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MARKET OUTLOOK

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THE REVENGE OF THE PRECARIAT OVER DAVOS MAN

The turmoil that erupted after the June 23rd Brexit referendum has purportedly prompted many people who voted "Leave" to rethink their decision. New PM Theresa May has stated that "Brexit means Brexit," dimming hopes that the referendum's results would be reversed; but also inferring that Article 50 will not be invoked until next year. May has also appointed a number of prominent Brexit supporters to her cabinet, with David Davis heading the new "Brexit Ministry" and Boris Johnson installed as the Foreign Secretary. These pronouncements and appointments could indicate that she has succumbed to Brexit (despite her earlier opposition) or it could be a shrewd political strategy to allow its economic and political consequences to hit home with voters and force her former rivals to "own" the fallout if and when the public turns on Brexit and its proponents. If future opinion polls show that a decisive plurality of UK voters favor remaining in the EU, this would give the British government the excuse necessary to call for a second plebiscite.

As the earthquake which was the Brexit referendum plays out, there has been no shortage of commentaries on the market's twists and turns from its aftershocks. In this quarter's outlook we maintain our near-term market views as initially portended in the immediate aftermath of the referendum result (see our Market Insights Alert, "Beyond Brexit"). But we also focus on the bigger picture, to contextualize the broader implications of the Brexit vote to the political economies of Europe and the United States. Our regular sector and region specific investment outlook for Q3 will follow at the end.

The broader context is that Brexit and other manifestations of populist revolts are symptomatic of a global phenomenon which I am calling the **Revenge of the Precariat vs. Davos man**. By **Precariat**, I refer to the modern proletariat of the developed economies. A global "precarious class" of people who are out of work, continually searching for work, or underemployed. Based solely on their accumulation of material "stuff" or access to basic services, they are not poor in a global (or even historical) sense. Yet as has been true of most class-based revolts, relative privation and perceived marginalization within one's community trumps absolute condition.

"**Davos man**", a term coined by sociologist Samuel Huntington, is on the opposite side of the social spectrum. He symbolizes the global elite which congregates at the World Economic Forum to shape world policy. This exclusive forum, held every winter in the Swiss Alps, allows its participants to look down at the world from above: both because of the high-altitude, but also because of the high incomes and high status that characterize this jet-setting crowd. The Davos tribe believes strongly that their superior intelligence has earned them the right to lord it over the Precariat. Their thinking is best exemplified by Winston Churchill, who famously said that "the best argument against democracy is to spend five minutes with the average voter."

The Remain campaign in the UK's Brexit referendum was led by quintessential Davos men. Their starting premise was that elections are decided by core middle class voters who are averse to economic risk and allergic to radical lurches towards political uncertainty. Forebodingly, this is the same operating premise for the so called establishment parties in the United States. Like their US counterparts, they thought they understood the Precariat, who after all, could be identified, profiled and targeted by professional pollsters. The anxieties, hopes and priorities of the Precariat could be plotted on charts that would then be translated into simple messages. EU membership might thus be lodged in their simple minds as a proxy for security and continuity – the natural preference of the sensible majority.

To their astonishment, the ill-tempered Precariat began to view these presumptions with suspicion. The pro-EU camp was supported by an impressive coterie of Davos men: world leaders, economists, business leaders and even David Beckham. But Brexit leaders' clever response was to convince the Precariat that they "have had enough of experts". And in America, our orange haired counterpart is also staunchly anti-intellectual and most cogently describes his plan to make America great again by exhorting us with "believe me".

Even before the global financial crisis (GFC), prosperity had bypassed the Precariats. Today's corporate giants, such as Facebook and Apple are far less labor intensive than their counterparts in 1950's and 60's, such as GM and Xerox, which propelled millions of the Precariat into the middle class. Many of their jobs have been replaced by technology, and increasing globalization led to a shift of income from low-skilled workers to high-skilled workers. These trends resulted in an overall decrease in the share of national income going to Precariat labor and a rising share of income going to the Davos men.

After the GFC, the Precariat were especially peeved at the apparent immunity of the elite from any consequences of their prior mismanagement that led to the financial crisis. And smoldering fears of economic vulnerability amongst the Precariat triggered a backlash against globalization, which had become an article of faith among the Davos tribe.

As a practical matter, Davos man long understood that the best way to lord over the Precariat was to manipulate their quaint attachments to their national and racial identities. The Davos insurrectionists have perfected these tactics. As Exhibit A, witness UKIP leader Nigel Farange's "Breaking Point" poster pointing at brown skinned refugees photo-shopped from a photo from Kosovo. Trump's scapegoating of Mexicans, immigrants in general, and Muslims are Exhibits B, C, and D.

In the UK, the Precariat had many motives to vote 'Leave', but the most potent elements were resentment of the elite Davos politicians; rage at decades of social alienation, and a determination to reverse the tide of mass migration. Brexit therefore provided a singular opportunity for the Precariat to collectively raise their middle finger at generations of Davos men and policies

Yet so far, Precariat's "leaders" have not emerged from their own ranks, but rather, they are political opportunists who merely seem to have gambled on populism at the right time. After all, Brexit leaders, such as Justice Minister Michael Gove and former London Mayor Boris Johnson are both Oxford Men. Our orange-haired version, Mr. Trump is hardly Precariat.

However, we believe that there is still opportunity for Davos men to address the legitimate grievances of the Precariat before they find more radical voices whose disruption to the economic system could be truly destabilizing. Thus Brexit could serve as the turning point to prompt the Davos men to adopt policies which raise employment and boost wages, even if only out of enlightened self-interest.

At bottom, the current angst among the voters has been spurred by insufficient economic growth – in that there's simply not enough of it to keep everybody happy while paying the debt and entitlements we have promised ourselves in old age. "Unconventional" monetary policies have been effective in stemming liquidity crises and propping up investment account balances through the so called "wealth effect"; but they are not designed to expand aggregate demand in the real economy in which the Precariat primarily preside. Additionally, some central banks like the BoJ appear to have reached the point at which monetary policy may be doing more harm than good.

Fiscal spending through infrastructure would be more effective for expanding aggregate demand. Such policies could not only satiate the Precariat, but they could also break the deflationary malaise plaguing the global economy. For example, IMF and others have found that the shift in income from poorer to richer households, along with a falling share of national income going to labor, has depressed US aggregate demand by about 3% of GDP since the late 1970s.

In the US there is also growing acceptance of the need to substantially raise the minimum wage in both the public and private sectors and UK Prime Minister Theresa May (another Oxford alumna) has already exhorted her colleagues to bridge the gaping chasm between the well heeled Davos man stronghold in London (which overwhelmingly voted "Remain") and the British Precariat. These words from her first speech as PM where she intoned that for an "ordinary working class family, life is much harder than many people in Westminster realize. When it comes to opportunity, we won't entrench the advantages of the fortunate few, we will do everything we can to help anybody, whatever your background, to go as far as your talents will take you;" speak for themselves.

However the most critical long term solution is to address the significant displacement caused by globalization with skills retraining and educational curricula that equip our citizenry for 21st century jobs. This is why the best predictor for Brexit support was level of education, suggesting that the Precariat ultimately decided based on their own personal level of competitiveness in a globalized economy.

POST-BREXIT OUTLOOK

A summary of our Investment Outlook is provided on PAGE 4. We continue to maintain our views elaborated on June 24th that in the immediate post-Brexit environment the likely winners are US equities and emerging markets while the losers are likely to be UK small caps and European equities. Indeed so far, this is precisely what has happened.

So far, the doomsday scenario articulated by the Davos men has not fully played out. Brexit did cause the British pound to plunge and credit conditions have deteriorated, mainly through European banks; but we have not seen the kind of acute strains that followed the collapse of Lehman Brothers. This relative calm probably reflects the fact that: (1) global central banks were fully prepared for Brexit, with an emergency toolkit already in place, and; (2) most professional investment types are assuming that UK leaders will not fully abandon the EU.

That said, Brexit related political and economic fallout may not be over. A technical recession in the UK later this year is likely, although a weaker pound should mitigate some of the damage. Thus far, there are lots of anecdotal reports about consumers and businesses cutting their spending. Business investment was already slowing ahead of the referendum, having peaked in Q2 2015, and is likely to drop further. Surveys carried out after 23 June suggest that capex concerns are not misplaced. One by Credit Suisse indicates that corporate sentiment has deteriorated significantly, with more than 50% of the respondents reporting that hiring and spending in Britain will be postponed (and not offset elsewhere) pending more clarity on the UK's position vis-à-vis the EU. UK consumers are equally worried. The GfK survey showed a plunge in consumer confidence and in expectations for economic growth (worst since the 2011-12 euro crisis) as well as a jump in savings intentions (highest since 2008). UK commercial property is also under significant pressure and could bring wider pain.

However, even if Remain is the ultimate outcome, the UK will still endure a period of heightened uncertainty over the coming months. Worries that Scotland could call a fresh referendum on whether to secede from the UK will remain elevated. So will concerns that the stark cleavage in voting patterns between Protestants and Catholics in Northern Ireland will revive the historic animosity between these two factions.

In our opinion, the main threat from Brexit has always been the risk it poses to political stability in **Europe**. We do not believe any other country will vote to exit the EU, but markets will be nervous around any moves in that direction: we are particularly focused on Italy, The Netherlands, Austria and France. If a country as important as the UK can leave the EU, why can't Italy decide to abandon the common currency? If there is a meaningful chance that investors who buy Italian bonds will be paid back in liras, then they will demand a hefty premium to compensate them for this risk. This could engender a vicious circle whereby rising yields make it more difficult for Italy to service its debt. Investors should pay particular attention to Europe's banks, looking especially for any signs of crisis among Italian lenders. As the IMF recently noted, Italian non-performing loans have reached systemic levels.

Fears about an imminent **US** recession have faded, with payrolls bouncing back and business surveys improving. The US outlook is reasonably good, especially given the economy's low exposure to Brexit. The US dollar remains strong, which is uncomfortable for manufacturers, but much of the pain has already been felt. The recovery in oil prices has also reduced the pressure on energy producers. This should bring an end to the sharp decline in energy capex, removing an important drag on the wider economy. However, S&P 500 margins and profits remain at risk as we stumble during this uncomfortable "muddle through" period in a mature business cycle.

Additionally, better US data could warrant additional Fed tightening, though officials have made it clear they will proceed extremely cautiously. A rate hike is still possible in 2016, but policymakers may now prefer to wait until 2017. The decision could depend on whether there is further fallout from Brexit on global financial markets during the rest of this year. A rate hike this year would incur temporary volatility in risk assets as the market has ascribed only a 20% probability for a hike in September (40% for December).

Brexit has been most problematic for the Bank of **Japan**. The yen surged following the vote and is now up sharply since the start of the year, though talk of coordinated fiscal and monetary expansion has since pulled the currency back down. A strong yen is, of course, bad news for Japanese exporters and the corporate sector. There is a lot of speculation about what the authorities will try next to stimulate the economy, with some talk about helicopter money. Whether we see outright monetary financing is uncertain, but the government is likely to resort to fiscal stimulus. This would be bearish for yen but would support Japanese stocks (on a dollar hedged basis).

For **Emerging Markets**, fortunately, we have seen only a modest safe haven rise in the US dollar, which might otherwise have spread tighter post-Brexit credit conditions to EMs that borrow in offshore USD. In **China**, officials have used fiscal and monetary easing, notably credit-fueled public infrastructure spending, to keep the economy going. While this reduces near-term risks facing the economy, it will compound medium-term problems. China's credit bubble will continue to inflate at a dangerous pace. Fortunately for the rest of the world, the authorities have so far resisted the temptation to sharply devalue the yuan. But given that the exchange rate remains significantly overvalued, we continue to expect further gradual depreciation. Meanwhile, the attempted coup in **Turkey** on July 15-16, though perhaps one of the most inept coup attempts in modern memory, will nonetheless provide Turkish President Erdogan the opening he had been seeking to deepen his own authoritarian tendencies and will add to the risk premia necessary for investors in Turkey for the foreseeable future. The next such flashpoint for emerging markets could be in Thailand, as they approach their own contentious constitutional referendum on August 7.

Brexit reminded investors of the need to position for tail risk. Although our tactical models suggest more performance for the **Materials** and **Industrial sectors**, we continue to maintain core positions in defensive markets (such as the US and developed markets) and sectors (such as **Consumer Staples** and **Healthcare**). We agree with our tactical model's call to underweight **Financials** because of the obvious earnings impairment caused by low to negative rates. Over the past two years, global equities have struggled, with the MSCI All Country World Index falling by 12% since its peak in May 2015. The US has been an outperformer over this time but even it has been caught recently in a trading range, with the S&P 500 stuck between 1800 and 2150. The key to equities generating a decent return over the next 12 months will be a recovery in earnings. With the negative impact of the commodities shock falling out, global earnings growth should turn positive this year on the back of a profit rebound in the energy and materials sectors. Risks, though, remain high, and style-wise, we favor **Large Growth** over **Value**. Please see PAGE 4 for a summary of our Investment Outlook.

TABLE 1 Global Country and Sector Positioning

Risk / Environment	-		N		+	
Global Equity Risk Environment				Strategic		Our systemic risk indicator entered risk on in late December and has stayed there.
U.S. Dollar				Strategic		The US Dollar weakened in the first half of 2016 in response to a more dovish Fed. But we expect the dollar to appreciate over the second half of the year given heightened risk and because the Fed is likely to raise rates faster than the market expects.

Regions / Countries	-		N		+	
United States		Tactical	Strategic			Our tactical models point to underperformance but we believe that this bourse's defensive nature as the Brexit related aftershocks play out, as well as a more benign earnings environment, warrants a neutral weight for now.
United Kingdom		Strategic				Our tactical models point to underperformance with moderate conviction. We agree although we do see potential opportunity in the globally focused FTSE 100 index.
EU (core)				Strategic		Our tactical models continue to forecast low conviction outperformance. Eurozone equities are trading at a discount of over 20% to U.S. equities. Brexit related risks warrant a higher risk premium however, particularly for banks.
EU (periphery)				Strategic		Tactical models are forecasting outperformance with moderate conviction. We are however especially cautious on Italian equities as a result of their troubled banking sector.
Japan				Strategic		Our tactical models forecast outperformance with moderate conviction, coordinated fiscal and monetary action should be positive for Japanese equities; but on a currency hedged basis.
Australia		Strategic				Although early positive signs from China's policy reflation should provide support of this market, our tactical models forecast underperformance with low conviction.
Canada		Tactical	Strategic			Expected increase in oil prices towards the end of the year should be supportive. Substantial Financials weight may drag because of weakening credit growth. Our tactical models forecast underperformance with high conviction.
Emerging Markets (Pacific Rim)		Strategic		Tactical		Our tactical models suggest an underweight in Chinese equities but an overweight in Korean equities. China has shifted from reform to stimulus in order to avoid a sharp slowdown and has put a temporary floor under growth. Consequently, new capital projects initiated have increased, the property market is heating up, PMI data has perked up, and industrial profits are recovering. The authorities must balance this policy with the risk of inflating the credit bubble even further.
Emerging Markets (South Asia)		Tactical		Strategic		India's current account and fiscal health render it less vulnerable to Fed normalization. We expect a rebound in Indian assets towards year-end as recent rate cuts and economic recovery drive sentiment ahead. Our tactical models forecast low conviction underperformance.
Emerging Markets (Europe)		Strategic				Russia will continue to rebound on the back of improved prospects for oil but this region could also be vulnerable to post-Brexit fallout.
Emerging Markets (Africa)		Strategic				For U.S. investors, significant negative basic balances and the rand's commodity sensitivity lead to a slight underweight.
Emerging Markets (LatAm)		Strategic				Our tactical models continue to predict underperformance here albeit with low conviction. The rally in LatAm equities was based on sentiment that is not supported by fundamentals.

Sector / Style / Capitalization	-		N		+	
Consumer Discretionary				Strategic, Variance		Our tactical models forecast outperformance with moderate conviction. In Europe, Japan and China, where reflationary policies are robust, we are bullish on this sector.
Consumer Staples				Strategic, Tactical		Our tactical models support an overweight. This sector will begin to struggle with higher energy input costs.
Energy		Tactical		Strategic		Our tactical models predict underperformance with high conviction. While we expected oil prices to balance towards year end; their recent rise based on a combination of supply disruptions and a weak dollar is ripe for a pull back.
Financials		Variance, Tactical	Strategic			Our tactical models project high conviction underperformance as bank earnings will continue to be challenged by low to negative rates. REITS remain our favorite play within this sector in the US.
Health Care		Tactical		Strategic		Our tactical models suggest some retracement in this sector's outperformance. We are nevertheless maintaining our strategic overweight to this sector.
Industrials		Strategic	Tactical			This sector's limited pricing power and dollar exposure warrants an underweight; a view somewhat supported by our tactical models that suggest low conviction in this sector's continued rally.
Information Technology				Strategic		For Q3, our models warrant a high conviction overweight. This sector has been a core overweight position for our strategy.
Materials	→ Strategic		Tactical			Although the bear market in base metals is still in its early innings, Chinese reflation could provide temporary support for this sector. Our tactical models are signaling outperformance with moderate conviction.
Telecommunications		Tactical	Strategic			Cheap and provides defensive haven while disinflationary undercurrent still a risk. Could also be boosted by M&A activity. However, our tactical model's underweight forecast leads to a neutral weight.
Utilities		Strategic	Variance			Utilities will typically struggle with rate normalization in US, but our tactical models support an upgrade in Q1. This recommendation was reversed for Q2 and continues for Q3
Style (Value at Left / Growth at Right)			Strategic	Tactical		On balance, we are maintaining a neutral style allocation but tactical models recommend an overweight to Growth.
Capitalization (Small at Left / Large at Right)		Variance		Strategic		In the U.S., large cap overweight. Improvement in credit availability will disproportionately help non-US small caps.

→ ← Change from Q2 2016 | Strategic (6-12 months+) | Tactical (3 months) | Variance for Non-U.S. Portfolios