Investors may need to lower return expectations in wake of Brexit

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- Brexit shockwaves added a layer of political and economic uncertainty, but fundamental impacts are likely to take time before they become apparent.
- Even just before Brexit, both the U.S. Federal Reserve and the market had ratcheted down expectations for rate hikes.
- Investors may have to recalibrate expectations – the lower returns that many asset classes experienced in the past couple of years could persist.
- Sectors not directly related to the U.K. – like U.S. corporate credit – could be very attractive in an environment of extended support by central banks.

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The historic Brexit vote on June 23 sent shockwaves through the capital markets and sparked a global flight to quality in fixed-income sectors, as investors reacted to new political and economic uncertainty.

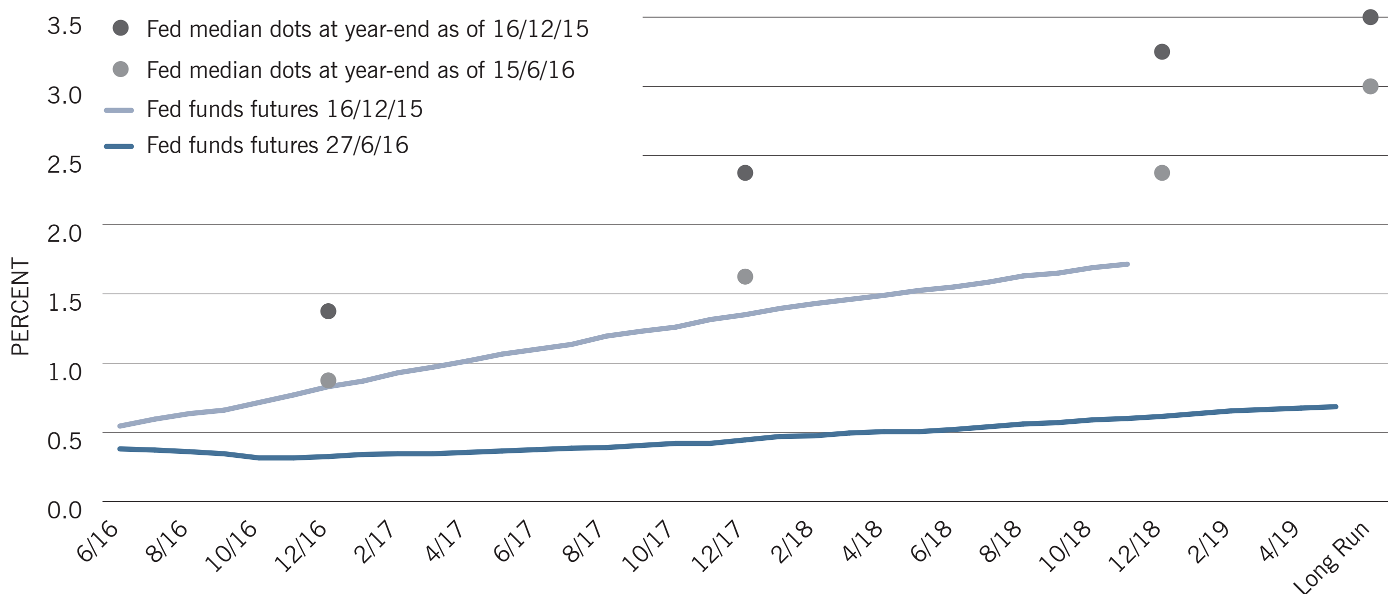
Substantive, fundamental impacts on trade and economic growth are likely to take time before they become apparent. In the meantime, investors will likely have an elevated perception of risk and we believe central banks will react accordingly. Following what is now a well-known script, central banks are likely to respond with renewed measures aimed at keeping financial markets on "Novocain."

Reduced rate-hike forecasts

Just one month before Brexit, both the market and comments by U.S. Federal Reserve Chair Yellen pointed to a rate hike by July 2016. Following the announcement of a weak U.S. payrolls number in May, the market lowered its rate-hike expectations and Yellen softened her previous more-hawkish tone. Moreover, over the past few years, the market has consistently been more skeptical than the Fed about the prospect for rate increases. Exhibit A shows that the Fed's "dot" forecast[1] for fed funds as of December 2017 dropped from 2.4% at December 2015 to 1.6% at June 2016. The market's expectations, as indicated by fed funds futures, fell from 1.4% to 0.45% over the same time frame.

The Fed took its first step toward tightening in December 2015, but that now appears to be on hold. Post Brexit, there is little reason to believe that monetary policy in Europe won't continue to be in a highly accommodative mode, pushing some sovereign yields further into negative territory. Many have questioned the effectiveness of unconventional monetary policy measures pursued by the world's major central banks, due to their apparent limited impact in spurring economic growth. However, there is little doubt such measures have caused risk assets to rally. For example, in the U.S., actions by the Fed can take much credit for double-digit increases in both the U.S. stock and high-yield bond markets. From 1 January 2009 through 31 December 2014, the S&P 500 had an average annual total return of 17.2% and high-yield bonds, 16.0%, based on the Barclays U.S. Corporate High Yield Index.

Exhibit A **Even before Brexit, rate-hike expectations were coming down.**



Sources: Eaton Vance, Bloomberg LLP as of 30 June 2016.

[1]Each "dot" represents the median forecast among the 16 members of the Federal Open Market Committee for where the federal funds rate is likely to be as of the end of the various years indicated.

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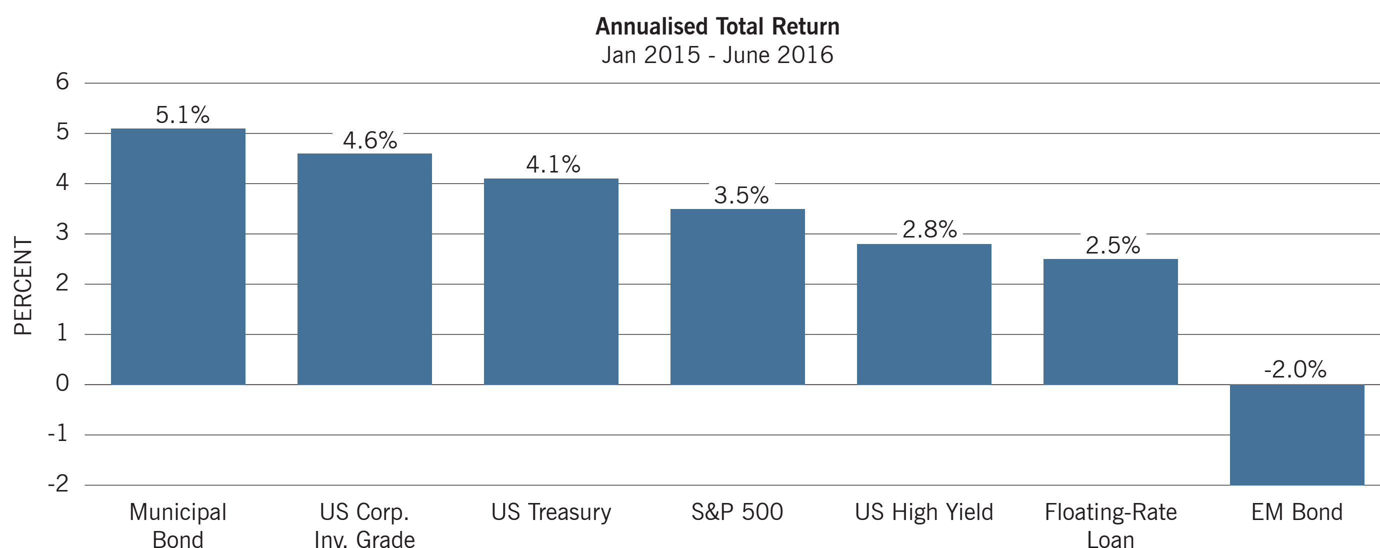
However, over the past couple of years, the continuing dovish stance by central banks has had less impact on financial asset prices and returns. In the past two years returns on risky assets fell, weighed down by concerns over faltering growth, credit quality and lack of value (Exhibit B). For example, from 1 January 2015 through 30 June 2016, the S&P's average annual total return was 3.5%, and high-yield bonds, 2.7%.

That said, the returns shown in Exhibit B are a cautionary sign that investors may have to recalibrate their expectations in a continuing world of central bank-dispensed Novocain that continues to fall short of stimulating real economic growth. (Fiscal stimulus would help, but achieving political consensus in this regard is a major hurdle.) Also, to the extent Brexit empowers similar anti-globalisation sentiment within European countries, or even in the U.S., price volatility is likely to remain the norm.

Exhibit B **Returns on risky assets have been modest since 2014.**



Sources: Eaton Vance, Factset, Morningstar as of 30 June 2016. Data provided are for informational use only. Past performance is no guarantee of future results. See end of report for important additional information. S&P 500 is represented by the S&P 500 Index. EM Bond is represented by JPMorgan GBI-EM Global Diversified TR USD. Municipal Bond is represented by Barclays Municipal Bond Index. U.S. High Yield is represented by Barclays U.S. Corporate High Yield Index. Floating-rate loan is represented by S&P/LSTA Leveraged Loan Index. U.S. Corp. Inv. Grade is represented by Barclays U.S. Corporate Investment-Grade Index. U.S. Treasury is represented by Barclays U.S. Treasury Index.

At the start of the year, we viewed investment sectors like U.S. high-yield bonds and floating-rate loans as extremely inexpensive based on historical and relative valuations. Those valuations attracted investors who bid up their prices and they are now closer to fairly valued, in our view. However, as Exhibit C shows, high-yield bonds and loans remain among the highest-yielding sectors; and unlike other fixed-income sectors, their yields are higher than a year ago.

Bracing for volatility

We do not believe the U.S. economy is headed for recession in the near term, but the fits and starts to growth are unlikely to go away. For example, three months ago, there was talk of a strengthening labour market and weak economic growth, but that has flipped. Recently we've experienced stronger economic growth and a weaker labour market. Moreover, we won't know the real potential

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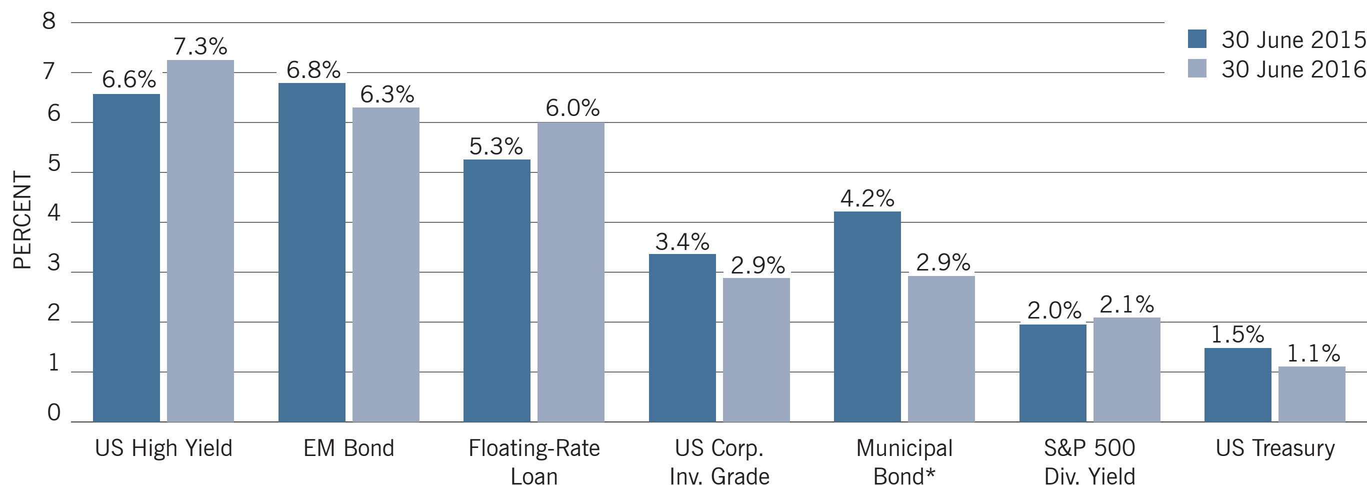
Exhibit C **High yield and loans offer attractive yields in today's environment.**



Sources: Eaton Vance, Factset, Morningstar as of 30 June 2016. Data provided are for informational use only. Past performance is no guarantee of future results. See end of report for important additional information. S&P 500 is represented by the S&P 500 Index. EM Bond is represented by JPMorgan GBI-EM Global Diversified TR USD. Municipal Bond is represented by Barclays Municipal Bond Index. U.S. High Yield is represented by Barclays U.S. Corporate High Yield Index. Floating-rate loans are represented by S&P/LSTA Leveraged Loan Index. U.S. Corp. Inv. Grade is represented by Barclays U.S. Corporate Investment-Grade Index. U.S. Treasury is represented by Barclays U.S. Treasury Index. *Reflects taxable equivalent yield, which refers to the yield an investor in a particular tax bracket would have to earn on a taxable investment to have the same after-tax yield as on a given tax-free security such as a municipal bond. This example assumes the investor is in the current maximum Federal tax bracket of 44.6% (which includes the new tax from the Affordable Care Act). That investor would need a taxable yield of 2.9% to match the after-tax yield on a municipal bond on 30 June 2016 of 1.6%. A portion of income may be subject to federal income and/or alternative minimum.

impact of Brexit for years. Questions following the referendum are many, but a few that come into focus are:

- What will the ultimate trade terms be between the EU and the U.K. The EU has an incentive to make them harsh, lest it encourages other countries to take the same path.
- How will other EU countries react, in light of growing public sentiment against staying in the EU? Will other countries hold similar referenda? Elections in France and Germany will be held next year.
- Will this lead to a greater divergence between U.S. and European economies?

Post-Brexit opportunities

For investors, we believe the most important consideration is to avoid hasty action driven by fear, without being complacent. We've already witnessed a significant recovery in the U.K., European and U.S. stock markets. Yet we have not seen a comparable recovery in the bellwether 10-year U.S. Treasury bond yield – it has stayed near its Brexit low. The bond market may be telegraphing that more price volatility lurks ahead.

In a low-growth, low-expected-return environment that is supported by central banks, we believe below-investment-grade U.S. corporate credit – high-yield bonds and floating-rate loans – offers a compelling risk/return proposition. (We believe their high coupons should more than offset possible credit losses). Any sharp sell-off in these sectors – or in specific securities that are insulated from the direct impact of Brexit – could present even more attractive buying opportunities.

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Index definitions

Barclays U.S. Corporate High Yield Index measures USD-denominated, noninvestment-grade corporate securities.

Barclays U.S. Corporate Investment Grade Index is an unmanaged index that measures the performance of investment-grade corporate securities within the Barclays U.S. Aggregate Index.

Barclays U.S. Treasury Index measures public debt instruments issued by the U.S. Treasury.

JPMorgan Government Bond Index-Emerging Markets (GBI-EM) Global Diversified is an unmanaged index of local-currency bonds with maturities of more than one year issued by emerging market governments.

S&P/LSTA Leveraged Loan Index is an unmanaged index of the institutional leveraged loan market.

Barclays Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S.

Standard & Poor's 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of U.S. stock market performance.

Unless otherwise stated, index returns do not reflect the effect of any applicable sales charges, commissions, expenses, taxes or leverage, as applicable. It is not possible to invest directly in an index. Historical performance of the index illustrates market trends and does not represent the past or future performance.

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