Global markets poised for growth – despite political upheaval

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As many have come to appreciate, Great Britain's vote to leave the European Union was far more than a question about Europe. The results indicate it was just as much an anti-establishment backlash in response to voter frustrations over wage stagnation and inequality. The Brexit vote exemplifies the wave of populism that is sweeping developed Western nations, with long-term implications for the European project, global trade and financial markets.

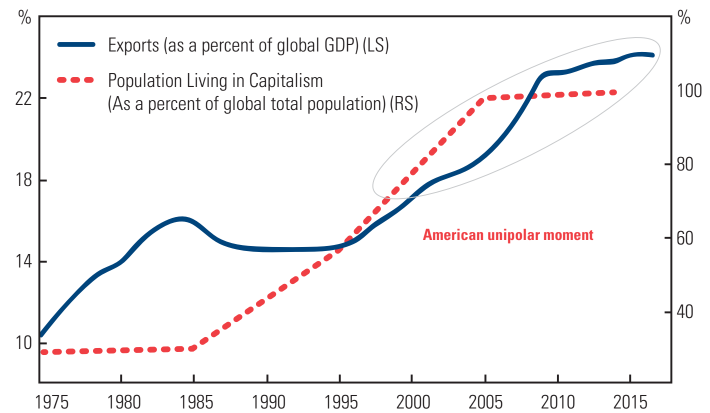
The well-being of society requires a balance between the interests of labour and the interests of capital. However, capitalism in its current form is failing too many of the Western world's citizens, and voters from the U.S. to Europe are taking their revenge at the ballot box.

> GATT opened the market to four billion people, many willing to work for next to nothing. At its signing, one U.S. worker was paid the same as the average of 47 Asian workers.

Since the signing of the General Agreement on Tariffs and Trade (GATT) in the mid 1990's introduced the modern version of globalization, the balance has shifted dramatically towards capital at the expense of labour, as multinationals either relocated or outsourced production to regions with lower labour costs like China and Southeast Asia. Graphic 1, right, illustrates the correlation between the growth in exports and the percentage of the world's population living under capitalism.

When a company relocates to reduce labour costs, the benefits can be shared between consumers, who gain access to a lower-cost product and the company, which can realize a higher profit. The loser is the labour force in the original country, which cannot find work with the same pay and benefits. Graphic 2 illustrates the degree to which wages in many developed countries have stagnated as a direct result of this trend.

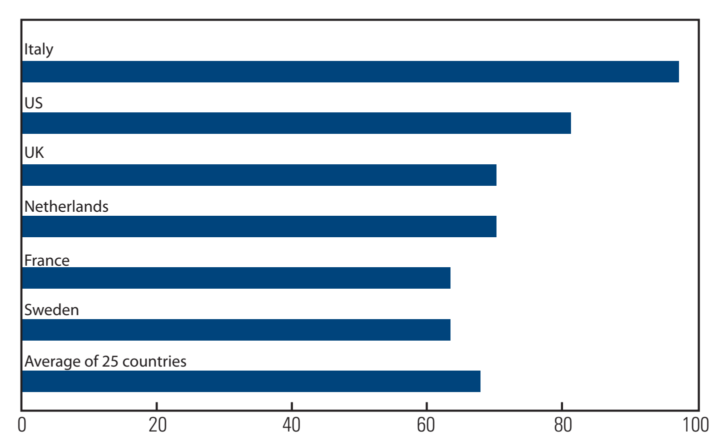
1. Globalization empowered capital over labour



*Based on IMF Data, shown smoothed.
**Percent of global population living in countries with Fraser Institute Economic Freedom Index equal to or greater than five.
Based on Fraser Institute and World Bank data.

2. The big hit

% of households with flat or falling real market income, 2005 to 2012/14*



*latest available for each country
Source: McKinsey

Stagnating wages were masked by strong real estate prices, especially in the U.S. prior to the financial crisis, along with the extensive use of debt and home equity loans to supplement income and maintain an elevated lifestyle. Unfortunately, this situation has been largely ignored by elected officials who have found it politically difficult to provide government assistance to displaced workers, and this is contributing to the rise of populist politics.

The graphs below provide an indication of just how good globalization has been for multinational companies and their investors as they lowered costs and increased margins.

The ongoing rise of populist candidates indicates that politics is likely to evolve over the next few years in a direction that favours labour at the expense of capital. It is also reasonable to assume that future trade deals are very unlikely in the current context. While that is not good for capital markets, offsetting factors such as fiscal policy to rebuild infrastructure would support economic growth and earnings. It is still too early to draw firm conclusions, but markets are clearly anticipating a loosening of fiscal policy in Western nations as a means to improve economic performance and raise wages, even if this will likely lead to inflation eventually.

Brexit could be as significant an event as the 2008 financial crisis.

The statement above might sound outlandish given that markets are rallying to new highs, but the consequences of Brexit, both intended and unintended, will not be appreciated for years to come.

Brexit is not the only factor contributing to the unravelling of the world as we have come to know it, but is highly symbolic, and has the potential to lead the Eurozone to its demise. European politicians have done a better job than their U.S. counterparts of addressing dislocated workers through social programs, but they have not replaced the jobs. They are failing to keep the promise that the European project would benefit the average citizen.

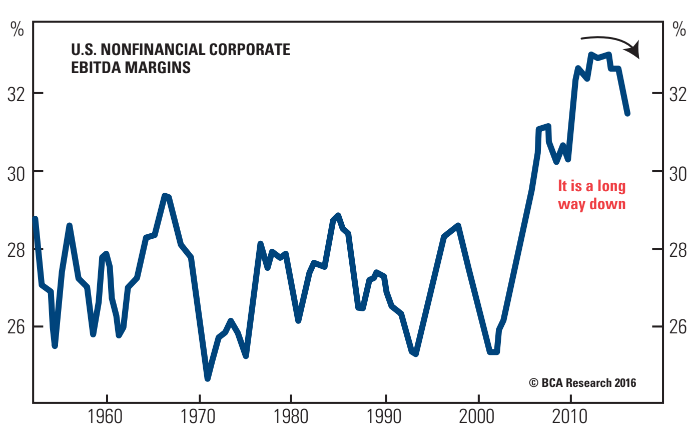
The possibility of an EU break-up has negative implications for world growth and ultimately capital markets. Nevertheless, markets have remained strong since the Brexit vote. With the specific consequences still many years away, investors appear to believe there is time to address the issues, while more stimulus is likely. Unlike the immediate aftermath of the great financial crisis, life in Britain and Europe for both its citizens and institutions like the banking system carries on as usual.

Global bond markets have rallied dramatically, with yields hitting new lows – in some cases going deeper into negative territory. Bond markets are signaling that financial conditions will once again be dramatically loosened, after more than a year of expectations that the U.S. would raise rates and try and normalize monetary policy.

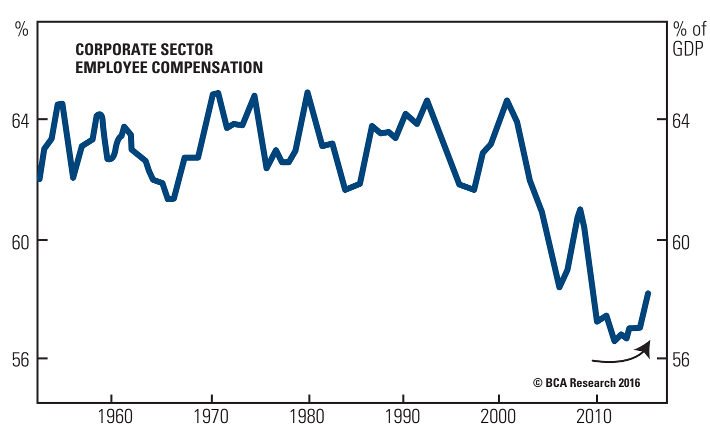
In fact, with bond yields negative in many countries and stocks offering reasonable dividend yields, investors have switched from low-yielding bonds to higher dividend- yielding stocks. In other words, equities are providing investment returns, while bonds have been a source of capital gains. In addition, improving global economic growth is supportive of cyclical stocks, largely thanks to an upswing in Chinese growth following a small stimulus package. A global loosening of financial conditions also helps emerging countries stabilize their economies and lower interest rates. The result is a generally more positive impact on the global economy.

Could this mean the end of the deflationary cycle, in force since the GATT treaty and which accelerated with the great financial crisis? If growth can be resuscitated globally over the next few years, there is a very reasonable chance that it is. This means

Profit margins are as high as ever...



Wages have fallen behind



Source: BCA Research 2016

we could also be nearing the end of the bond bull market, and while long rates are not expected to rise meaningfully anytime soon, we do believe we are nearing the bottom in rates. This type of generational low takes years to reverse, so while we are not making wholesale changes to portfolios, we are considering these changes at the margin when making new investments.

The market outlook is much more constructive in the near term, thanks to the additional stimulus, both real and anticipated. Following two years of cautious positioning during which equity markets have been broadly lower, we are rebuilding our stock weightings in the Signature balanced funds. This is based on our view of more positive financial conditions that should spawn growth improvement and a slowing of the earnings downturn of the past few years. Brexit, however, is an indication that the world has become a more uncertain place, so negative events leading to spikes in volatility associated with rapid market sell-offs should be expected. Given the current backdrop, sell-offs represent opportunities to buy equities.

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