Southern Capital Perspective

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BREXIT

A SHORT-TERM STOCK MARKET PANIC OR A MAJOR HISTORICAL EVENT?

It is likely that both assertions are true. There is no doubt that the market volatility which took place beginning Friday, June 24, 2016 came as a result of the Brexit vote (the British referendum to leave the European Union). In just two days, the US stock market in terms of the Dow Jones Industrial Average lost over 870 points. Then in the succeeding three days gained about 790 points, almost erasing the entire Brexit sell-off. Clearly the market volatility was an emotional reaction that was based upon fear not economics.

[See our response on local news on our homepage video: www.southerncapitalservices.com]

In reality, perception is all that changed. The trade agreements and contracts that existed before the vote are still in effect today. Therefore, actually nothing has changed as of yet. If Britain does truly leave the European Union (EU) (there is some doubt because there is a movement to have another vote), it is scheduled to take place gradually over a two year period. Consequently, the international economy will adjust and adapt over time and new trade agreements and contracts will be put in place to facilitate international trade.

The second assertion about the historical significance of Brexit is less clear but could mark a turning point in modern world history. Britain in effect declared its independence from the EU, not because the British people are against international trade, but because they resented being dictated to by the EU bureaucrats in Brussels, Belgium. There are numerous examples of this imposed government by non-elected bureaucrats from immigration policy to telling the English what kind of teapots they can legally use.

There are some indications that this independence movement is beginning to spread to other members of the EU which could result in unraveling the entire Union. If that occurs, there would be uncertainty and the markets would react. However, even if that should occur, it is impossible to predict the long-term economic effect and whether it would be beneficial or negative for the global economy. One thing that we can be sure of is that much will be said and written about the possibilities and the predictions based upon the viewpoints of the speakers or writers. We will just have to watch as history unfolds.

WHAT IS WITH THE PHENOMENON CALLED "NEGATIVE INTEREST RATES?"

To begin: What is a negative interest rate? According to Investopedia: "A negative interest rate means the central bank" *(like the European Central Bank [ECB], Bank of Japan [BOJ] or someday possibly the US Federal Reserve [FED])* "and perhaps private banks will charge negative interest: instead of receiving money on deposits, depositors must pay regularly to keep their money with the bank. This is intended to incentivize banks to lend money more freely and businesses and individuals to invest, lend, and spend money rather than pay a fee to keep it safe."

Negative Interest Rate Policy or NIRP as it is called is the latest effort of central banks to deal with the aftermath of the 2008 global financial crisis. It is important to note that the bankers only control what is called monetary policy which involves primarily the money supply and determining the appropriate levels of the inflation and interest rates. Whereas, the government controls the government spending levels and the rate of taxation as well as government regulation. This distinction is important because using monetary policy alone without cutting taxes and other fiscal policy stimulation has not been successful in

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lifting the various global economies to previous rates of growth enjoyed prior to 2008.

The central bankers put forth a valiant effort. They started by dropping interest rates; at first the markets responded and so did the economies but to a lesser extent. Then, when lowering interest rates were not enough, they started creating massive amounts of money called "quantitative easing" (QE). Initially QE had a significant effect, but then its effectiveness began to diminish and more and more was required just to maintain current levels with very little growth. For example: the ECB is adding 80 billion euros per month and the economic growth rate is expected to be less than 2%. In Japan things are even worse with massive QE and yet a growth rate of less than 1%.

Then the concept of negative interest rates began to gain acceptance probably out of desperation because the other monetary policy tools were becoming ineffective. The ECB started the NIRP in 2015 and the BOJ put Japan on the negative interest rate track early in 2016. The jury is still out on the effectiveness of this bold strategy but there are growing doubts among some of the influential economists and money managers. One such financial services professional is Mohamed A. El-Erian, the chief economic adviser at Allianz. His contention is that our politicians will not act to use fiscal measures to solve global economic woes but instead rely on the central banks to use monetary tools like NIRP.

El-Erian was quoted in a PBS interview saying: "So the simple answer is that our political process has basically sidelined most of our economic instruments. So the one instrument that has relative political autonomy is monetary policy. Central banks do not need to go to

Congress to get approval for an interest rate hike." *PBSNewshour, 03-10-16*

Then he went on to say: "But the world changes! So we're in a situation today where the only policymakers that have flexibility are central banks. But they don't have the instruments! So they've had to experiment, and the more you experiment, the more uncertainty and the higher the risk of collateral damage." He is not predicting disaster, but he is saying that we are in uncharted waters and the outcome is uncertain.

El-Erian's former associate at the financial services firm, PIMCO, Bill Gross has a more pessimistic outlook for the future impact of negative interest rates. Gross says that "Global yields lowest in 500 years of recorded history. $10 trillion of negative rate bonds. This is a supernova that will explode one day." *Fortune.com 06-10-16* He does not predict the timing of the economic disaster, and even if he is correct it is sometime in the future and not information that helps with current investment positioning.

What about interest rate policy in the US? Could we also face the prospect of negative interest rates? The answer is possibly. In the publication Fortune – the May 13, 2016 edition: "Federal Reserve Chair Janet Yellen said on Thursday that while she "would not completely rule out the use of negative interest rates in some future very adverse scenario," the tool would need a lot more study before it could be used in the United States."

The negative interest rate phenomenon that has been instituted by the world's central bankers has definitely arrived and currently there is over $10 trillion worth of negative yielding debt. Whether or not this new monetary policy comes to America is as yet unknown but it is having an effect; US interest rates have fallen because many foreign investors want to buy US bonds because they do pay some interest unlike those in Europe or Japan. We do not know how all of this will end, therefore we must remain vigilant.

Outlook

The second quarter of 2016 turned out to be slightly positive. It looked like Brexit was going to derail a positive quarter but the three day Brexit rally recovered most of the lost ground. The two sectors that caused the first quarter to be difficult, healthcare and technology, have begun to recover. The economy during the April to June period continued its sluggish forward movement, but in comparison with the rest of the world, the US is the strongest major economy.

The third quarter is likely to continue to be volatile because of the uncertainty produced by the US election, the unrest in the EU, not only from Brexit but also from the massive refugee immigration, and the economic problems in Japan and in China. It would be reasonable to assume that the global problems would overwhelm the sluggish US economy and plunge the world into recession. However, we must not forget about the central banks. They stand ready to further reduce interest rates (more negative rates will be on the way) and the FED has indicated that their anticipated rate increase is pretty much off the table for 2016. Also, if the economies and markets get into trouble, more QE will begin to flow. The central bankers fear a recession and will fight it with everything they have at their disposal. Therefore, despite the volatility, we feel that the stock market will continue its sluggish path forward and avoid a major sell-off. As always we will monitor the global and economic events and respond to changes as necessary.