening in China has led us to downgrade industrial metals to a neutral score. On the demand side, industrial metals could remain well-supported with the recovery in global growth and stability in the Chinese economy. Nevertheless, we are cognisant of the downside risks, particularly if there is a reversal of Chinese demand and further disappointments from Trump's policies. However, the outlook is more constructive on the supply side with most sectors likely to move into deficit next year. During the quarter, the energy sector has been downgraded to a neutral position as the rebalancing in inventories is occurring slower than expected given the strong recovery in US shale production. While OPEC members remain committed to control production, it may be faced with a dilemma of sacrificing market share over the medium-term, the recent uptick in Libya and Nigeria supply also further reduces the pace of inventory adjustment. On precious metals, we have retained our neutral stance as gold and real rates could remain range bound with the Fed committed to a gradual normalisation of monetary policy.
-	UK Property	In the occupier market, retail real estate is faced with growing competition from on-line sales, slowdown in consumer spending and a squeeze on profitability. Conversely, the industrial sector continues to see steady rental growth as demand is supported by the structural growth in on-line retail. In the office market, most regional office markets development has been modest over the last few years and vacancy rates have supported rents. By contrast, developers have pushed ahead with projects in London, despite the possibility that financial firms could transfer certain activities to the Eurozone. While headline rents may be flat, net effective rents including incentives have started to fall. We expect this decline to continue through 2017-2018 as more office schemes are completed. While UK institutions and REITs have been fairly quiet since the EU referendum, foreign investors have picked up the running prompted by the sharp fall in sterling. The capital inflow also reflects the strategic goal of many international investors to diversify their portfolio and the relative liquidity of the UK market. Consequently, the all property initial yield has been stable at 5.1% since last July. Looking forward, our concern is that sentiment among foreign investors could turn particularly if the Brexit negotiations stall.
+	European Property	In the investment market, the favourable outlook for rental growth and the significant gap between real estate and 10-year government bond yields means that there is a large amount of capital trying to invest in continental Europe. Eurozone REITs have raised fresh capital and even German open-ended funds are enjoying a revival. In addition, Brexit means that some investors have switched their attention to continental Europe. Despite the large amount of capital waiting to be deployed, prime yields appear close to their floor, assuming that investors will start to factor in higher bond yields over the medium term. Similarly, although secondary real estate yields is likely to fall a little further over the next 6 to 12 months, the cautious attitude of banks towards lending is likely to act as a dampener. We forecast total returns of 5 to 7% per annum on average for investment grade European real estate between end-2016 and end-2020, assuming the Eurozone economy continues to grow. The mainstay will be an income return of 4.5%, while capital values will be driven primarily by a steady increase in rents.

Note: Property views based on comments from the Schroders Real Estate Research team.
Key: +/- market expected to outperform/underperform (maximum ++ minimum - -) 0 indicates a neutral position.

Economic views

Central view

World economic recovery remains intact, inflation rates are peaking

The recovery in global activity remains intact, whilst inflation appears to have peaked following the stabilisation in energy costs. We continue to forecast global growth at 2.9% this year after 2.6% in 2016, but have trimmed our inflation forecast to 2.4% from 2.7%. On inflation, we have reduced our forecasts across the board to reflect a lower oil price profile and subdued core readings. Looking into 2018, global growth is expected to stabilise at 3% with modest downgrades to developed markets offset by a small upgrade to Japan.

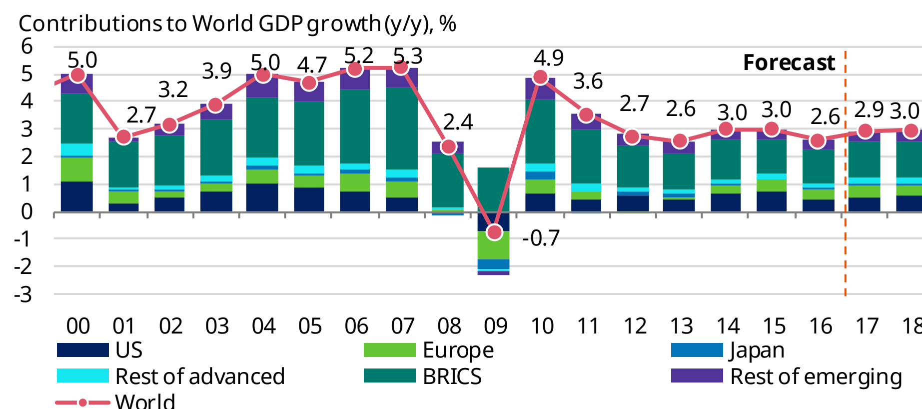
Divergence is a growing theme on the growth side as an upgrade to the Eurozone forecast this year is offset by a downgrade to the US and emerging markets. Leading indicators such as the Purchasing Managers new orders indices show that the Euro area continues to strengthen whilst the US and Japan have begun to roll over. The divergence has been a factor behind the relative strength of the euro.

In the emerging world, our forecast for China has not changed and the downgrade to our growth forecast for 2017 reflects cuts to Brazil and Russia. Despite tighter lending and regulation, the stronger than expected Q1 growth in China means that even though we see a slowdown in the second half of the year it is not enough to lower our overall forecast. There is no universal driver for the other downgrades, which instead rest on idiosyncratic factors: politics for Brazil, oil for Russia, and uncertainty over taxes in India.

Meanwhile, we are passing the peak in inflation globally with the turn in commodity prices. Headline inflation rates are now expected to decline as the increase in energy prices fades from the annual comparison. The UK may prove to be an exception to this trend as weaker sterling is likely to push inflation higher.

In terms of monetary policy, we continue to expect the theme of divergent monetary policy to play out with the Fed expected to raise rates to 1.50% by the end of 2017. US rates are then expected to reach 2% by the year-end of 2018. However, interest rates elsewhere are expected to remain on hold reflecting the earlier stage of the cycle in Europe and Asia. Rates in China are now expected to be on hold this year, but fall further in 2018 as activity softens. We expect the ECB will continue quantitative easing over the forecast period but will begin to taper again in 2018. The BoJ is expected to keep rates on hold, but maintain qualitative and quantitative easing (QQE) as it struggles to reach its target of above 2% inflation.

Chart 1: Global growth and forecast for 2017 and 2018



Source: Thomson Datastream, Schroders Economics Group. 25 May 2017.

Scenario analysis

Macro risks: Fading political risk

Full details of the scenarios can be found on page 14.

Following the French election result, we have dropped our **"Le Pen breaks EU"** scenario. Whilst political risk still exists in Europe, we believe it has moved on from the acute phase experienced over the past six months. President Macron is likely to unite rather than divide Europe, and on current opinion polls it looks as though he will be doing so alongside Angela Merkel.

The remaining risk is Italy where a general election is due by next May, but could happen sooner, and the Five Star Movement is level with the incumbent Democratic Party in the opinion polls. However, should the Five Star Movement win, they would still have to form a coalition and it is not clear that they would garner sufficient support for a referendum on the euro/ EU membership.

We believe that the risk on Italy is more of a chronic one where growth remains weak and the government loses control of the budget deficit. In this respect, Italy and the EU are vulnerable to some of the downside scenarios which reduce global growth, a factor which would have negative repercussions for the heavily indebted.

Another area where risk has declined is on trade and tariffs and we have dropped our **"rising protectionism"** scenario. We previously attached significant weight to this following the election of President Trump. However, although we have seen one-off tariffs in areas like lumber – and relations with Mexico have been fractious – there has been no outbreak of major protectionist policy. In particular, relations with China have thawed considerably, with President Trump saying that China is not a currency manipulator and finding common interest over North Korea.

We have also dropped the "**Russian rumble" scenario** as, notwithstanding the investigation into Russian involvement in the US election, relations have thawed with the west.

The first new scenario is **"inflation accelerates"** where the relationship between growth and inflation takes an adverse shift. In terms of our earlier discussion, this would mean a steepening of the Phillips curve with wages rising significantly in response to low unemployment. This would be a global shift, with output gaps being found to be smaller than currently estimated. For the Eurozone and Japan such a development would initially be welcome as they seek to dispel deflation. However, both the ECB and Bank of Japan could be expected to begin raising interest rates. Meanwhile the Fed would be engaged in more aggressive rate hikes with the policy rate rising to 3.5% by the end of 2018. Growth slows as policy tightens and economies hit capacity constraints, the net result is a period of stagflation.

The second new scenario this quarter is **"secular stagnation"** where growth and inflation continuously underperform. This of course is a return for the deflationary scenario which appeared regularly before the economic recovery in 2016.

Another scenario making a come back is **"China credit crisis"** which is a variant of the various China hard landing scenarios we have presented in the past. In this version, the recent monetary tightening goes too far and sparks a seizure in the financial system which chokes off the supply of credit to the real economy. China growth slows to 4% in 2018 with a significant impact on the rest of the world economy. Deflationary pressure is increased by a fall in the renminbi (to 8.0 versus the US dollar).

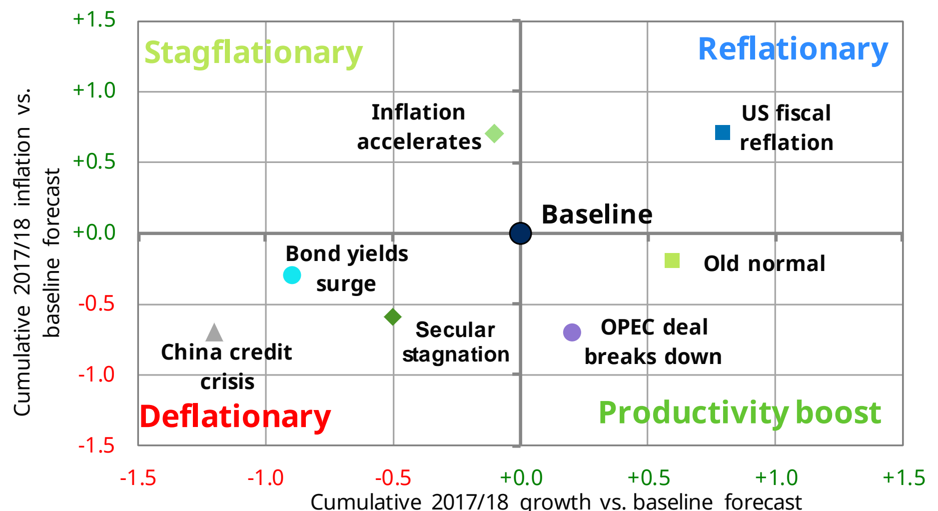
In terms of the remaining scenarios; **"bond yields surge"** has been adjusted with the trigger now an adverse reaction to the Fed balance sheet reduction programme. The scenario expounds a significant tightening of financial conditions in the US, with contagion to markets in the rest of the world. The impact is deflationary as credit and growth slow whilst inflation eases lower.

"US fiscal expansion", "old normal" and "OPEC deal breaks down" remain intact. "Old normal" refers to a world where global growth picks up pace to around 3% as a result of the improvement in near term momentum becoming self sustaining as animal spirits rise and/or fiscal policy kicks in. However, rather than a rise in inflation, productivity improvements mean that price stability is maintained. The trade-off between growth and inflation returns to pre-financial crisis levels. Central banks respond by raising interest rates in recognition of a higher equilibrium real rate. In terms of our classification we would label this as a productivity boost scenario.

In the "OPEC deal breaks down" scenario, tensions between Saudi Arabia, Iran and Russia cause production quotas to fail, resulting in the oil price dropping to $30 per barrel. After an initial period of weakness as oil producers cut back, global growth revives via stronger consumer spending. The net effect is similar to a productivity boost with growth stronger and inflation lower.

"US fiscal reflation" where President Trump succeeds in pushing a significant or "phenomenal" stimulus package through Congress (3% GDP compared with 0.75% in the baseline). This boosts economic activity in the US with spillover effects to the rest of the world. Commodity prices rise and labour markets tighten with the result that inflation rises. The Fed hikes rates to 3.25% by end 2018 as US GDP growth hits 3.6%.

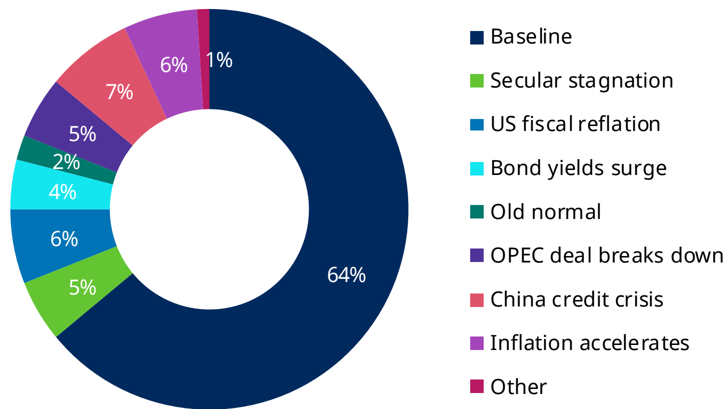
Chart 2: Scenario analysis – global growth and inflation impact



Source: Schroders Economics Group, 25 May 2017.

Chart 2 summarises the impact each scenario has on global growth and inflation relative to the baseline. Compared to the last quarter, the balance of risk has shifted in a more deflationary direction with the return of hard landing concerns over China and secular stagnation. The stagflationary risks have diminished with the loss of the "rising protectionism" scenario. The political risks associated with the Trump administration have also diminished with the decline in weight on the "fiscal reflation" scenario. On balance, lower political risks in Europe and the US have been replaced by some of the traditional macro risks around China, secular stagnation, inflation and the unwinding of QE by the Fed.

Chart 3: Scenario probabilities (mutually exclusive)



Source: Schroders Economics Group, 25 May 2017.

Table 2: Scenario summary

Scenario	Summary	Macro impact
1. Secular stagnation	Weak demand weighs on global growth as households and corporates are reluctant to spend. Animal spirits remain subdued and capex and innovation depressed. Households prefer to de-lever rather than borrow. Adjustment is slow with over capacity persisting around the world, particularly in China, with the result that commodity prices and inflation are also depressed.	**Deflationary:** Weaker growth and inflation versus the baseline. The world economy experiences a slow grind lower in activity. As the effect from secular stagnation is more of a chronic than acute condition it takes policy makers time to identify the trend. However, as economic activity fails to accelerate, more stimulus is added. The US reverses its interest rate hikes, while the ECB and BoJ prolong their QE programmes.
2. US fiscal reflation	President Trump is true to his word and succeeds in pushing a massive stimulus package through Congress (3% GDP versus 0.75% in the baseline). Global growth accelerates to 3.7% in 2018 with the US growing at 3.6%. Demand spills over and boosts growth in the rest of the world whilst an increase in animal spirits further boosts activity through stronger capex. However, higher commodity prices (oil heading toward $70 per barrel) and tighter labour markets push global inflation up to nearly 3% in 2018. US Fed funds reaches 3.25% by the end of 2018, 125 basis points higher than in the baseline.	**Reflationary:** Stronger growth and higher inflation compared to the baseline. Central banks respond to the increase in inflationary pressure with the fastest response coming from the US, which is more advanced in the cycle compared with the Eurozone where there is considerable slack. As well as raising rates to 3.25% by end-2018, the Fed starts to actively unwind QE by reducing its balance sheet. Although there is little slack in Japan, higher wage and price inflation is welcomed as the economy approaches its 2% inflation target. This is likely to lead the BoJ to signal a tapering of QQE, with modest increases in interest rates. Fed action and inflation concerns result in tighter monetary policy in EM compared to the baseline. The ECB also starts to unwind QE and raises rates.
3. Old normal	The pick up in global activity is sustained through 2017 and gathers pace in 2018 with global growth exceeding 3% in both years. However, rather than a sustained rise in inflation, productivity improvements mean that price stability is maintained. The trade off between growth and inflation improves and is closer to that achieved before the GFC than since.	**Productivity boost:** Higher growth but lower inflation characterises makes this a productivity boost scenario. Central banks respond by increasing interest rates in recognition of the fact that equilibrium real rates have risen in line with the gain in productivity growth. The scenario is characterised by higher growth and higher real rates, the "old" normal.
4. Bond yields surge	Bond markets react badly as the Fed starts to reduce its balance sheet with yields rising significantly in response to the arrival of a major seller of duration. US 10 year yields spike to 4.5% with a knock-on effect to global bond markets. Yields then settle back to 4%, but have the effect of tightening monetary conditions as mortgage rates and the cost of credit increase and equity markets weaken.	**Deflationary:** The tightening of monetary conditions results in a sharp slowdown in consumer and corporate borrowing. Demand is also hit by an adverse wealth effect as equity markets fall thus further slowing consumption. Weaker demand results in lower commodity prices and inflation.
5. OPEC deal breaks down	After some success in boosting world oil prices by cutting supply, some smaller OPEC members start to cheat and expand production once again. Outraged by this, and by the growing hostilities from the US, Israel and Saudi Arabia, Iran decides to break from the OPEC agreement, followed by Russia. Soon after, Saudi also decides to expand production, causing the price of Brent Crude oil to plummet to $30 per barrel, where it remains.	**Productivity boost:** The fall in oil prices boosts the disposable income of households and most businesses across the world, although energy producing countries suffer greatly. In the US, as investment in energy has fallen sharply in recent years, the impact on the energy sector is smaller than the 2015/16 episode. However, households receive a similar benefit with the usual lags. Overall, stronger GDP growth, but lower inflation.
6. China credit crisis	Recent monetary and macro-prudential tightening goes too far and sparks defaults in the interbank market. This leads to a seizing up of the financial system as banks refuse to lend to one another, and chokes off the supply of credit to the real economy. By the time the authorities intervene, real demand has already fallen and so loan demand is much weaker. Reviving the system takes longer than anticipated and the crisis drags on growth throughout 2018.	**Deflationary:** With credit frozen, Chinese real estate suffers on both the demand and supply side. Accounting for one third of final demand in China, this has a significant impact on Chinese GDP growth. Globally, this transmits first through commodity prices and financial contagion, hurting EM, and soon after through real demand as Chinese consumers cut back. Global growth and inflation both fall.
7. Inflation accelerates	After a considerable period where wages have been unresponsive to tightening labour markets, pay begins to accelerate in response to skill shortages. Wages accelerate around the world and economists revise their estimates of spare capacity considerably lower. Some economies such as Japan welcome the move as they seek to raise inflation expectations, others find they are facing stagflation as they effectively run out of capacity forcing the central bank to tighten policy.	**Stagflationary:** US inflation rises to 3% by the end of 2018 on both headline and core measures. The Fed responds by tightening more aggressively taking its target rate to 3.5% by end 2018. Interest rates also rise more rapidly in the Eurozone and UK whilst Japan returns rates into positive territory. Currency changes provide some cushion to the emerging markets which see a modest boost to growth alongside higher inflation in this scenario. Overall, global growth is slightly weaker and inflation considerably higher.

Source: Schroders Economics Group, 25 May 2017.

Mid-year markets review

Azad Zangana
Senior European Economist and Strategist

"I would say have some stocks in your portfolio. It could go up 50% from here. That's what it did around 2000, after it reached this level, it went up another 50%. So I'm not against investing in the stock market when you consider alternatives. But I think if one wants to diversify, US is high in its CAPE ratio[1]. You can go practically anywhere else in the world and it's lower."

Nobel Prize-winning economist Robert Shiller, CNBC, 23 May 2017

2017 has been an interesting year for investors so far. Buoyed by a rally in risk assets at the end of 2016 sparked by President Trump's election victory, investors started the year confident that the "Trump reflation rally" could continue. As the first half of the year ends, we look back at recent trends and examine which were the best broad asset classes and markets to be invested in.

What happened to the Trump reflation rally?

Trump's promises of tax cuts, infrastructure spending and deregulations drove the "Trump reflation trade"…

The Trump reflation rally initially continued at the start of 2017, but has faded away slowly over the course of recent months. His promise to cut tax, increase infrastructure spending and deregulate industry and banking were music to the ears of investors in US companies. Investors piled in to sectors that were set to benefit from Trump's agenda, like energy, banks and some tech stocks. From a macroeconomic perspective, extra fiscal spending and deregulation could spur faster growth, and with unemployment already at cyclical lows, concerns over inflation had returned.

Expectations of higher inflation were reflected by inflation-linked bonds, but also the performance of long-dated US Treasuries bonds. Chart 4 shows the yields-to-maturity of 30-year Treasury bonds, along with the shaded section highlighting the period of the presidential election.

Chart 4: The Trump reflation trade unwinds

Source: Thomson Datastream, Schroders Economics Group. 26 June 2017.

[1]CAPE – Cyclically adjusted price-to-earnings ratio. A measure of long-run valuations developed by Robert Shiller.

The immediate reaction to Trump's victory last November was for investors to sell long-dated Treasury bonds, causing prices to fall and yields to rise. This makes sense if higher inflation is a concern as these fixed income assets do not protect investors from rising inflation.

...however, as he has disappointed, the reflation trade has unwound.

However, as time has passed, investors have lost some faith in the president's ability to deliver on his promises. The clumsy and combative nature of the administration has seen delays to the reforms promised to the Affordable Care Act, which in turn has delayed progress on budget reforms in the House.

To make matters worse, questions over both Trump and members of his team's conduct before and since the election have raised the possibility of impeachment. While this is unlikely given both the House and Senate are controlled by Republicans, investors' confidence in Trump has taken a blow. As a result, the "Trump reflation trade" has been unwinding as shown in chart 4 on the previous page, although this has not stopped equities from performing well, as we will discuss later in this note.

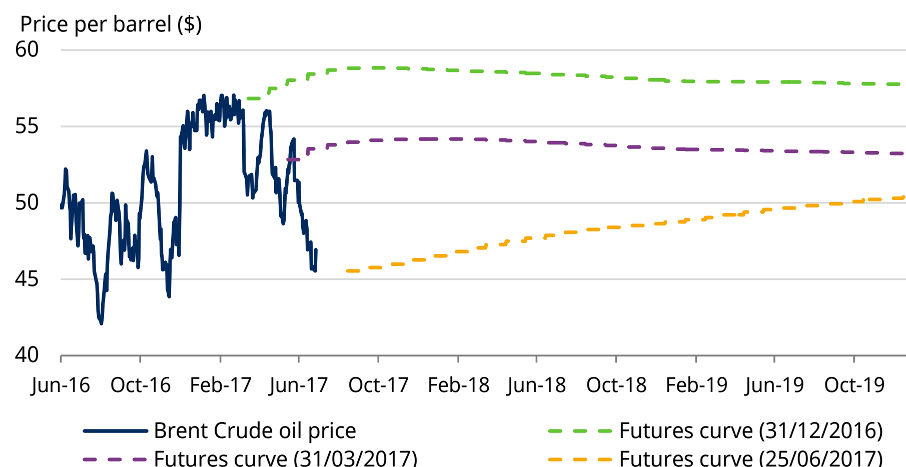
Oil prices slip despite OPEC cuts in output

OPEC decided to extend its previously agreed quotas, but it did not stop oil returning to a bear market

After almost two years of battling with other energy producers for market share, the Organisation of the Petroleum Exporting Countries (OPEC) came together towards the end of 2016 and agreed to cut oil production by a million barrels per day. OPEC had suspended its quota system over the previous year in an attempt to drive less competitive producers out of the market. US shale gas producers were key targets and as they suffered over 2015, the price of oil started to rebound last year. However, as momentum faded, OPEC decided to cut production to help prices higher.

In May 2017, OPEC members decided to extend the new quotas through March 2018, as they felt that the cuts had been working. However, some analysts had expected a further cut in production, especially as US shale producers had appeared to have adapted their businesses to lower oil prices. Combined with some concerns over global growth and inflation, oil prices have once again come under pressure of late. Chart 5 shows the fall in both the spot and futures markets since the start of the year. With a 20% fall since the last peak in March, oil has re-entered bear market territory.

Chart 5: Oil enters a bear-market



Source: Thomson Datastream, Schroders Economics Group. 26 June 2017.

Lower oil prices will lower inflation forecasts, and possibly change policy paths of central banks

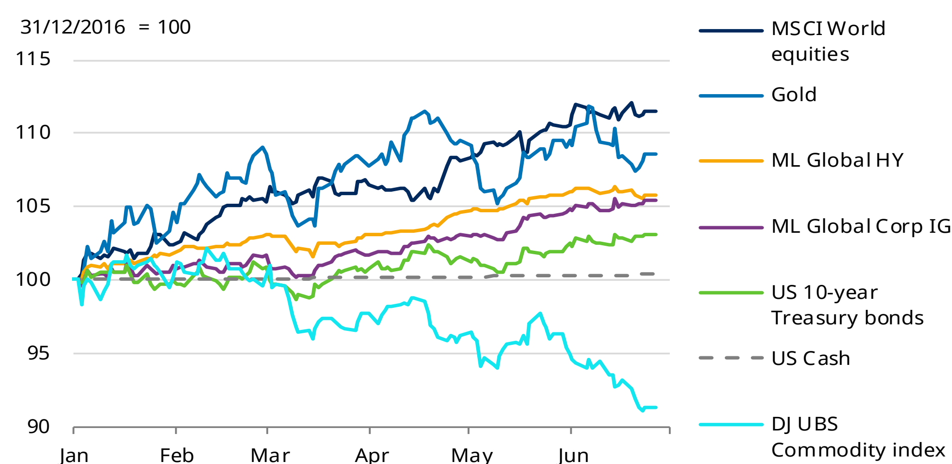
The ramifications of the decline in oil prices do not appear to have been fully considered by markets. First, oil producers will be negatively impacted, although oil consumers will eventually enjoy the savings made. Meanwhile, inflation is likely to be lower everywhere, which is likely to lead to more dovish sentiment from central banks. While the Federal Reserve is the only major central bank actually raising interest rates, the Bank of England came close in its June meeting. At the same time, pressure for the European Central Bank to scale back stimulus has also risen. Undoubtedly, fears of secular stagnation will return (as it did in our scenario analysis), but investors should consider whether oil prices are really signalling a slump in demand or, more likely, whether they are reflecting improvements in productivity.

Cross-asset performance comparison

Over the first half of the year, equities have been the best performing asset class as measured by total-returns in US dollars (+11.5% year-to-date). Gold has actually led the way over the first quarter, but the Fed's March rate rise caused real yields to rise, hurting the precious metal. Nevertheless, gold has had a good year so far, returning 8.5%. Global high yield (+5.8%) and global investment grade (+5.4%) corporate bonds follow.

So far this year, equities have been the best asset class to be invested in. Commodities have been the worst.

Chart 6: 2017 to date, cross-asset performance (USD)



Source: Thomson Datastream, Schroders Economics Group. 26 June 2017.

Government bonds as represented by US Treasuries were underwater over the first quarter, but the unwind of the Trump reflation trade has helped improve performance since (+3.1%). Finally, the Dow Jones/UBS commodity price index was by far the worst performer, down 8.7% so far, with the performance of energy a big contributing factor.

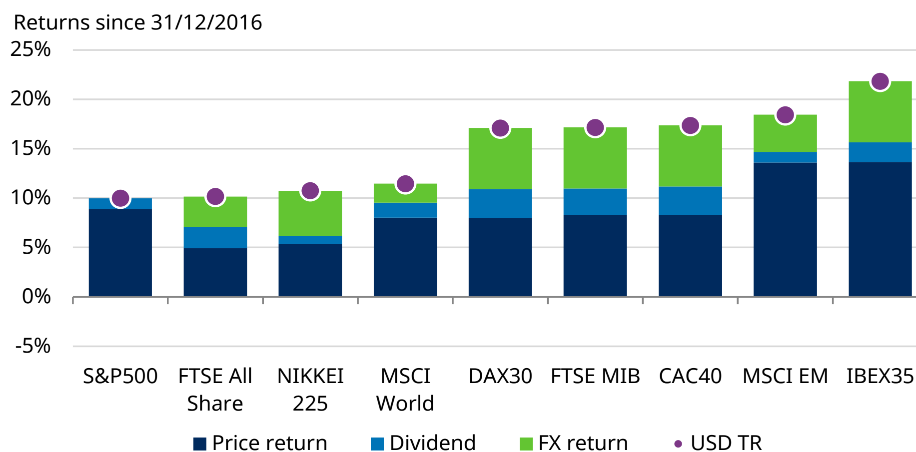
Comparing equity market performance

Within equity markets, high-beta markets have generally performed well against a backdrop of positive risk sentiment. The best performing market was the Spanish IBEX 35, returning 21.8% (USD) and helped by a stronger local economy and a pick up in world trade. The absence of a major European crisis also helped, although the huge liquidity provided by the ECB also played a role.

The second-best performer was the MSCI Emerging Markets index (+18.4%). Despite fears over the impact of Trump on trade, the improving macro environment has helped these markets regain the momentum they had in 2015 (pre-November).

Within equity markets, the Spanish IBEX 35 has been the best performer, followed by MSCI Emerging Markets

Chart 7: Equity markets performance



Source: Thomson Datastream, Schroders Economics Group. 26 June 2017.

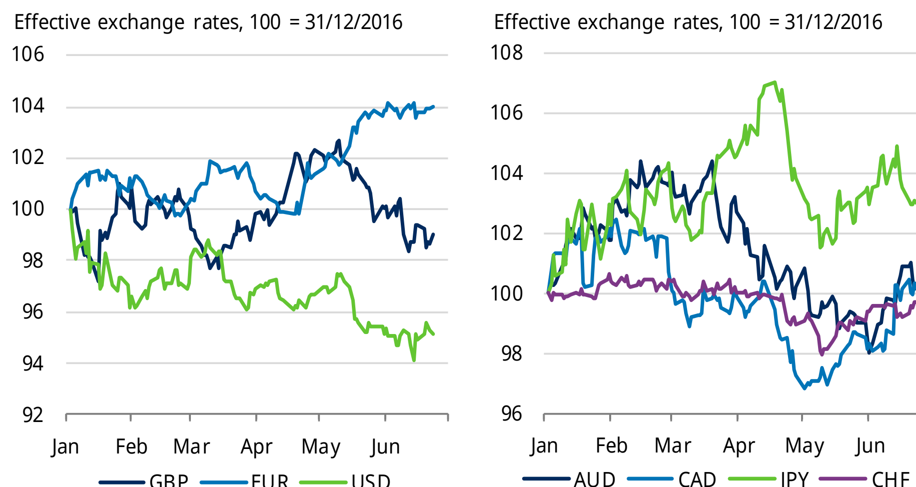
Next is a group of European markets again, with the CAC 40 (+17.4%), the FTSE MIB (+17.2%) and the DAX 30 (17.1%). The MSCI World (11.5%), Japanese NIKKEI 225 (+10.7%) and the UK FTSE All Share (+10.2%) indices follow, with the US S&P 500 (+10%) in last position. Although, given the concerns over the Trump rally unwinding, the positive performance from US equities is a solid achievement.

Comparing currency market performance

Part of the reason for the European and emerging markets outperformance in equities was the weaker US dollar. On a trade-weighted basis, the greenback has depreciated 4.9% so far this year (chart 8). Meanwhile, the euro has been stronger, helped by stronger growth and a less dovish outlook from the ECB. Also, the current account surplus remains substantial, with the monetary union benefiting from the pick-up in world trade. Sandwiched between the two is the British pound, which is down just 1% – not a bad performance considering the Brexit and election uncertainty over the past year.

The euro and yen have strengthen this year, while the dollar has been one of the weakest currencies

Charts 8 and 9: Currency performance in developed markets



Source: Bank of England, Schroders Economics Group. 26 June 2017.

Elsewhere, the Japanese yen has been volatile this year, but up overall (+3%), while the Australian dollar, Canadian dollar and Swiss franc area all near to where they started the year.

Comparing debt market performance

In the fixed income world, the best performance within government bond markets came from UK gilts (+3.3%). Gilts led the way as a slowing economy and Brexit uncertainty made the safe haven asset more attractive. US Treasuries also performed well (+3%), although most of this performance came in the second quarter, as the Trump trade was unwinding.

French OATs (+1.75%) and Italian BTPs (+1.7%) both had a terrible start to the year. Concerns over the French presidential election caused yields to spike and prices to fall, with Italy seen as a candidate for contagion given the political situation there. However, once the election result was largely secured, investors poured back in, helping to lift performance back into positive territory. Lastly, though more volatile than Japanese government bonds, German bunds returned a similar amount.

In government bond markets, UK gilts were the best performing, closely followed by US Treasuries

Chart 10: Government debt returns

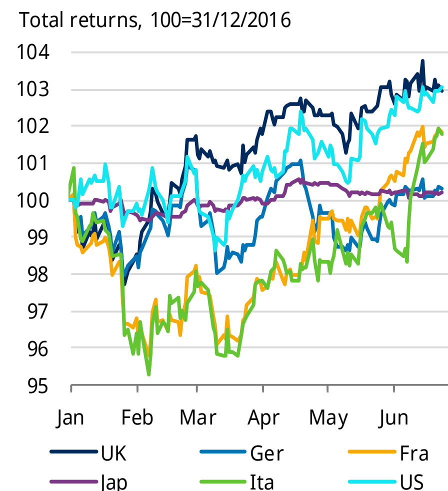


Chart 11: Corporate credit returns

Source: Thomson Datastream, Schroders Economics Group. 26 June 2017.

As for credit markets, US markets outperformed their European peers comfortably as yields came down (prices up) sharply last year in the latter as the ECB added corporate debt to its QE portfolio. Therefore, there was greater scope for US credit to outperform, which it did against a backdrop of falling bond yields but rising equity markets.

Are current trends sustainable?

Looking ahead, can equities continue to outperform while bonds see yields falling?

The fall in government bond yields alongside the ongoing rally in equities suggests investors are split on the current outlook. Volatility remains very low despite the Fed tightening policy. While liquidity is ample and has in the past been a major factor in causing these markets to move in the same direction and suppressing volatility, history suggests that this trend is unsustainable.

The fall in oil prices is a possible factor for the current state of markets. Although lower oil prices will hit the energy sector, with lower inflation ahead, some central banks like the Fed and BoE may become less ambitious in tightening monetary policy, while some, such as the ECB, may be forced to step up stimulus again. This suggests risk assets can continue to do well, especially as growth continues unabated, while inflation remains low. The next section considers the outlook for markets in greater detail and explores these questions further.

Global strategy: Are investors complacent?

Keith Wade
Chief Economist
and Strategist

"Keeping interest rates too low for long could raise financial stability and macroeconomic risks further down the road, as debt continues to pile up and risk-taking in financial markets gathers steam"

Bank for International Settlements, Annual Report 2017

Equities rally and the fear gauge stays low

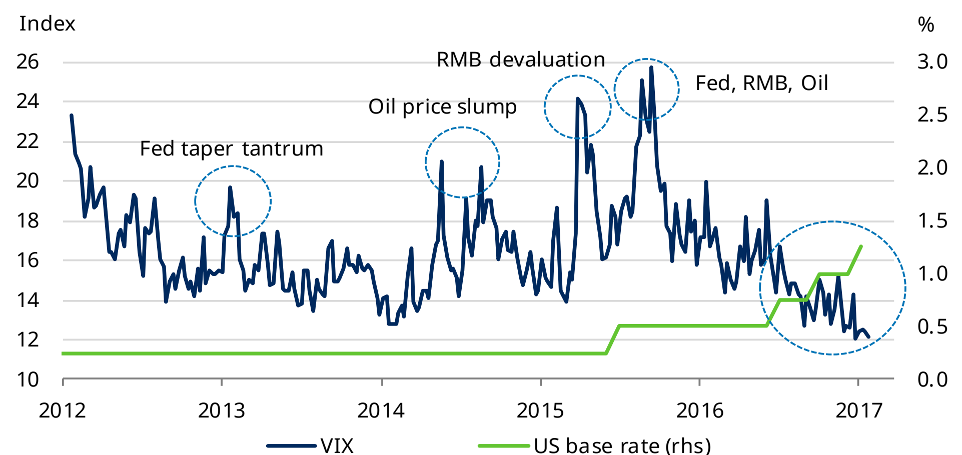
The rally in equity markets continues with the MSCI World index reaching new highs in June (Chart 12). However, the strength of equities against a backdrop of falling bond yields and elevated political uncertainty has raised the question as to whether investors are becoming complacent.

Chart 12: Global equity market and G7 government bond yields

Source: Thomson Datastream, Schroders Economics Group, 26 June 2017.

Evidence of such can be found in the behaviour of the VIX index, often referred to as the "fear gauge", which has recently touched new lows. The move is particularly surprising given that the US Federal Reserve has just hiked rates for the second time this year and is signalling another move in September as well as balance sheet reduction (chart 13).

Chart 13: Fed tightens, but volatility falls



Source: Thomson Datastream, Schroder Economics Group, 24 June 2017.

We examine the factors driving volatility in more detail below, but first we would note that although the VIX is low, markets are not entirely ignoring the risks as is often claimed. Gold, which is often seen as the ultimate safe haven asset, has performed well this year. In equity markets there has been a rotation away from the cyclicals, which benefitted from the Trump reflation trade, and back toward the high quality dividend payers. These moves are consistent with lower rates and the bull flattening of the yield curve. The surge in technology stocks also reflects strong liquidity and a preference for stocks which can increase earnings when top line growth is scarce.

Until recently Fed tightening has been associated with increased, rather than decreased volatility. For example, the VIX index spiked after the first move in Fed funds in December 2015 and again during the taper tantrum of 2013, when the Fed signalled an end to quantitative easing.

Other factors have also played a role in driving volatility. Prior to the Fed tightening in 2015, concerns that China would significantly devalue the RMB sent the VIX higher in August of that year. Along with worries over Fed tightening, those concerns resurfaced in January 2016.

Another key factor has been the oil price. Sharp falls in the oil price in 2014, 2015 and again in 2016 caused volatility to soar as investors feared an increase in defaults in the energy sector.

Concerns over Fed tightening, China and the oil price have all faded

From this perspective it could be argued that volatility is low because investors are now comfortable with the Fed's tightening policy, China has clarified its position on the RMB and the oil price is more stable. We would add that the current low level of volatility today also owes something to favourable political outcomes in Europe where there has been no swing toward populism. We still have to negotiate the German and Italian elections, but so far voters on the continent have chosen not to join the UK in leaving the European Union.

What could possibly go wrong? Threats to low volatility

Of course this is hardly an exclusive list of the causes of market volatility, but to focus on the three areas – China, oil and the Fed – mentioned above.

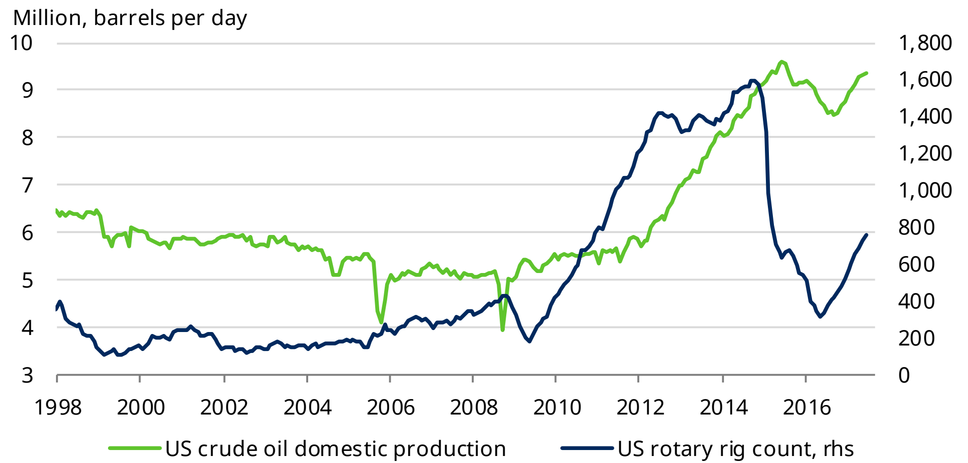
China does seem to be less of a concern as the authorities have regained control over the RMB by reining in capital outflows. Foreign exchange reserves have stabilised and recently the RMB has appreciated. The cost though has been a significant increase in capital controls.

The risk of a further oil price drop remains

There are still worries about oil with the crude price falling recently, although the decline has been modest compared to the past. Nonetheless, the risk of a sharper fall remains and we do have a weaker oil price as one of our key risk scenarios where the OPEC deal breaks down and Brent crude prices drop back to $30 per barrel[2]. Despite a significantly lower rig count, US production of crude oil is now close to peak levels thus putting pressure on the ageing cartel. Saudi Arabia's efforts to drive US shale out of business have been for naught.

[2]See Economic and Strategy Viewpoint, June 2017.

Chart 14: The rig count and oil production in the US

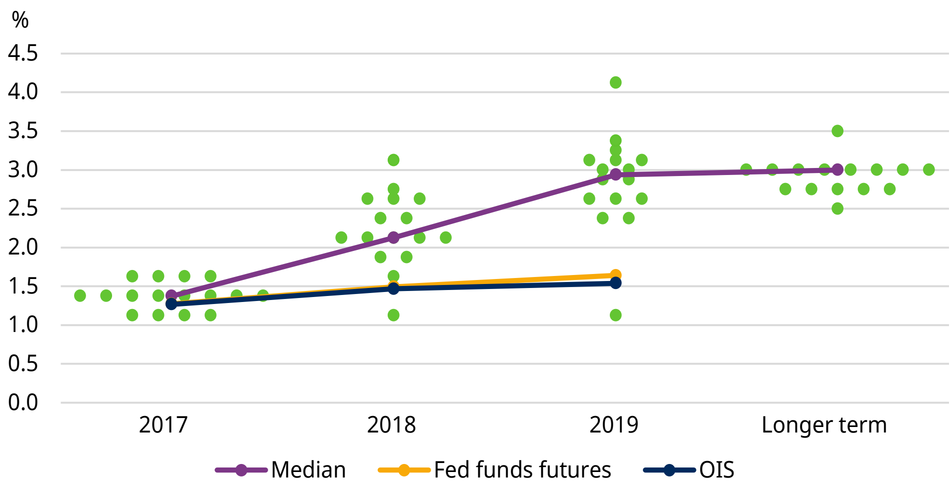


Source: Thomson Datastream, Schroder Economics Group, 26 June 2017.

...and markets are vulnerable to further tightening in US monetary policy

From a volatility perspective, the greater concern is on US interest rates as we see some complacency in market expectations about the degree of tightening by the Fed. At present the market is only discounting one, or possibly two more rate hikes to the end of 2018. Meanwhile, the Fed's FOMC members projections (know as the "dots"), put rates at just over 2% at the end of 2018 (see chart 15).

Chart 15: Fed rate setters expectations (the "dots") well ahead of the market



Source: Thomson Datastream, US Federal Reserve, 24 June 2017.

Despite expecting inflation to remain relatively subdued we also see further rate hikes as the Fed continues to normalise interest rates. Such a view is consistent with models such as the Taylor rule which say rates should be higher given the position of the US in its cycle.

Support for higher interest rates has also come from the Bank for International Settlements (BIS) who recently commented that central banks should be prepared to tighten policy "when demand is strong, even if inflation is weak, so as not to fall behind the curve with respect to the financial cycle"[3].

Arguably an excessive focus on inflation allowed central banks to ignore the build up of debt and excessive risk taking in financial markets which preceded the global financial crisis. While we are some way from that position today, demand is healthy, risk assets are performing strongly and there is talk of

[3]See BIS 2017 Annual report.

bubbles in some markets. The Fed appears to recognise this with chair Janet Yellen playing down low US inflation at her last press conference following the decision to raise rates on 15th June.

Market looking for a weaker economy, or an even more dovish Fed chair?

Meanwhile, financial markets are discounting a benign outcome for interest rates. This could reflect expectations of a weaker economy, or the appointment of a new Fed chair who is reluctant to tighten (perhaps under political pressure from the president). Janet Yellen's term expires next February.

On balance though these are risks rather than the central view. We would certainly put more weight on a fiscal stimulus next year than the market given the political pressures for the Republicans to deliver ahead of the mid-term elections. Consequently, alongside a fall in the oil price, tighter policy from the Fed has the potential to trigger an increase in financial market volatility.

This suggests a note of caution for financial markets, but we would make two points.

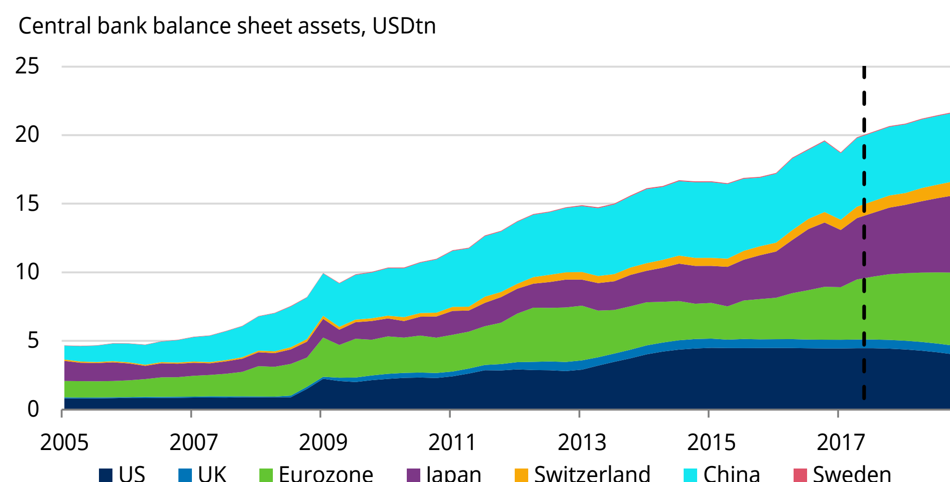
First, global inflation remains low, a trend which is likely to be reinforced by the recent fall in oil prices. Notwithstanding the BIS analysis, central banks are mandated to target inflation and will be reluctant to tighten in a world where there are fears of secular stagnation. If the choice is between having a financial market bubble or deflation, the bubble wins every time.

Second, global liquidity will remain supportive. Policy rates in Japan and the Eurozone are set to remain in negative territory throughout 2018 and probably beyond. Meanwhile, central bank asset purchases will continue in the Eurozone throughout 2018 and in Japan for longer. The latter is some way from hitting its inflation target of 2% or more.

Moreover, on our calculations total central bank asset purchases can be expected to continue to rise over the next 18 months thus maintaining a high level of liquidity in global markets. This largely reflects a view on the Bank of Japan. We expect it will gradually raise asset purchases in response to the need to boost inflation and pressure to maintain 10-year government bond yields at close to zero through its Yield Curve Control policy. Rising BoJ purchases offset tapering by the European Central bank and the reduction in the balance sheet at the Fed.

Global liquidity to remain robust even as the Fed reduces its balance sheet

Chart 16: Global liquidity to continue to rise



Source: Thomson Datastream, Schroders Economics Group, 26 June 2017.

Are investors complacent?

The next shock to markets may not be driven by the Fed, oil or China. It could be geopolitical in origin, for while political risks may have eased in Europe they are building in Asia where tensions between the US and China will rise if North Korea does not ease back on its nuclear weapons programme.

Notwithstanding such an outcome, more conventional economic risks are not insignificant. In particular the market appears to be underestimating the potential for US interest rates to rise. The desire to normalise remains high and rates are still well below where most models would have them given where the US is in its cycle.

However, such pressures will not become apparent until further out. Low inflation will keep the Fed cautious and the start of balance sheet reduction will probably see the US central bank pause rate rises to monitor any more general tightening of financial conditions. Unless the Fed signals otherwise, the difference of opinion between the market and the "dots" will probably not be resolved until spring next year. Meanwhile, central bank asset purchases are likely to continue to expand. In this environment investors may find it hard to resist being "complacent" as liquidity will continue to drive markets with the risk that they move into bubble territory.

Research note: The impact of presidential impeachment on markets

Craig Botham
Emerging Markets Economist

Political noise has been on the rise in developed markets in recent years, bringing what are regarded as the more stable economies in line with emerging markets. Though it can hardly be ignored, political noise is often hard to trade. In this note, we examine one of the more disruptive political events in a democracy, presidential impeachment.

US impeachments few and far between

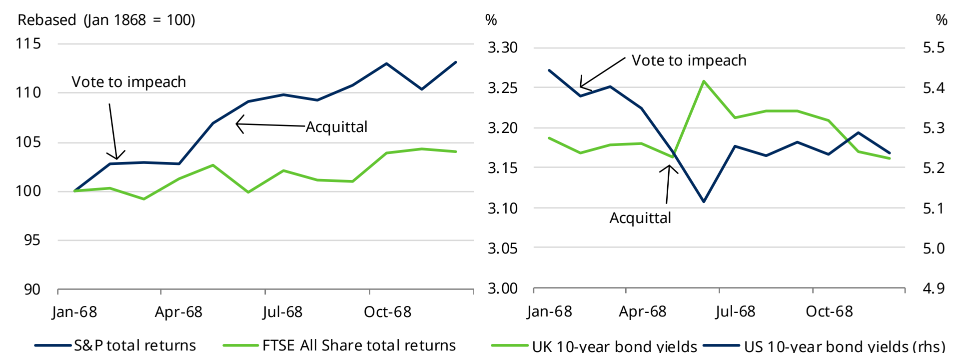
Elements in the US have called for the impeachment of current president Donald Trump for a range of reasons. We can offer no view on the validity of these reasons, but we can look at past US presidential impeachments as a guide to what might happen to the markets. Happily for the US, the incidence of impeachment is limited, with only three impeachment attempts (none successful) since the founding of the republic. Consequently, we also consider a couple of examples from emerging markets, where impeachment was successful.

Andrew Johnson and the Tenure of Office Act

The first impeachment attempt in the US came in 1868. President Johnson, who took office after the assassination of President Lincoln, was charged with violating the Tenure of Office Act by removing the Secretary of War, Edwin Stanton. The vote to impeach came in February 1868, three days after Stanton's dismissal. The trial ended with Johnson's acquittal on 26 May of that year.

The short timescale does not afford us much opportunity for analysis, but all the same chart 17 depicts the performance of US equity and bond markets in 1868, with the UK as a comparator. One could infer that the May acquittal prompted the subsequent outperformance of the US equity market. The bond market meanwhile rallied through the impeachment process before levelling off. Whether this tells us anything about the likely market reaction to impeachment today is highly debatable, of course, given how financial markets have changed since the 1800s.

Chart 17: US asset performance during the 1868 impeachment of President Johnson



Source: Global Financial Data, Schroders Economics Group. 23 March 2017

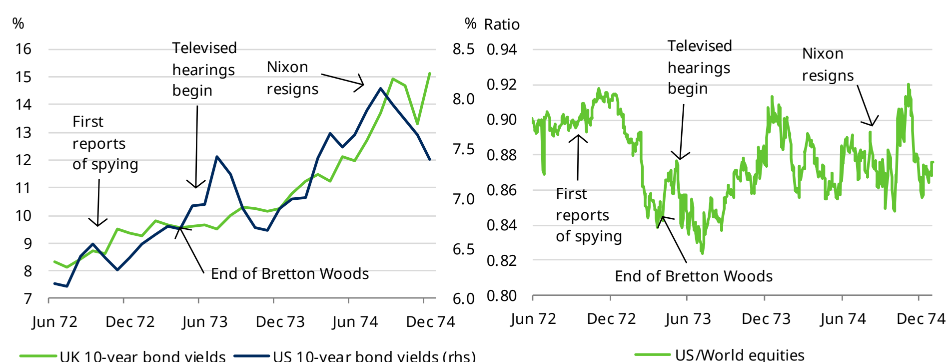
Watergate

President Nixon offered clearest case for impeachment, but resigned before conclusion

In June 1972 burglars broke into the offices of the Democratic National Committee at the Watergate office complex. The eponymous scandal followed attempts by the Nixon White House to conceal its involvement; the subsequent investigation by Congress met with resistance from the Nixon administration and prompted a constitutional crisis.

Perhaps the relevant period for markets begins from September 1972, as reports surfaced of Republican-financed spying and sabotage of the Democratic Party. January saw another step up in significance when the burglars were convicted and the ties to the White House were becoming more apparent. Ultimately, Nixon would resign in August 1974, before the impeachment process could conclude. Chart 18 shows how US equities and bonds performed during this time.

Chart 18: The impact of Watergate on US assets



Source: Global Financial Data, Thomson Datastream, Bloomberg, Schroders Economics Group. 15 March 2017.

Need to disentangle impeachment response from global events

Teasing out the bond yield response is difficult. For one, the expected reaction is unclear. Nixon's notable economic policies included wage and price controls (which hurt demand), dollar devaluation (which boosts inflation and growth), and a short-lived import tax, which weakened the dollar (another inflation boost). Impeachment could therefore have led to a less inflationary policy set. The rally in bonds, with yields falling through September into November, could reflect hopes of lower inflation.

Equally, the rally might mark a flight to safety as political risk rose. However, bond yields then began to climb steadily. An inflection point was reached in August 1973 after which yields declined until the end of the year. They then climbed again until Nixon's resignation, which seemed to mark a high water point. However, we can see that UK gilts behaved in much the same way, with only some deviations.

US bonds seem to have underperformed between April and July 1973, and outperformed from August 1974. April 1973 saw the resignation of the FBI director for destroying evidence, while the White House counsel was fired, and in May of that year televised hearings began. It seems plausible therefore that Watergate caused some weakness in the US bond market at this time.

Some evidence of positive response to Nixon's removal

However, probably more important is that in March 1973, the Bretton Woods fixed exchange rate system became a floating exchange rate system. As for the outperformance, we think it reasonable to suggest that the resignation of President Nixon provided a catalyst. As mentioned above, investors might have welcomed a change in economic policy, as well as an end to uncertainty.

When considering equity market performance, we take a ratio of the US index against the MSCI World index. We aim here to remove the impact of the OPEC crisis from the data. The S&P 500 underperformed from December 1972 to

March 1973, then after a short rally resumed its decline into July, when its underperformance peaked. This of course coincides with the bond market weakness, supporting the idea that Watergate drove asset weakness to some extent. Perhaps oddly, the S&P 500 then outperformed into end 1973, after which relative performance looks fairly trendless, with the index underperforming in the immediate aftermath of Nixon's August 1974 resignation.

The Lewinsky Scandal

More important market events coincide with Clinton impeachment

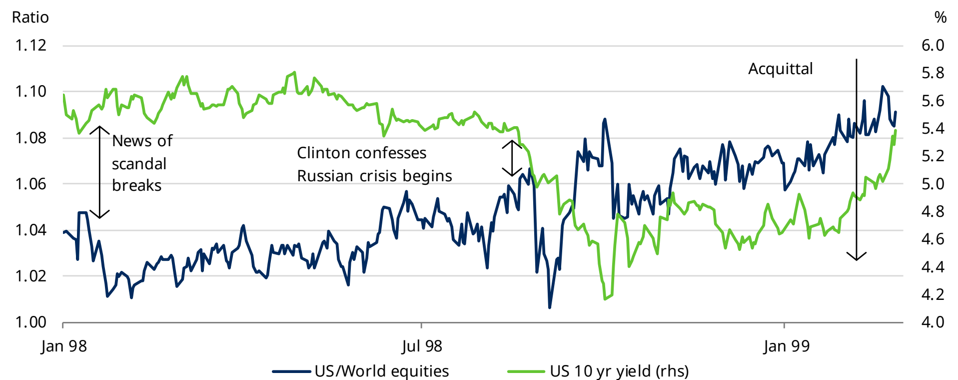
Without going into excessive detail, the news of President Clinton's involvement with Monica Lewinsky broke on 17 January 1998. Lewinsky eventually agreed to testify in late July of that year, and on 17 August Clinton admitted to an "inappropriate" relationship. A Republican dominated Congress voted to begin impeachment proceedings in December for perjury and obstruction of justice. The trial began in January 1999 and concluded with Clinton's acquittal in February of that year.

From chart 19, it is difficult to note much impact of the scandal in the first half of 1998. We do see increased volatility following Clinton's confession, but it should also be noted that this coincided with the Russian debt crisis and subsequent failure of Long Term Capital Management in the US. The US market then outperformed following his acquittal. Bonds, meanwhile, rally on the confession and then sell off on the acquittal. It is tempting to suggest this post-acquittal performance reflects assumptions of fiscal stimulus under a Democratic president. However, this does not tally with the budget surpluses achieved 1998-2001, or the Balanced Budget Act passed in 1997.

Possible risk on sentiment following acquittal on removal of uncertainty

An alternative reading is that, with uncertainty over the presidency removed, investment could return and growth expectations rise, prompting rising equities and higher bond yields. Again though, we would be remiss to omit events elsewhere: the tech bubble was inflating rapidly at this point, and is likely muddying the waters.

Chart 19: US asset performance during the Lewinsky Scandal



Source: Thomson Datastream, Schroders Economics Group. 15 March 2017.

EM provides examples of successful impeachments

With only limited examples available in the US, we could also look at more recent examples elsewhere. Both South Korea and Brazil have successfully impeached their presidents in the last two years, and so could prove instructive examples.

South Korea: Impeachment of Park Geun-hye

In October 2016, it emerged that a key presidential aide in South Korea had abused their position for personal gain. There were allegations too that the same aide had interfered with the policy of the state council. The daughter of a shamanic cult leader, media speculation was rife over the possible religious

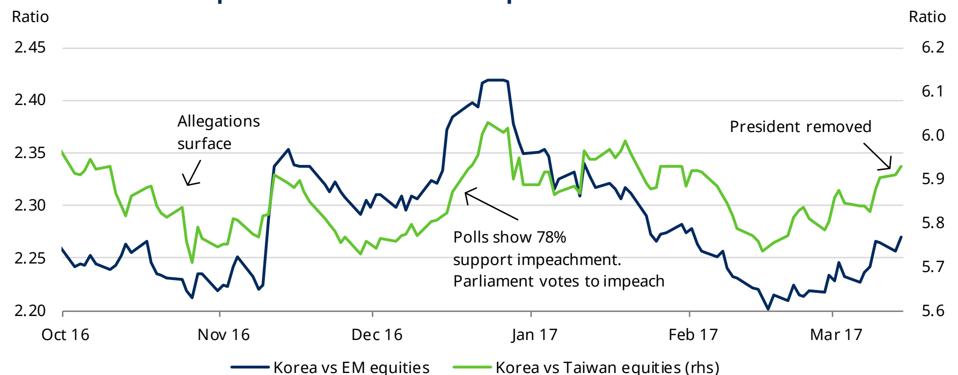
influence exerted by the aide over President Park, The aide was arrested and, amidst protests, President Park apologised, but to no avail. By December, 78% of South Koreans supported her impeachment, and a parliamentary vote proceeded to that effect. President Park was then suspended for 180 days, and dismissed from her post entirely on 10 March 2017, with new elections held in May of this year.

While shamanic cults made for fascinating media gossip, they seem to have had limited impact on the Korean markets. Chart 20 shows the relative performance of Korean equities and bonds, and equities seemed to perform broadly in line with the rest of the emerging markets as news of the scandal broke. We do see underperformance versus Taiwan (chosen because it is an equally export sensitive market), but that seems to have been a pre-existing trend.

Impeachment seems to have generated a strong equity rally in Korea on hopes of reform

A more meaningful impact seems to have arisen from the vote to impeach in early December, following which Korean equities outperformed the rest of EM, including Taiwan (so it was not simply the result of stronger global trade, for example). It might also be possible that the November outperformance resulted from anticipation of successful impeachment. However, the positive effect appears not to have lasted long, with underperformance following from January through to mid-February. Korean equities subsequently outperformed peers on news of the arrest of a Samsung vice president for paying bribes to the presidential aide. This might seem an odd factor for a rally, but the arrest brought hopes of corporate governance reforms in Korea, a holy grail for many investors.

Chart 20: Relative performance of Korean equities

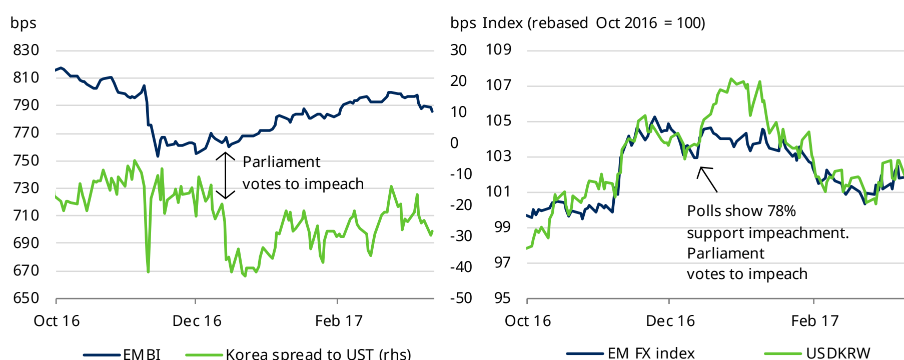


Source: Thomson Datastream, Schroders Economics Group. 15 March 2017.

In the bond space, Korean performance was almost exactly in line with the rest of EM when we look at the spread to US Treasuries, so there seems to have been no discernible impact here. However, if we look at the currency compared to other EM currencies, we can see that the Korean won weakened more than its peers between December 2016 and January 2017, tying in with the weakness in equities. To us, this looks like a flow-driven move in the currency. Otherwise, performance was very much in line with the rest of emerging markets.

Impact on Korean bonds negligible

Chart 21: Relative Korean fixed income and currency performance



Source: Source: Thomson Datastream, Schroders Economics Group. 15 March 2017.

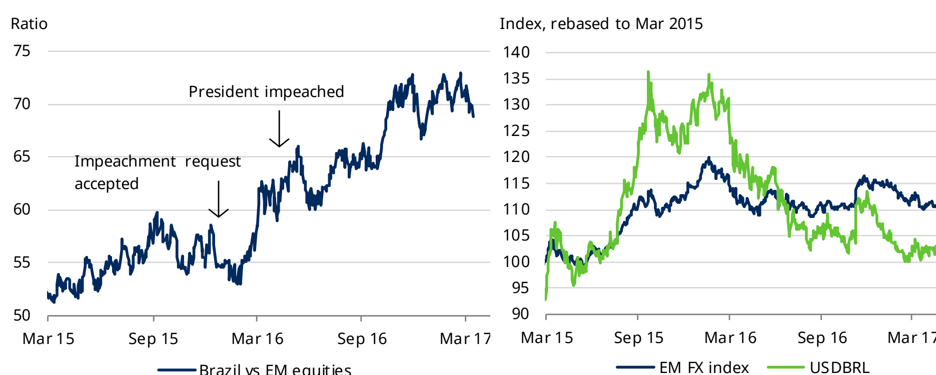
Brazil: Lava Jato, fiscal pedalling and the downfall of Dilma Rousseff

The Brazilian impeachment story took some time to unfold

Perhaps the longest-running case we will discuss, the events leading to the impeachment of Brazilian president Dilma Rousseff began in February 2014, when Operation Lava Jato (Car Wash) commenced. This began as an investigation into money laundering but unearthed corruption at the highest levels of Brazilian business and politics, involving oil giant Petrobras and members of the major political parties.

President Rousseff would win re-election in October 2014, much like Nixon untroubled by the growing scandal. Following a series of revelations and arrests of prominent politicians and businessmen, March 2015 saw protests demanding the impeachment of Rousseff. However, at this stage there was no material evidence suggesting the president herself was corrupt. Protests therefore also focused on her alleged illegal manipulation of the fiscal accounts, also known as fiscal pedalling. In August, the president reached a 71% disapproval rate. The following month, a request for impeachment was filed on the grounds of manipulation of the fiscal accounts. The request was accepted in December, and impeachment occurred in April and May of 2016 as the lower and upper houses held respective votes. Vice President Temer assumed office on 12 May, and became president with Rousseff's removal from office at the end of August.

Chart 22: Brazilian equities and currency boosted by impeachment



Source: Thomson Datastream, Bloomberg, Schroders Economics Group. 16 May 2017.

The prospect of reform again helped lift markets

Brazilian equities and the currency largely benefitted from the impeachment process, showing modest outperformance versus emerging markets as the probability of impeachment grew. As it became apparent that the lower house would vote to impeach, Brazilian outperformance became more pronounced. Rousseff's suspension in May coincided with a temporary ceiling to the equity rally, viewed as all but a done deal after the April vote. Meanwhile the currency

continued to gain thanks in part to the high carry it offered for seemingly low risk.

Investors were cheered by the prospect of Rousseff's removal because it promised a move away from left wing populism and the policy paralysis of much of her second term. Vice President Temer, drawn from an ideologically different opposition party, seemed a much more market friendly option with promises to fix the damage done to Brazil's fiscal and economic position.

The impact of uncertainty

Impeachments seem to boost volatility, though QE clouds the picture in recent years

Before we conclude, let's take a quick look at how impeachments feed through to market volatility. Intuitively, the increased uncertainty generated by an impeachment attempt should lead to higher volatility because the expected return is less clear. Table 3, below, shows the annualised volatility for the equity markets considered in the above, alongside "control" groups, in the form of global and EM indices.

Impeachments in the US (we have omitted President Johnson due to data constraints) seem to boost volatility relative to the historical average (excluding crisis periods), and also to widen the volatility gap between the S&P 500 and the MSCI World index. However, in Korea's case, the impeachment of President Park seems associated with lower volatility than the historical average, though it is worth noting that all markets show much lower volatility in this period. We suspect confounding effects from global easy monetary policy and a stabilising China are suppressing volatility in this time period. For Brazil, President Rousseff's impeachment seemed to generate marginally higher volatility relative to historical norms (from which we have stripped out a lot of Latin American crises!). However, volatility was also higher in the US, and broader EM and MSCI World indices in this period.

Overall then there is weak, rather than compelling, evidence that impeachment leads to higher volatility. However, if globally easy monetary policy is the reason for volatility suppression, an impeachment which threatened a change to that status quo seems more likely to generate the volatility increases evident in the US examples.

Table 3: Some evidence impeachments boost market volatility

Annualised volatility (%)	Brazil	Korea	MSCI EM	S&P500	MSCI World
Historical ('96 – present, ex crises*)	23.71	17.55	14.60	13.65	12.02
Nixon (Sep '72 – Aug '74)	#N/A	#N/A	#N/A	15.49	10.72
Clinton (Jan '98 – Feb '99)	64.03	49.51	24.95	19.97	16.05
Park (Oct '16 – Mar '17)	21.29	9.42	11.73	7.52	6.45
Rousseff (Mar '15 – May '16)	25.48	12.69	17.43	15.39	13.49

*ex Global Financial Crisis, LatAm debt crisis, Tequila crisis, Asia debt crisis, Russia crisis, Argentine crisis. Source: Bloomberg, Thomson Datastream, Schroders Economics Group. 16 May 2017.

Conclusion

The market impact of impeachment depends on the perceived implications for policy

At first glance there appears to be no obvious pattern. Presidential impeachments are associated with weaker, stronger, and indifferent asset market performance. However, less superficially, we can link the impact on market performance to expectations of policy change resulting from an impeachment. Where the perception is that a government's policies are damaging the economy, the possibility of a change in government boosts asset performance, as in Brazil. However, where a government is seen as benefitting the economy, or at least doing no harm, the prospect of an end to that policy set can induce market jitters. We might read the market reaction to events around President Clinton as an example of this, particular given the rally following his acquittal. Of course, this can be as much due to the removal of uncertainty as a seal of approval on government policy.

Investors concerned about how to trade similar political events – the ongoing struggle to remove President Zuma in South Africa, for example – could therefore consider two key questions. First, what is the likely direction of policy if an impeachment attempt (or similar) is successful? Second, how likely is the success of such an attempt? Though this might seem obvious, sticking to these simple guidelines can provide clarity when one might otherwise drown in market noise.

Market returns

	Total returns	Currency	June	Q2	YTD
Equity	US S&P 500	USD	0.6	3.1	9.3
	UK FTSE 100	GBP	-2.4	1.0	4.7
	EURO STOXX 50	EUR	-2.9	0.4	7.4
	German DAX	EUR	-2.3	0.1	7.4
	Spain IBEX	EUR	-3.4	1.2	13.9
	Italy FTSE MIB	EUR	-0.6	2.7	9.7
	Japan TOPIX	JPY	3.0	6.8	7.4
	Australia S&P/ ASX 200	AUD	0.2	-1.6	3.2
	HK HANG SENG	HKD	1.4	8.5	19.5
EM equity	MSCI EM	LOCAL	1.7	6.7	15.0
	MSCI China	CNY	2.5	11.0	25.6
	MSCI Russia	RUB	-0.1	-6.0	-16.0
	MSCI India	INR	-0.6	2.4	14.8
	MSCI Brazil	BRL	0.4	-2.5	5.0
Governments (10-year)	US Treasuries	USD	-0.7	0.9	1.7
	UK Gilts	GBP	-1.7	-0.7	1.1
	German Bunds	EUR	-1.6	-1.3	-1.7
	Japan JGBs	JPY	-0.3	0.0	-0.1
	Australia bonds	AUD	-1.5	1.6	2.7
	Canada bonds	CAD	-3.1	-0.3	0.8
Commodity	GSCI Commodity	USD	-1.9	-5.5	-10.2
	GSCI Precious metals	USD	-2.8	-1.8	6.9
	GSCI Industrial metals	USD	3.2	-1.0	8.1
	GSCI Agriculture	USD	3.3	-0.1	-2.2
	GSCI Energy	USD	-4.3	-10.2	-18.8
	Oil (Brent)	USD	-4.4	-9.1	-15.7
	Gold	USD	-1.9	-0.3	7.4
Credit	Bank of America/ Merrill Lynch US high yield master	USD	0.1	2.1	4.9
	Bank of America/ Merrill Lynch US corporate master	USD	0.2	2.4	3.9
EMD	JP Morgan Global EMBI	USD	-0.3	2.2	6.2
	JP Morgan EMBI+	USD	-0.4	2.4	6.3
	JP Morgan ELMI+	LOCAL	0.2	0.9	2.0
Currencies	EUR/ USD		1.5	6.8	7.7
	EUR/JPY		3.1	8.2	4.3
	JPY/ USD		-1.6	-1.2	3.3
	GBP/USD		1.0	3.5	5.1
	AUD/USD		3.5	0.9	7.0
	CAD/USD		4.1	2.6	3.4

Source: Thomson Datastream, Bloomberg, 30 June 2017.
Note: Blue to red shading represents highest to lowest performance in each time period.

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