

# Investment Outlook June 2016.

## Ahead of Brexit.

China growth is also stabilizing but this has a cost in credit creation. The natural growth rate is slower in the new regime but the government cannot allow the economy to function there. As a result it is overstimulating the economy with side effects in commodities and real estate. These sectors will be very sensitive to Chinese policy and timing these markets will be quite difficult.

Japan is back in a difficult position. The sales tax has been postponed but this will not be sufficient. An outsized fiscal package is likely but this will only worsen the balance sheet. The BoJ will be drafted into more debt monetization. If the inflation target is to be achieved, another round of concerted fiscal and monetary policy will be needed.

The US economy is fundamentally on sound footing and we expect a pick-up in growth as spreads have stabilized. We also note that the manufacturing sector appears to have completed its pivot to a domestic audience. The poor employment number in May was an indication of a skills mismatch and not weakness in the economy. Wages are holding up, quits rates have recovered, initial claims have been subdued. Manufacturing PMI has been over 50 for 3 months now.

Oil prices have done very well this year. Oversupply peaked in January and has receded a little. At these levels we are seeing now a 3rd week of increasing rig counts. Oil prices should not rise any more from here. At these levels, however, HY defaults will still rise although the headline correlation will be reduced.

FOMC: Fed could not have moved even if it wanted to. The Fed's control is the Fed funds rate but the real economy funds

itself at market rates. Sell offs lead to spread widening and de facto tightening. Is a rate hike on July 27? It all depends on the market price of credit. If markets are well behaved, the Fed can act, if they are not, then the Fed cannot act.

The EU referendum is on the agenda. The polls have Leave in the lead by 43 to 42. The bookmakers have Remain in the lead by 65 to 35. We believe the bookmakers. Polls pick up what people want to do but bookmakers pick up what people intend to do. Negative voting has been prevalent in recent elections which have led to inaccurate polls.

Europe also looks to have been stabilized by the ECB but growth is fragile. A Brexit is going to hurt the EU. The UK is 17% of EU exports but the force of sentiment will have more immediate impact and could derail the recovery. We expect the impact on Europe could be greater than the impact on the UK. The UK economy is relatively strong compared with the EU and better able to absorb the shock of disengagement. If sterling weakens more, it could improve the UK's competitiveness. If the euro is also weak, and there are reasons to expect this, Europe may benefit also. This might achieve what QE could not, which was to weaken the euro.

Peripheral spreads will widen on Brexit but France and Germany and the ECB will most definitely move to strengthen the union. This would see peripheral spreads snap back quickly.

Liquidity is low in the summer and we have a number of events including EU referendum, Spanish elections, Republican and Democratic conventions, Japan upper house election, and the run up to the US presidential election.

Equity valuations are high. Apart from the US, fundamentals are still fragile. Credit spreads are tight. Sovereign yields are too low. The margin for error is very small. There will be some who hope the financial press can keep the Brexit flame alive, and even hope for Brexit, to bring markets lower. At

current prices there are few opportunities and one almost needs to shake the tree.

### **Is Brexit a globally systemic event?**

- How immediate is the problem? 2 year holiday.
- Contagion risk? European problem. Could escalate. EU exports to UK 17%. UK exports to EU, 45%. Exports to ROTW should not be affected. UK is 2.36% of world GDP. EU ex UK is 13% of world GDP. UK is not part of Eurozone. Not part of TARGET2.
- Sentiment risk? High in the short term.

For those with a high cash holding it is time to add some risk, pre EU referendum.