[Michael Gapen]
Hi, I'm Michael Gapen, Head of US Economics Research here at Barclays. I'm with Ajay Rajadhyaksha, Head of Global Macro Research. We are here to discuss the main themes of our *Global Outlook: A tactical shift toward risk assets*.

Ajay, you're taking a more positive tone toward risk assets in this quarterly, relative to the last one where you were a bit more defensive. Could you explain the shift in tone – where did it come from and is this tactical or something that is long-run in nature?

[Ajay Rajadhyaksha]
It is tactical, and it's driven by a few reasons. The first is the fallout from Brexit is playing out a little more smoothly than we expected, and there's a few reasons for that as well. For one, remember the United Kingdom government had initially said that it was going to trigger Article 50 immediately and now they are taking a much slower, more deliberate approach. We were also worried that if Brexit happened, it would increase Euro skepticism in the rest of the euro area and so far there are no signs that that is happening. So, the economic fallout for both the United Kingdom and the euro area is not great, but it's a little less bad than we thought.

The second is China has had a big quasi-fiscal stimulus across the first half of 2016 and it now seems like that will continue for the foreseeable future. We think it is ultimately unsustainable, it sets the stage for an eventual more difficult rebalancing, but there's no question that for 2017 China enters the year with a little more economic momentum than before.

And finally, the United States had a weak first half, but that means that the strong second half is more apparent, that there is a bigger contrast there. We upped our forecasts, we now expect 2.5% growth in the second half. Coupled with that is a Fed that signaled at Jackson Hole that they were going to hike, only to walk away at the September meeting. So, here is what you're looking at – global monetary policy remains ultra-easy, growth is looking solid for at least the next three to six months, and equity risk premia are still elevated – so that is why we shifted our tone. But like you said, it's still tactical in nature.

[Michael]
So some reduced concerns on the global front. Does that mean it's smooth sailing for the global economy as we look to the end of this year and into 2017?

[Ajay]
Not necessarily over the medium-term. The medium-term outlook is still very uninspiring for growth sensitive assets, for risk assets. So even with our upgrades to our economic forecast, we're still calling for 3.5% global growth next year, which by historical standards is still pretty disappointing. Also some of the risks I mentioned have merely been postponed, they haven't been resolved. So, how China will balance the trade-off between growth and its burgeoning debt; whether elections in euro area countries lead to more risk flares; the populist tide in the United States, whether that leads to market-unfriendly outcomes – we won't know answers to all of these, but I do not feel comfortable that all of these risks have gone away. And finally, remember Michael

that we have had QE globally for several years now, there are few assets that truly qualify as cheap, so this is a tactical shift for all of those reasons.

[Michael]
Interesting. The second theme that permeates your report is where we are in terms of monetary policy, that central banks globally have pursued unprecedented, unconventional monetary policies and you believe that's reaching a limit. Could you tell us a little more about where you see that happening?

[Ajay]
We see operational and political hurdles looming for both the BoJ and the ECB as two of the most aggressive, most unconventional central banks. Their two tools of choice have been negative interest rates in the short-term and on the policy side and QE. If we look at QE, the scale is such that both banks will start to face looming scarcity issues, they will run out of bonds of the type that they like to buy at some point in the future.

The European Central bank can still buy itself some time by dropping self-imposed restrictions, but if it wants to extend QE well past March 2017, which we think it does want to do, then we think it will have to make far more politically controversial decisions such as whether it wants to drop the capital key or not. Both central banks also have the issue that ultra-flat yield curves mean banking systems are suffering, and in both economies, banks are a much greater source of credit than in the United States.

The BoJ has tried to move past this by targeting the 10-year JGB yield, but then that raises the question of whether they will need to buy as many JGBs as before. If that is not the case, if they are to buy fewer JGBs because yields are rallying for economic reasons, then that means that the monetary base expands less than it previously used to which can create its own set of headaches for both inflation and the currency.

On the US side, this is truly as visibly split an FOMC as we can remember. If you look at the September FOMC meeting, three voters dissented because the Fed did not hike, and yet three others believed that the Fed should not hike even in December. That is a much bigger visible split than is normally the case. The Fed has a difficult balancing act, and we think that markets will question its credibility and its willingness to do what it says in the months and years to come.

[Michael]
So on net, where do you think this leaves investors as we look toward the end of the year, and what are you recommending?

[Ajay]
We are moderately overweight global equities, we are moderately underweight safe haven fixed income, not because we think there is a big rates sell off coming, we don't, but the fact of the matter is that large parts of the European and Japanese bond markets are at such eye-watering valuations that there's just no upside left. Within equities, what we typically like at this point is euro

area equities, we like emerging market equities. We are marketweight on US stocks which we think are fully priced, but we don't see a catalyst for a near-term downturn. And we are underweight on both UK and Japanese equities. On the fixed income side we like US fixed income over Europe and Japan for the valuation reasons I mentioned. On the credit side similarly we like US credit over European credit. And finally, we like most things emerging markets.

So if you take a look at our near-term economic outlook, we're saying no near-term China weakness, we're talking about stabilising commodity markets, we are talking about an ever-slower Fed hiking cycle, and we're pointing to the fact that many emerging market economies have high real rates where there is room to cut as inflation settles down. That means we like EM equities, we like US dollar EM debt, and in many cases we also like local currency EM debt.

[Michael Gapen]
That's Ajay Rajadhyaksha, Head of Global Macro Research. Ajay, thank you.

[Ajay]
Thank you.