MARKET
PERSPECTIVES

STC Investment Committee

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The month was marked on June 23 by the decision of United Kingdom voters to withdraw from the European Union (EU). While a narrow outcome was long anticipated, investors had become increasingly convinced that "Remain" would prevail as the date approached, with the British Pound gaining 4% the week before. Although the so-called "BREXIT" surprise and the associated market volatility overshadowed other news, the month also featured reassuring election results elsewhere (Spain) and increasingly dovish Federal Reserve Board ("Fed") interest rate forecasts following a disappointing May jobs report.

As described in last month's letter, June had been on track for a strong "risk-on" month across asset classes after an unexpectedly weak employment report and subsequent Fed guidance removed near-term fears of a Fed interest rate increase and a strong dollar. The first two post-BREXIT trading days saw global equity market declines of 7%, with 15% declines in the UK and the Eurozone. Safe haven bids lifted Treasuries and the dollar, which clawed back some of its early month losses.

Investors quickly convinced themselves that the market decline represented a major buying opportunity for two reasons. First, BREXIT was more a European political event than a systematically important economic one. Second, any additional downside tail risks would be more than offset by the government policy responses in the form of even-lower for even-longer interest rates and more aggressive central bank accommodation, as well as hopes of new fiscal stimulus in the UK and Japan.

The net result was that global equities were little changed over the month, returning 0.6%. U.S. equities returned 0.3%, splitting the difference between weak (-3.6%) international developed markets and strong (+3.8%) emerging markets. Within the U.S. equity market, defensive yield plays were the big winners with telecom stocks up 9% (25% year-to-date), utilities up 8% (23% year-to-date) and consumer staples up 5% (10% year-to-date). At the other extreme, financials and technology stocks fell 3%, driving negative returns for the year.

The monthly performance spread between Brazil (+20%) and Italy (-10%) illustrates the international dispersion, as emerging Latin America was up 11% while the Eurozone (Euro Top 50) declined nearly 7%. Small-cap EAFE (Europe, Africa and Far East) stocks lost more than 5%, no doubt hurt by their greater exposure to potentially weak domestic economies in Europe and Japan. Despite the currency plunge, overall United Kingdom equities actually outperformed European markets, partially due to the more global and defensive nature of their index constituents. Japanese equities fell 2.5%, as the spike in the Yen came at the time when the economy was already falling short of its growth and inflation goals.

Equities were not the only asset class to experience a "yo-yo" month. Commodities gained 4%, led by precious metals (silver 17%; gold 9%) and natural gas 28%; oil finished down only 1% after rebounding 6% from post-BREXIT lows. While the trade-weighted dollar declined only 1%, dollar weakness was broad-based with the notable exception of an 8% rally against the UK Pound, which plunged to a 30-year low. The dollar fell 7% against the Japanese Yen and nearly 3% against emerging market currencies. It even failed to gain against the Euro. The Chinese Renminbi quietly weakened 1% against the weak dollar, falling to its lowest level in six years.

Fixed income markets were unidirectional, as global bond yields hit all-time lows as the news flow encouraged investors to speculate that bonds would continue to rally. Earlier in the month, six members of the Fed foresaw only a single rate hike; after the BREXIT vote, even that sounded hawkish as contagion fears drove longer-term (10-year) German and Japanese yields to negative levels. Treasury moves were significant, with 2-year yields cut by 1/3 and 10-year yields by 20% as intermediate term bonds gained 2%. Municipal bonds gained 1%, but underperformed the very strong Treasury market. Dollar-based bond gains were even stronger outside the U.S., with the non-U.S. bond index gaining nearly 4%. High-yield bonds gave back only part of their gains, ending up 1% as spread widening did not fully offset benchmark

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gains. For the fourth straight month, the more speculative issues outperformed, with CCC-rated bonds up 2.3%; distressed bonds and emerging-market local-currency bonds each gained 5%.

July Preview

Equity markets have rallied strongly thus far in July on the back of both fundamental and technical factors. No doubt some investors had deferred purchases until after the BREXIT vote, while others may have been whipsawed and had to cover bearish positions as the market kept rallying. The fundamental support has come from the unusual combination of record low bond yields and a string of positive economic releases, as the Citibank Global Economic Surprise Index has reached its highest level in more than two years.

July month-to-date returns reflect these forces, with equities and high-yield bonds rallying and safe-haven bonds and currencies retreating. Global equities have gained more than 3%, with domestic equities performing better than developed market peers, but once again lagging emerging markets (up 4%). The high-yield bond rally has continued, with the index up nearly 3%, showing strength across the rating spectrum. The Treasury market has lost as much as 1%, with non-dollar bonds down nearly 2%. The dollar has been stronger, particularly against the Yen (+3.5%). Within the U.S. equity market, the defensive telecom, utility and staples sectors have lagged along with energy (commodities down 5%).

Current Positioning

There is little change in my thinking from what I wrote in the immediate aftermath of the BREXIT vote: the U.K. will be the only country to leave the EU; it will do so no earlier than 2019 on terms that preserve freely traded goods but not financial services; the U.K. will do well to avoid a 2017 recession given its poor starting conditions in terms of an output gap, London real estate excesses and a dependence on foreign capital flows and direct investment; and the EU will remain otherwise divorce-free but hardly happy as uncertainty restrains capital spending.
The most important takeaway remains that, while BREXIT is expected to reduce global growth only by 0.2% over the next year, downside economic and political tail-risks have increased. Economically, I have seen 2017 U.K. growth estimates vary from -5% to +2%, reflective of the timing and terms of its expected divorce from the EU. Politically, BREXIT has the potential to energize Eurosceptic voters in front of 2017 European elections in France, Germany and the Netherlands. Italy's October 2016 referendum on constitutional reform could be decisive.

The increased downside tail risk is of particular interest to the Fed, given its institutional asymmetric risk aversion and pronounced dovish bias. BREXIT-induced uncertainties have increased the odds that the Fed will wait longer, let the economy run hotter and view asset price distortions as a second-order problem. In other words, with the Fed remaining on hold at near-zero interest rates despite full employment (initial unemployment claims at 40-year lows, consumer price index up 0.2% month over month and wages up 2.5% year over year), the near-term market upside is greater, but so are the ultimate downside risks. It's hard to fault investors for thinking the Fed is their friend (at least in the short-term).

Treasury yields have increased 10 basis points in July and municipals have outperformed. I would be particularly alert for signs of a steepening of the yield curve, as steadily lower out-year inflation expectations and negative yields overseas have thus far pulled down longer-term Treasury yields, making the yield curve remarkably flat.

I was surprised at the vehemence of the equity recovery that has continued into July. While some of it represents relief that there was no sustained market contagion, it is hard to argue that BREXIT did not have at least a modest negative impact on global growth and corporate earnings. As such, the resulting rally leaves equities even more overvalued, dependent on bubble-level benchmark rates and exposed to downside tail-risks. Near-term Eurozone risks would be greatly reduced by an early resolution (fudge) if the EU re-capitalizes Italian banks in a manner that does not alienate Italian voters in front of their October referendum. While emerging markets should benefit from a weaker dollar (which also reduces China macro risks), that has become more of a consensus view, with emerging-market equities up 4% in July and double digits in 2016, versus negative returns for international developed markets.

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