



Third Quarter 2016 Outlook and Commentary

Should the United Kingdom remain a member of the European Union or leave the European Union? Three weeks ago, on June 23rd, that question was put to the British electorate. Markets opened the day confident voters would choose Remain. Investor optimism was due in equal part to: polls leaning slightly in that direction, a tendency for voter interest in risky referendums to fade in the voting booth, and plain old wishful thinking. In the end, by a margin of 52% to 48%, British voters chose Leave. The unexpected “Brexit” vote rattled financial markets and sent headline writers into overdrive.

Drama aside, how big a deal is Brexit? The answer seems to depend on which market you ask. Given a week to think about it, equity markets mostly shrugged it off. Stocks sold off in the first two trading sessions after the vote, with losses around five percent in the U.S. and nine percent in Europe. After the initial shock, however, stock markets bounced back quickly. The S&P 500 has been trading higher, at or near all-time highs in recent days, and as of this writing the Stoxx Europe 50 Index is below pre-Brexit levels by only two percent¹.

Bond markets told a more dramatic story. While stocks were bouncing back close to pre-Brexit levels, yields on long-term government bonds were dropping to never before seen lows. Entering June, the British 10-year government bond (the gilt) had never yielded less than 1.3%. In the aftermath of Brexit, the yield got as low as 0.74%. The German 10-year government bond (the bund) descended into negative territory, getting as low as -0.18%. U.S. Treasury yields likewise plunged to record lows. Yields have risen a bit in recent days but remain at levels that until very recently would have been unthinkable.

Perhaps the single most astonishing number in the bond market is that on July 5th Swiss government 50-year bonds had a negative yield. In essence, investors were prepared to lock up their money for fifty years compensated only by the eventual return of almost their entire principal.²

The severity of the bond market reaction is surprising if you focus solely on the direct implications of a presumed departure of the U.K. from the European Union. (We must append the word “presumed” because the vote is non-binding. Only when the British government invokes Article 50 of the Treaty on European Union does the separation become a fait accompli, and that may not be until 2017.) In the context of the global economy the U.K. just isn’t big enough to have a huge impact. Undoubtedly though, bond investors are thinking about the integrity of the EU itself. For over six years the European Union--28 countries within which goods and people flow freely--and the smaller euro zone--19 countries which share a common currency--have faced a slow-moving existential crisis. Initially the crisis centered around

¹ Oddly enough, the UK’s FTSE 100 stock index is at this time up nearly five percent from pre-Brexit levels, driven primarily by expectations that large exporters will benefit from the decline in the British pound.

² That’s a bit of an oversimplification. The bonds in question were sold two years ago and have increased substantially in price, so the actual cash flows look more like this: a buyer pays, let’s say \$110,000, collects a modest amount of interest along the way and then gets \$100,000 back 48 years from now. But, financially this is equivalent to someone paying \$110,000 now, collecting no interest and getting, let’s say, \$109,900 back in 48 years. Of course, the idea may not be to hold to maturity. Perhaps the hope is that yields get even more negative allowing the investor to sell at a profit. Seems crazy any way you look at it.

countries like Greece (and to a lesser extent Portugal, Italy and Spain) that had borrowed recklessly before the financial crisis. For now at least, that bullet seems to have been dodged.

Brexit appears to signal a new and extended phase of the crisis centered on surging nationalism. While the U.K. vote brings the issue to the fore, it has been simmering for years. Initially fueled by resentment at having to bail out the likes of Greece, nationalism has been further stoked by the flood of refugees from Syria and other countries into Europe over the last couple of years, as well as the terror attacks in Paris, Brussels and now Nice. Extremist nationalist parties from Marine Le Pen's National Front in France to Geert Wilders' Party of Freedom in the Netherlands to the Freedom Party of Austria have gained in popularity riding a wave of anti-immigration sentiment. With freedom of movement a core principal of the European Union, rising anti-immigration views has led to growing "Euroskepticism."

EU leaders may have bought some time with the tenuous deal on refugees that it struck in March with Turkish president Erdogan. Turkey has agreed to absorb refugees who will now be turned away in Greece. In exchange Turkey received promises that its citizens will be allowed to move freely in the so-called Schengen Zone and also that Turkey's eventual admission into the EU will be accelerated. Even if the deal holds, it won't be enough to stem the momentum of nationalist parties, who are now agitating for their own referendums on leaving the EU.

The good news is that winning a Frexit or Nexit or Italeave vote will be a major uphill climb. The big difference between the U.K. and these other countries is that the U.K. was never part of the currency union. A decision to leave the common currency would be vastly more daunting than a Brexit and it's unlikely that any country will vote to go down that road any time soon³. Still, parties proposing just that have momentum and will probably gain in popularity as ISIS-directed or inspired terror attacks continue. And even if these parties are unlikely to engineer a departure from the Euro, that possibility will lurk in the background as Europe and the U.K., under new Prime Minister Theresa May, negotiate the terms of the Brexit. The likely outcome is that the U.K. ends up looking a lot like Norway, which abides by all EU regulations, makes sizeable contributions to the EU budget, and in return is allowed to trade freely with EU members. The sticking point in the negotiation will be immigration, which is precisely what 52% of British voters want desperately to restrict. If Europe insists on unadulterated free movement of people and labor as the price for free trade between Europe and the U.K., negotiations may break down. At that point, the EU and the U.K. would each be free to impose tariffs on goods imported from the other, a prospect that could frighten financial markets, which have harbored fears of a global trade war for some time. If, on the other hand, Europe appears to be granting significant concessions regarding the free movement of people and labor, anti-immigration voters within the EU will clamor to get in on the action.

The tensions threatening to tear the European Union apart create challenges for Europe's political leaders but also for the European Central Bank. In March of last year the ECB, in an effort to stimulate economic growth and prevent deflation, began a program of "quantitative easing" or bond buying, similar to the six-year effort of the U.S. Federal Reserve. European QE has driven yields on many government bonds into negative territory. In fact, worldwide over thirty percent of all government bonds have negative yields! The bond market expects the ECB's QE policies to continue for many years. With no prospect in sight of an end to the European Union's existential crisis, it's hard to argue otherwise. GDP growth in Europe hasn't been too bad over the last several quarters. But with a major political crisis seeming always to lurk around the corner (did we mention that Italy's largest banks appear to be on the verge of collapse?), it's hard to imagine the ECB even hinting at the end of QE any time soon.

³ Suppose, for example, that French voters were allowed to vote on EU membership. If at any point polls began to look remotely favorable for the Euroskeptics, the French stock market would nosedive, giving voters a massive dose of reality.

All of this raises the question of how long interest rates can stay this low. Longer than you might think if history is a guide. In the wake of the Great Depression, yields on short-term Treasuries stayed below 0.5% for thirteen years. We're not predicting that will happen again, but in the immediate aftermath of the Brexit vote, bond markets were forecasting not only that the Federal Reserve would hold off on raising Fed Funds rates for the remainder of 2016 but for all of 2017 as well. Only eight months ago, when the Fed announced a 0.25% rate increase, it also signaled that there would be three or four additional increases in 2016. And we were inclined to believe it. (If you are beginning to get the idea that our thinking on interest rates has evolved significantly over the last several quarters, you're right.) But the plunge in oil prices shook financial markets in January and February and, together with a stronger U.S. dollar, took more of a toll on the U.S. economy than anticipated. The Brexit vote, and the political and economic cloud that will hang over the U.K. and Europe, will force the Fed to be cautious for the foreseeable future. And looking over the horizon, Chinese debt continues to build and is likely unsustainable. The pipeline of global crises is depressingly full. Rate hikes will eventually come but we may be stuck in a low growth, very low interest rate environment for a long time.

The prospect of rock-bottom rates continuing for a long time is probably behind the sharp bounce-back in global stocks. In the U.S. for example, a 10-year Treasury bond only yields around 1.5% and a typical long-dated BBB-rated corporate bond yields around 3.5%. By comparison a blue-chip stock with a dividend yield of 3% or more, with the possibility of dividend growth and share price appreciation, looks pretty attractive. In Europe, where bond yields are lower and dividend yields are higher, the case for stocks over bonds is even more compelling.

Fundamentals in the stock market aren't ideal to be sure. U.S. corporate earnings have been declining for five straight quarters. That is largely due to collapsing earnings in the energy sector and the effects of a stronger dollar (which causes profits earned overseas to translate into fewer dollars). Even if you exclude those factors though, earnings growth is barely positive. Valuations are above average as well, but if you take the record-low interest rates into account, valuations are reasonable. And as the headwinds from low oil prices and a strong dollar subside over the next couple of quarters, earnings growth may turn slightly positive. Not a ringing endorsement, but the bar for stocks is set pretty low when bonds yield next to nothing (or less). The background of extremely low interest rates also benefits foreign stocks, which have higher dividend yields and are more attractively valued.

Perhaps the biggest question confronting the stock market is whether the plunge in bond yields signals a looming recession. We may sound like a broken record on this score but we're not seeing the evidence. Economic data in the U.S. trended weaker throughout 2015 into early 2016 as a stronger dollar hurt U.S. exporters and falling oil prices led to all pain (energy company cutbacks) and no gain (lower gas prices failed to lift consumer spending). But those two problems seem to have run their course and U.S. GDP appears set to get back into the 2 to 2.5% range. Not very exciting but not a recession either.

Even if one can justify U.S. stocks setting all-time highs, that may not be a reason to celebrate. If the pattern of very low interest rates and tepid economic growth remains in place for the indefinite future, the low interest rates could put a floor under the stock market, but tepid economic growth combined with valuations that are above average by historical standards may result in a period in which stock returns fall somewhat short of their long-term historical averages.

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Boston, MA*

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