CAERUS Market Commentary – June 2016

The global market impact of Brexit

Market overview

June was dominated by the UK referendum on whether the country should stay in the EU or not. The UK voted by 52% to 48% to leave the Union and thus sparked one of the most interesting weeks in capital markets for some time. Not only did the outcome of the vote raise interesting economic questions, it has impacted politics and diplomacy. Whilst the implications are potentially profound for both the UK and Europe, the ramifications also have scope to impact other world markets.

UK

The outcome of the referendum was first felt in the sterling currency markets. The 24th June saw one of the most violent overnight swings in the value of sterling for a generation. From a high of $1.50 at midnight, when the UK was still expected to remain part of the EU, the value of sterling began to slide, dropping below $1.33 as evidence mounted that the City had been wrong and the country had voted 'leave'. The stock markets promptly followed with dramatic falls for the FTSE100, but even greater falls for the domestically orientated FTSE250 (ultimately falling 6% for the month).

However, as the implications of sterling's weakness began to be absorbed (exports are more competitive and overseas earnings worth more in sterling terms), the FTSE100 rallied from its low and ended the month higher than its pre-BREXIT level (up 4.7% in June). However, many now expect the UK economy to slow down as imports become more expensive, consumers rein back spending and companies delay Investment until the outlook becomes clearer, most notably our trading relationship with the EU. Already the Gilt market is anticipating interest rates to fall in the next couple of months (the 10-year Gilt has fallen from 1.38% to 0.86%), to maintain aggregate demand.

Europe

Unsurprisingly, the UK vote spilled over into European markets, which fell by approximately 4% in euros. However, when translated into Sterling, the FTSE Developed Europe ex UK index was actually up on the month, with a rise of 3.8%. The most striking outcome for Europe so far has been in the European bond markets. The difference in yields, referred to as the 'spread', has widened between those of Germany, which are now negative across much of the maturity, and those of the peripheral countries, such as Greece, Spain and Portugal, which have increased.

Will the outcome of the UK vote encourage other countries to demand a vote of their own? At the moment it is simply not known. However, Europe faces six elections in the next 18 months and their results should indicate how secure the European project is.

US

Similar to Europe, the United States stock market did well during the month, when translated into sterling, with a rise of over 9%. However, in dollar terms, the rise was much more modest, at 0.24%. The impact of BREXIT for the US is much more on the politics rather than economics. Does this give a fillip to the Trump presidential bid?

One outcome has been the attraction of the US dollar for its 'safe-haven' status. This makes it harder for the US to export but will lower its inflation. A recovering economy has pushed up US wages, house prices, mortgage lending and retail sales. This may have tempted the Federal Reserve to raise interest rates. However, given the current uncertainties, this appears less likely, as a rate rise would make the dollar even more attractive and further push up its value, thereby exacerbating the problem.

Japan

The yen also attracted those fleeing sterling's weakness: BREXIT has done no favours for Japan and its hoped-for recovery. Although the Japanese economy has been sluggish for many years, it is still the world's third largest economy. A weak yen to boost the country's exports, and hence growth, has been one of the key planks of its Premier's plan, known as 'Abenomics'.

However, the yen has been strengthening for the whole of 2016 and last week's referendum result prompted a flight to safety, and that included the yen. However, interest rates in Japan are now negative, causing consumers not to save (they earn no interest) and companies hold back Investment in response to a lack of demand and an ageing population.

It is little surprise that the stock market has fallen by over 10% in yen terms over the past month, albeit it has risen by 6% in sterling.

Emerging Markets

Although the majority of Emerging Market (EM) trade is with each other and the United States, there are still risks if the US dollar continues to strengthen. Many EM companies and governments borrowed 'cheaply' in dollars but the more the dollar rises, the more expensive it becomes to repay those debts in local currencies. And should interest rates rise in the US, there will be a flow of monies leaving EM markets in search of the higher yield in the US, not unimportant when so much of the world offers so little yield, if any.

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However, sentiment may improve. If the US delays rate rises and the gyrations of the dollar and other countries settle down, then EM stock markets may offer good value. Emerging Markets were up by just over 3% in the past month, much better in sterling terms with a rise of 11%, adding to a good year-to-date figure of close to 16%. And, finally, for once, political instability has not come from the developing world, but in this instance a developed one – the UK.

**All performance data quoted in this article is derived from FE Analytics.*

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