International Equity Outlook: With Reappraisal, Can Come Opportunity

Chris Bailey, *European Strategist, Raymond James Euro Equities**, provides perspective on international opportunities and risks.

"If people perceive themselves as having very little opportunities to be fulfilled, then it cheapens their life and outlook. The solution is to reverse it; make sure they know opportunities abound." Michael Lee-Chin

In the investment world, what should worry us most is rarely obvious. It's the unknown – for better or worse – that moves broad financial markets and individual investments.

Recent sentiment surveys unveil a common fear factor among global fund managers: the future cohesion of Europe following the EU referendum vote. Beyond Europe's struggles, the spectre of a slowing Chinese economy would be the next biggest concern. However, these much-discussed risks and issues, while having the potential to impact the investment world in the future, shouldn't worry international equity investors in 2017.

EUROPE

BREXIT UPDATE

Europe had a volatile 2016 with the narrow decision by the UK electorate in late June to punish our political hierarchy and vote to leave the European Union, a precursor to much political angst. While the UK is not a member of the single-currency euro zone, last June's events again highlighted a lack of solidarity across Europe. This region of the world is still struggling, on average, with weak economic growth, too many fragile banks, a migration crisis that threatened to spill over into a populist swing against incumbent regional politicians, as well as a number of important elections in 2017 – most notably in France and Germany.

However, caution must be exercised on extrapolating too aggressively from Brexit. First, there are bound to be delays in the practical application of our decision to leave the European Union. In our opinion, procedural legal challenges are unlikely to stop Brexit from eventually occurring, but what is very clear is that a rapid Brexit is extremely unlikely.

There are no precedents to fall back on, and a complex agreement that covers future trade and labour movement between the UK and the European Union will be difficult to form. However, cooler heads have prevailed in recent months, as seen by a clear reduction in last summer's inflammatory rhetoric and an acknowledgement that the desertion of current trade agreements underpinning mutual wealth generation may not be in the interest of either party. 2017 is more likely to be a year of Brexit delay where investors are positively surprised by the establishment of the groundwork for a "soft" rather than a "hard" agreement between the UK and the European Union.

I say positively surprised because the ~$100 billion in outflows from Europe by global investment managers concerned about the region's future prospects, has left investors underweight versus their benchmarks. Initial steps toward a soft Brexit, coupled with mainstream political success in upcoming European elections, could induce some reappraisal of the region's prospects, especially as the European Central Bank and the Bank of England undertook new stimulus initiatives during the second half of 2016. And with reappraisal, can come opportunity.

CHINA

ECONOMIC GROWTH

International investor outflows from the Chinese equity market were also a theme in 2016. China has continued to deliver attractive headline economic growth rates, but rising concerns over the sustainability of these rates has investors worried. This is a relevant concern given that China is already the world's largest marginal consumer of many commodities and is anticipated to be a top contributor to global consumption levels as it transitions from an infrastructure-driven economy to a consumption-driven economy.

Rising debt levels have been at the forefront of these concerns, as they have the scope to potentially derail economic growth levels both domestically and internationally.

There is little doubt that corporate debt levels in many of the old-style State-owned Enterprises (SoEs) are a concern. SoEs are typically made up of lowly competitive industrial companies that still employ large numbers of people and sit uncomfortably in the Chinese political leadership's vision of a dynamic service sector-led economy. The better news is that Chinese government debt levels are very modest and the central government is slowly restructuring and merging these businesses, all of which can be financed via China's fledgling but fast-developing bond market.

PROPERTY MARKET

The property market in China has also attracted concern due to the sharp increase in prices in tier one cities like Beijing and Shanghai over the last year or two. As with many major cities around the world, sharply rising property prices threaten numerous aspects of the economy. In China, this price appreciation is placing pressure on the ongoing viability of the rural-to-urban shift – a driver in the modernisation and growth of the local economy. While there may be some bumps in the road in 2017, tailwinds such as real wage growth, tax incentives and other efficiency/flexibility-inducing supply-side reforms put in place by the Chinese government are priming the local economy for growth. With high savings rates and low consumption levels, China still has a lot of upside potential.

CURRENCY

The biggest squeeze for China may come from one aspect of policy the government is finding hard to sustain – the level of the Chinese yuan – which currently tracks the value of the U.S. dollar. A strong U.S. dollar typically causes issues

EUROPEAN POPULISM

In 2017, elections are all-critical in Europe with both France and Germany – the two largest economies in the euro zone – going to the polls. Concerns that electoral angst will be apparent is an issue that international investors are currently grappling with.

The cause of rising populism, and the seemingly associated discomfort with European cohesion, integration and ideals is complex, but a combination of low real wage growth, stubbornly high unemployment, social pressures from migration, and high living costs are all factors influencing populism.

Should investors worry about these elections in 2017? France is the first and biggest test, with a populist far right candidate likely to be one of the two final presidential candidates. However, the opposing candidate at this time has an agenda which is just what the French economy needs: deregulation, less government influence and lower taxes. Combine the current poll leadership of the latter with confirmation that Mrs. Merkel will run for a fourth term as German chancellor, and the chances of Europe gaining two pro-European, centrist officials from its two largest countries in 2017 is on the rise.

With the first European populist government in Greece toeing the line and sticking within the euro zone for the foreseeable future, the realities of populist governments in power have been stark. Has populism in Europe passed its high point? A confirmation of this in 2017 would be positive for perceptions toward European equities.

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for both China and the broader emerging markets. Dollar-denominated debt burdens build and commodity prices sometimes wane. While most emerging market currencies fell versus the U.S. dollar, China's yuan fell to a much lesser degree, causing increased competitiveness in Asia's largest economy. A more meaningful and realistic concern surrounding China's economic policy is the government's potential decision to formally devalue its currency, which could, in turn, unleash a round of foreign exchange and trade uncertainties as other countries react to China's shift.

Pulling it all together, the biggest concern for international investments would be if the U.S. dollar remains overly firm. That is the power of the world's current reserve currency looking into 2017.

"Post-election uncertainty surrounding global trade disruptions remains a key threat to emerging market economies going into 2017. Various economies could be adversely affected by potential changes to established trade deals and/or tariffs on imported goods. Applying tariffs to U.S. imports raises the cost of foreign goods for U.S. consumers, making them more competitive with goods made in the US. While the implementation and subsequent success of such policies is questionable, investors are likely to err on the side of caution until clarity presents itself."

Nicholas Lacy, CFA, Chief Portfolio Strategist, Asset Management Services

KEY TAKEAWAYS:

- Europe: 2017 is more likely to be a year of "Brexit delay" where investors are positively surprised by the establishment of the groundwork for a "soft" rather than a "hard" agreement between the UK and the European Union
- China: Tailwinds for China's local economy include real wage growth, tax incentives and other efficiency/flexibility-inducing supply-side reforms put in place by the Chinese government
- Broad Emerging Markets: Post-election uncertainty surrounding global trade disruptions remains a key threat to emerging market economies going into 2017

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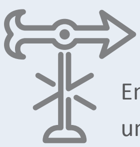
EMERGING MARKET EQUITY: HEADWINDS TURNED TAILWINDS?



Emerging market (EM) equities have been undervalued relative to their domestic counterparts for some time now. Still, bargain prices haven't been enough to lure investors back into these volatile markets, which lost more than 30% between April 2015 and January 2016.*

Things started looking up for these beaten down markets in 2016 as equities recovered and various headwinds began to subside. Despite rising growth prospects and improved earnings expectations, 2017 will likely remain challenging as U.S. policy under the new administration unfolds. Only time will tell if there is enough positive momentum to gain back the trust of wary investors. In the meantime, here is a look at some of the biggest headwinds turning potential tailwinds for emerging markets going into the new year.

With many emerging markets tied to commodity exports as a primary source of revenue, plummeting commodity prices sent countries like Russia and Brazil into recession territory. With prices coming off their lows in 2016 and trade imbalances continuing to improve, these economies will likely see the benefits of a continued commodity price recovery in 2017.

Many emerging countries with reform processes in place have started to see the fruits of their labour through increased growth prospects and improved earnings. Countries like China, Indonesia and India have implemented processes that encourage supply-side structural reform, fiscal consolidation and market deregulation.

China is perhaps one of the most visible emerging markets due to the sheer size of its economy. While headlines and sentiment have been mixed, the government continues to guide the economy through a "soft" transition from an infrastructure-based economy to a service-based economy. Additionally, structural reforms have been successful and improved earnings are likely given a rebound in growth.

The strong U.S. dollar has hurt EM countries on numerous fronts and remains a wild card going forward. Not only does it make the servicing of dollar-denominated debt more expensive for EM governments and publicly traded companies as local currencies fall, but it also erodes investment returns for U.S. investors who convert profits back to their own higher currency. A slowdown in the dollar's ascent would surely be welcomed by local borrowers and U.S. investors in 2017.

*Return data is based on the MSCI Emerging Markets NR Index from 4/24/15 – 1/15/16. Performance does not include commission and fees, which would reduce an investor's returns.

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www.RJIS.co.uk