[Rob Martin]
Hi, I'm Rob Martin, Senior US Economist here at Barclays. I'm here today with Ajay Rajadhyaksha, Head of Global Macro Research to discuss our *Q3 Global Outlook: Playing defense*.

Ajay, one of the key risks you've been highlighting in the last few *Global Outlook*s has come to pass - the UK has voted to leave the EU. But financial markets have, so far, been relatively well-behaved and we haven't seen any real spillovers to financial market volatility in the US, yet we've marked down our global forecast about a half a percentage point in the second half of 2017. What's driving that downgrade?

[Ajay Rajadhyaksha]
I'll first answer the financial market issue. You are right, equities markets have held up relatively well. The US, for example, is hardly off of where it was pre-Brexit, and we think there's a couple of reasons for that. First is the slow-moving nature of future steps by the United Kingdom. For example, there is speculation that the UK might not actually trigger Article 50 until after Christmas of 2016. The second is obviously soothing noises made by central banks, not just the Bank of England but also the European Central Bank - whether it is walking away from the capital key, whether it is extending QE beyond March 2017, etc.

But I'll also say this about financial markets: equities investors are relatively sanguine, bond investors are not – they are screaming at the top of their lungs. It seems like every second day US bond yields touch a new record low. The Japanese twenty-year just went below zero. And the UK, which is the epicenter of this crisis, the ten-year gilt yield is now below 80 basis points. So they are signaling their concern.

In terms of the impact on the economics, we think the first impact for both the United Kingdom and the European Union is through uncertainty about a bunch of things: when Article 50 will be triggered, how a new deal evolves, etc., spill over through business investment and household spending into the real economy. You know that confluence is a tangible thing that actually matters to an economy, businesses do put off their investing and spending, households hold back on purchases of big-ticket items like cars and housing for example, and that is how an economy eventually starts to keel over, it spills over into the job market, etc.

We think that is likely to happen in the United Kingdom. Our growth forecasts pre-Brexit for the UK for 2017 were plus 1.9 percent. We now expect a contraction of 0.4 percent for next year. For the European Union, our growth forecast has come down from 1.7 percent pre-Brexit, when we assumed the UK would stay, to 0.6 percent for 2017. So both are significant swings.

Part of our view is predicated on the belief that markets will keep worrying about more 'shoes to drop' on the political side. In particular, if market-implied probability of a European Monetary Union country - not just an EU country, but a country that is part of the Euro zone - markets start to worry about the probability of such a country leaving the European Union, then that is a huge deal. That is, I think, a repeat of the summers of 2011 and summer of 2012. Redenomination risks will start to come back, financial fragmentation fears will start to play out, etc.

We think the probability of that happening is low. It is more difficult than many investors realise for countries to hold referendums on Europe, on existing European treaties.

But investors will look at every single development in Europe on the political side through the prism of whether it helps political parties that are anti-EU or not. So that includes the constitutional reforms and referendum in Italy in October, what actually has nothing to do with the European Union. It includes the general elections in The Netherlands next march, and then the Elections in France and Germany. And again, we think the risks are low, but political developments tend to be fickle and investors will keep worrying about this for the next 18 to 24 months.

[Rob]
So leaving the UK referendum aside for a moment and moving away from European political uncertainty, we've seen a lot of slowing in US labour markets and some signs that the US economy itself might be slowing down, which would obviously have its own follow-on effects across the globe. Do you think that the expansion in the US can remain robust in the face of the slowing labour market?

[Ajay]
Well as you know, the US labour markets have historically been the single cleanest the single best indicators of inflection points in the US economy. And in that context, the fact that four of the last five payroll reports are now showing job creation well below the post-expansion average is actually very concerning to us, to all of us you included. The only thing is that there is virtually nothing else in the US economy that seems to corroborate that. For example, initial jobless claims, continuing claims, they are both at record lows. Fewer jobs may be being created, but it doesn't seem like a lot of people are being let go of yet. Consumer spending is holding up very well. Growth in Q2 bounced back after a weak Q1, so we don't see any other signs apart from these jobs reports of weakness in the US economy. For now, our baseline remains a continuing expansion, but if the US job market does not show signs of recovery from the numbers of the last few months then we would be forced to consider recession as a distinct possibility, as closer to our baseline for 2017. So we'll see how that goes.

[Rob]
Given the background that you've painted here, asset allocation actually seems particularly difficult at this time. So, how should investors position coming into Q3?

[Ajay]
I think what you're supposed to look for is the least ugly choice, and I realise those are not fighting words. We think capital preservation will remain key. As I told you earlier, we are underweight global equities, especially in Europe and the United Kingdom. The problem is, usually when you are underweight equities, the logical byproduct is to be overweight all of fixed income, but we don't quite see how one can be in either Japan or the Euro area. Virtually all of the Japanese bond market on the sovereign side is now at zero, or significantly negative yields. Ten-year German bunds are at minus 18, minus 19 basis points as we speak. Ten-year French bonds are at plus 11 basis points. These valuations are extreme, so that leaves US fixed income almost by default.

We still like, even at these historically low yields, being long US rates. In particular we look to hide in high grade, if you'll allow the alliteration. We like being long US investment grade. We also like being long European investment grade on a spread basis. In EM fixed income, there are some pockets of opportunity, not enough to solve all of your asset allocation problems, but Latin American emerging market fixed income, their dollar denominated debt, in a global context, now looks attractive.

On the currency side we are still very cautious. We still like being long the yen for valuation reasons and as a future flight to quality instrument. We are still expecting the euro and the pound to continue to weaken. And we think emerging markets currencies will have a hard time making headway against the dollar. So, slim pickings in general is the trend for the next few months.

[Rob]
Well Ajay, thanks for taking the time to share your thoughts with us today. You can find more details on all of these topics in our *Q3 Global Outlook: playing defense*.