Sparinvest

Monthly comment by
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Immediate and dramatic reaction to the British EU referendum

Surprising Brexit result

The most significant event in June has without doubt been Great Britain's referendum on the country's relationship with the EU. Opinion polls before the referendum almost constantly indicated a modest lead for the Remain faction, and the bookmakers' odds massively favoured a Remain result.

No matter which way you look at it, the results of the referendum will cause significant uncertainty regarding Great Britain's relationship with the EU for many years to come. Everything from trade deals, legislation within Great Britain, immigration, foreign exchange, financial policy, the country's relationship with Scotland and Northern Ireland, the balance of power in the EU's remaining countries, the necessity to revise the existing treaties, Turkey's relationship with the EU and a coming EU army – all are topics that are on the negotiating table.

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A first step to minimising some of these uncertainties is to establish a new British political leadership. The current Prime Minister, David Cameron, has announced his resignation and will step down in three months. Given the parliamentary situation in Great Britain, it would be expected that one of the senior Conservative ministers take over but an early general election in connection with a change in leadership cannot be ruled out. At the time of writing, Boris Johnson has announced that he will not be seeking the premiership so it looks like the choice will be between Theresa May and Michael Gove. Whoever wins will be faced with a colossal leadership challenge.

The current Chancellor of the Exchequer, George Osbourne, who favoured Great Britian staying in the EU, has just announced that he wishes to lower corporation tax from 20% to 15% in order to attract new business and to dissuade existing businesses based in the country from relocating as a result of the referendum. It is this kind of thinking that means I have no serious worries that Great Britain will suffer a painful death by being outside the EU – if indeed it ever happens. It is also possible that they will be able to negotiate a series of opt-outs, as Denmark did after the country rejected the Maastricht Treaty.

The market reacted with surprise at the Brexit result

The market's reaction to the British referendum was prompt and dramatic because it was so surprised by the result. However, the most risk-heavy asset classes regained most of their lost ground within a few days. Practically speaking it is only the pound, interest rates and interest rate expectations that have settled at new levels for any length of time.

Sudden drop in British pound

It is possible that, due to the fall in the pound and interest rates together with the significant and lasting uncertainty about Great Britain's relations with the EU, it is too soon conclude anything about the situation, but it is still my opinion that the outcome for Great Britain has not been as bad as it was feared.

There has probably been too much focus on the negative aspects of Brexit in the media and market analyses, and too little focus on the positive. While a great deal of energy has been spent on the negative aspects, it can be mentioned that Brexit will make it much easier for Great Britain to enter into trade agreements with its previous colonies, who in many cases have a shared language and culture.

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India is an obvious example, where despite many years of effort it has not been possible for the EU to achieve a satisfactory agreement. Many African countries could also be possibilities, as can USA, Canada and Australia. Great Britain's trade with the other EU countries accounts for approximately 15% of the BNP; trade with countries outside the EU accounts for more than double that amount. At the same time, Brexit supporters have pointed out that low growth in the EU region means that its significance in the global economy is decreasing, whereas the global share of other trading partners is increasing.

On the background of this, it is perhaps not a problem in the longer term that Great Britain has a looser connection to the EU, even though all parties have a continued interest in maintaining close trade connections. It is perhaps no surprise that both the Indian rupee and South African rand have risen sharply after the first reactions to the referendum results.

A change of tone from ECB

Over the last six months, the market has gradually begun to realise that the ECB's purchasing programme for bonds will run into serious problems within the next few months, simply because there are not enough bonds on the market with the required quality, so other bonds can start to be considered.

This development has been further accelerated after the significant fall in interest rates that Brexit provoked, because bonds with interest rates lower than their deposit interest rate of -40 bps are excluded from the purchasing programme. In the days following the referendum, anonymous sources revealed that the decision to expand the purchasing criteria was on its way – which caused Italian and Spanish national interest rates to fall even further. The background for this is that the ECB has previously used a geographical key for a purchasing programme based on the countries' BNP (which favours countries like Germany). Now it appears that they will instead look at the extent of outstanding bonds, which clearly favours the south European countries.

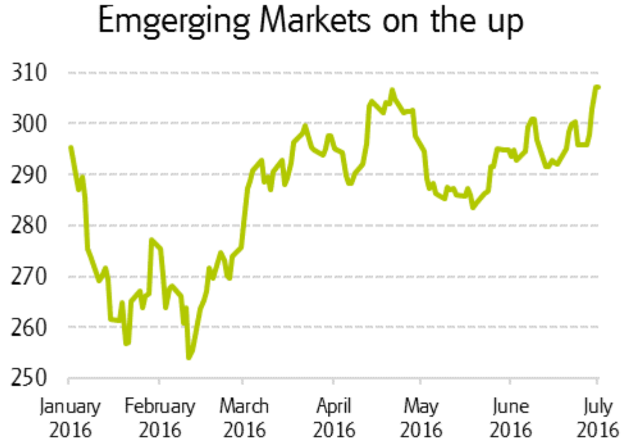
Speculation strengthens the dollar

Immediately after the Brexit referendum, Janet Yellen indicated that the FOMC would postpone a planned interest rate increase, which caused interest rate expectations to fall. However, the US dollar was strengthened as a result of the speculations over changes in the ECB purchasing programme and the fact that the Brexit referendum indicates a weaker European partnership and greater insecurity.

At the present time, STIR Futures market prices indicate that the next rise in interest rates will take place in June 2017. With regards to the Eurozone, it is expected that the short interest will only become positive again in March 2021.

Emerging markets – negative focus shifts to Europe

It is often the case that investors place a market or a region in the doghouse for months – or even years – on end. In recent years, the emerging markets have been the most reviled asset classes, both for bonds and equities. For equities, since 2010 the emerging markets have actually almost constantly yielded poorer returns than the developed markets. This looks like it will change in 2016, which is probably because at least some of the market's negative focus will be on Europe.



I expect that we will be seeing systematic increases in returns in emerging markets equities in the coming years

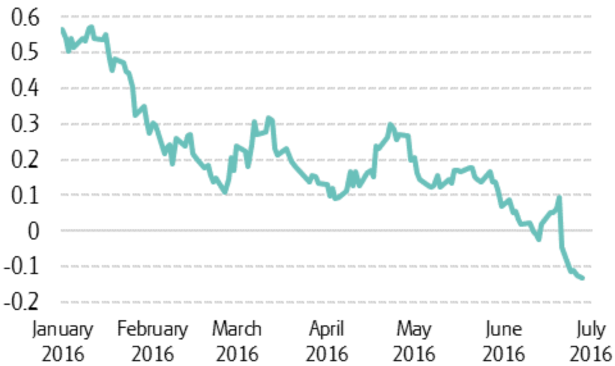
So far we have seen an increase in returns of more than 5% relative to MSCI World. I expect that we will be seeing systematic increases in returns in emerging markets equities in the coming years. This is partly due to a quite small exposure to the asset class in many portfolios and partly that the major outflows from the asset class are now ebbing out, which means we will start to see inflow again. A third factor is that emerging markets equities are priced much cheaper in relation to MSCI World.

Beware of inflation in a few months

I will repeat my warning from previous monthly reports about rising interest rates and interest rate expectations – well aware that I was completely wrong about the Brexit referendum, where interest rates and interest rate expectations have plummeted. But it is extremely important to take extra care now.

In the Eurozone the latest inflation figures are -0.1% for headline (in other words excluding energy and foodstuff prices) and 0.8% for core inflation. The corresponding figures for the USA are 2.2% and 1.0%. The long-term inflation expectations for the Eurozone (5Y5Y inflation swaps) are at 1.32% in the Eurozone and 1.87% in the USA. Both are way under their usual levels.

German 10 year rate below zero



With money supply growth in the Eurozone at 4.9% and at 6.8% in the USA, there is reason to perceive money supply policies are supportive inflation – also even though the money supply growth turnover rate is significantly lower than normal. In particular, the very large drop in the price of energy and raw materials has contributed to exceptionally low inflation rates over the past two years. But this influence is now gradually being phased out and can easily become a positive contribution to the development of inflation in a relatively short space of time – approximately three to six months.

In my eyes, a market that recognises long-term inflation expectations as low as 1.3% is not prepared for headline inflation figures in November or December, for example, to come out at 2% at a time where ECB is holding short interest at 0% and deposit interest rates at -0.4%.

The momentum indicator says "buy"

Our MomVol indicator, which can assume values between 0 and 1 where values over 0.6 indicate "buy", shows a value of 0.9%. This indicates the probability of good prospects for returns in the stock market in July. Statistically, since 1970 returns in the month following our MomVol indicator having a value of between 0.9-1 averaged 2.4% (in USD-terms). No fewer than 77% of the following months have given a positive return, so it appears that July will be good for the stock market.

Editorial deadline: July 5 2016