Economic Discussion

A Review of the Economy and Financial Markets

July 2016

Well, They Really Did It!

The Brits voted to leave the European Union (EU). In the weeks leading up to the referendum, it was clear that the vote would be close. Although, the margin was not large (48%-52%), it was a clear victory for the "leavers." The mystery is why it was such a surprise in the event. After the vote Prime Minister Cameron announced his resignation to be effective when a replacement can be chosen, probably in the early fall. Mr. Cameron favored a "remain' verdict and said he was not the person to lead Britain through its exit from EU. There are several candidates for the post, all conservatives and some supported the "remain" position. The Prime Minister's decision surprised many.

Financial markets registered surprise and dismay. There was an immediate plunge in stock prices around the world. Interest rates fell as investors rushed for safety. Stock markets have staged a recovery of sorts. Bond prices have stayed high, meaning that interest rates have stayed low.

The British pound has been pounded. (Sorry, couldn't resist it.) At the time of writing it is down about 11% versus both the U.S. dollar and the euro. The significance of the British economy relative to Europe's and to the global economy as a whole shouldn't be underestimated. It is the second largest economy in Europe after Germany. It is the sixth largest in the world.

The political fallout will be significant. In the United Kingdom (UK) the ruling Conservative party is experiencing a leadership crisis. It seems unlikely that Labour will regain control. It is having its own problems. The Labour leader, Jeremy Corbyn, was a lukewarm supporter of the "leave" contingent. He is facing a challenge to his position within his party. Also, the Scots voted in favor of remain. This event may revive the Sottish independence movement.

The British leaving could be a bigger problem to the other nations in the EU. They already were facing internal strains over immigration policies brought on by the influx of refugees/migrants from the Middle East and North Africa. The fiscal woes of Italy, Portugal, Spain and Greece have strained the common currency scheme. There are so-called nativist movements in several European countries that could be encouraged to stage their own "leave" referendums.

There are political as well as economic questions raised by "Brexit." Will security and military cooperation continue? Will Russia be emboldened to try annexation moves similar to that which assumed Crimea from Ukraine? Are the Baltic nations safe?

EU officials themselves are on the horns of a dilemma. If they make it too painless for Great Britain to leave the union, it might encourage others of the remaining 27 nations to leave. Italy, Spain, Portugal and Greece have bridled at the austerity measures demanded in return for economic support. If they are too tough, they risk losing a valuable economic and political ally.

If there is any lesson from this, it's that those in power in western capitals including Brussels should not be dismissive of the opinions of the "common folk." The anti-immigration mood in the UK and other parts of Europe is reflected in the U.S.

The economic effects of the British exit will unfold over time. Britain

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must first invoke Article 50 of the Lisbon Treaty. That starts a two year "disengagement" process. Uncertainty will run high for at least the first few months until the post exit terms are clearer.

The U.S. economy was already on a decelerating track. Even though the final revision of first quarter growth was higher than the earlier estimates, it still was a disappointing 1.1%. Chart I shows the pattern over fifteen years.

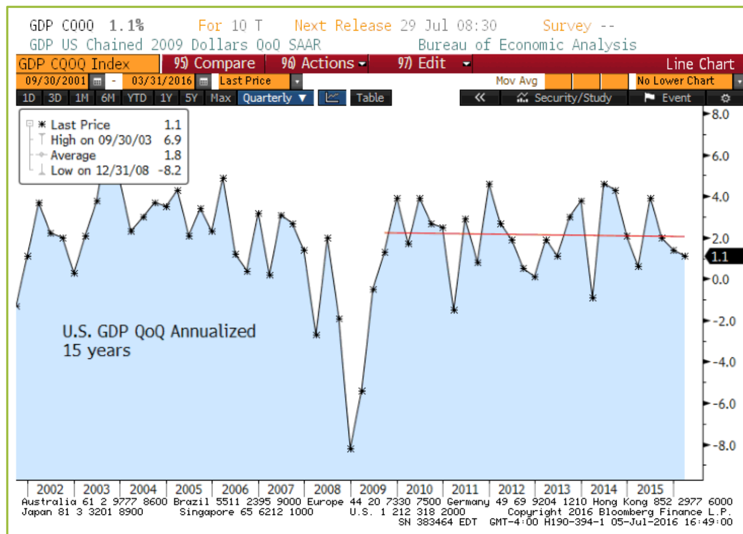

Chart I

The red line denotes the trend since the economy emerged from recession in late 2009. In the last year the growth rate has slowed. Employment in the U.S. is steady. On July 8th the Bureau of Labor Statistics released the June employment report. There were 287,000 new jobs added, above pre-release consensus expectations. The unemployment rate ticked up 0.2% to 4.9%. The labor force participation rate moved up 0.1% to 62.7%. The June report was much better than May's, but probably not enough to change the FOMC's cautious stance.

Prior to the British vote the U.S. Federal Open Market Committee (FOMC) had expressed caution regarding economic growth. The committee left the overnight rate target unchanged in a range of 0.25% to 0.50%. In their post-meeting press release they said, "Since the beginning of the year, the housing sector has continued to improve and the drag from net exports appears to have lessened, but business fixed investment has been soft."[1] More revealing is the release of presentation materials for the press conference that followed the meeting. The median forecast of the committee members for real GDP growth is 2.0% for this year and the following two years as well as for the longer run. The projections for the overnight rate (also known as the fed funds rate) are less than 1.0% at the end of 2016, about 1.63% at 2017 year end and about 2.50% at the end of 2018. The longer run median forecast is 3.00%. The FOMC's "dot chart" is reproduced below.[2]

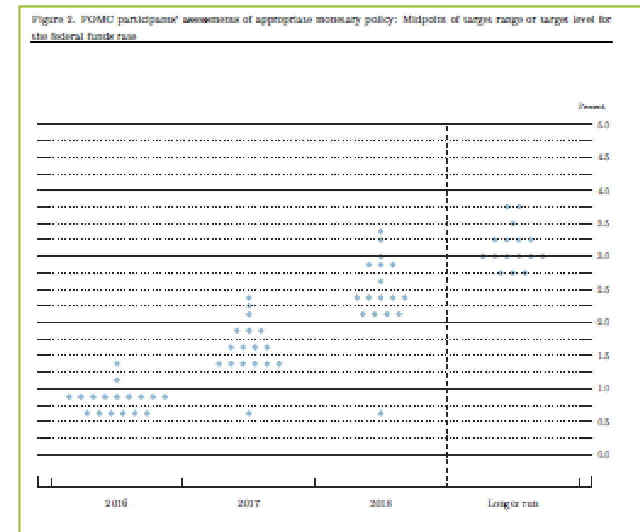

Chart II

Each of the dots indicates the prediction of one of the committee members. We have estimated the median in the foregoing paragraph. The dots show the range of opinion among the FOMC members. The FOMC's increasing caution is reflected in private forecasts. Even prior to the British vote, there was a perception of decelerating growth. In 2016 U.S. real GDP is likely to grow about 2%. Inflation will likely be under 2%.

Growth in Eurozone and the UK will be inhibited by Britain's exit from the EU. It is too early to quantify the effect. In a month or two the picture will become clearer. Business investment will probably slow for a time, as firms decide where the best locations are. British Chancellor of the Exchequer, George Osborne, has said he will propose a reduction of the corporate tax rate from 20% to 15%. He had earlier expressed a desire to reduce it to 17%.

Growth in emerging markets will be mildly affected by the European situation. There is a risk that U.S. dollar denominated debt service will become more expensive if the dollar gets stronger and "flight-to-quality" continues.

It is likely that central banks around the world will be reluctant to increase rates until the effect of the UK's exit is clearer. Central bankers are naturally cautious and this event will not embolden them. Furthermore, their machinations have been mostly ineffective. Even though we don't hear such admissions, they must be less confident than just a few years ago.

Financial Markets and Interest Rates

Stock markets around the world reacted immediately. Chart III shows the domestic (black line), developed (red line) and emerging (gray line) stocks in the week following the election.

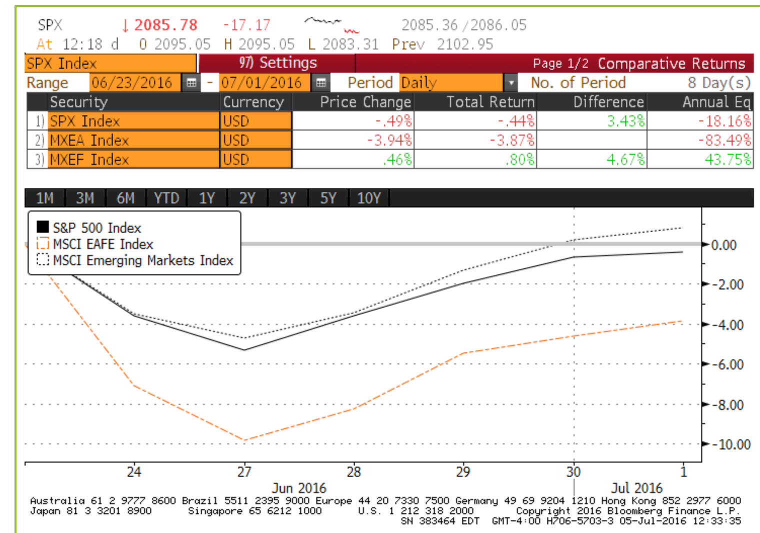

Chart III

Prices fell everywhere in the first two days with the greatest plunge in developed, foreign markets. At the end of the week domestic stocks were a bit ahead. Emerging markets were a bit behind. Developed foreign markets were off 4%. Since the first week, markets have had no direction.

The dramatic drop in the first couple of days can be explained by the phenomenon of large, short-term traders covering their positions. This group, which includes hedge funds, takes very big positions, often on borrowed money. When reverses occur, they scramble for the exits. The only question is why the "smartest people in the world" were caught so off-guard.

Bond markets may be a bigger story. In the U.S., rates fell dramatically and have stayed low. The U.S. Treasury ten year note yield fell 37 basis

points[3] to 1.379% in just twelve calendar days. Rates on German and UK sovereign debt also fell. Part of the reason for the drop in rates is that central banks are buying treasury securities. The Federal Reserve started buying longer term treasury securities early in its quantitative easing efforts following the Great Recession. That was unprecedented. Previously, Fed buying was limited to short term issues. Since then other central banks have followed suit. This has created demand for the securities which drives prices up and yields down. Negative interest rates in many countries make even the low yields on Treasury securities attractive.

Even before central banks got into the act, there was an underlying base of demand for high quality securities in the "repo" market. Repurchase agreements ("repos" in the vernacular) are used by large institutions and security dealers to fund their day-to-day operations. In effect, "repos" are collateralized loans. Low rates are not just an inconvenience to investors looking for income. They also threaten the smooth functioning of financial markets.

Markets have not yet fully assimilated the British exit from the EU. It may take weeks or even months, although there should be a gradual clearing of the outlook over that time. Stock investors should stand pat with our recommendation of last month to hold normal allocations for domestic as well as foreign, developed equities. Market movements will have created a modest under-weight in foreign, developed stocks. Emerging market issues should be at a normal or slightly over-weighted position. Although there will be turmoil in foreign developed markets, there will be both winners and losers. On balance it should even out over a period of a few months.

This is not a time to be making new investments in bonds; existing positions should be held. There have been gains across the maturity spectrum. The following chart shows the movement in treasury yields over the course of the last three quarters.

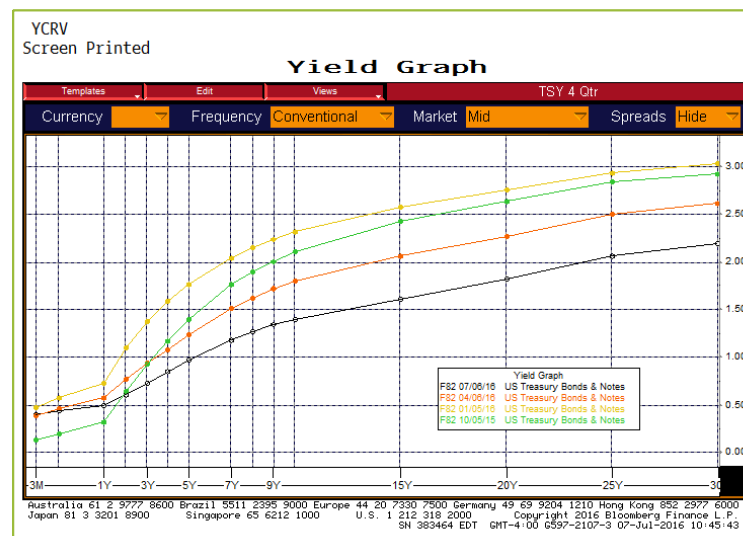

Chart IV

The black line is the yield curve at the present time. We thought rates were low three months ago (red line), didn't we? Look at them now. As investors and central banks come to grips with the new reality of Great Britain out of the EU, rates will move back upward.

These are uncertain times. It will take time for market participants and policy makers to adjust. Don't make big changes but remain alert for the fog to clear.

July 8, 2016
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[1] Federal Reserve Press Release, June 15, 2016.

[2] FOMC Press Conference Presentation Materials, June 15, 2016.

[3] A basis point is 0.01% of a bond's yield. In the above example, the yield on the ten year Treasury fell from 1.749% to 1.379%, a difference of 37 basis points.