# THE ECONOMIC MONTH IN REVIEW AND OUTLOOK – JUNE

**US Markets and Economy**: Brexit! Markets around the world were hammered by the surprise decision of Great Britain to leave the European Union. Turbulence in America was brief, though: American stocks fell very sharply for two days, and then recovered all of their losses by the end of the month. This bounceback reflects the fact that the major damage of Brexit will be in Britain and Europe. The US may see some weakness in export demand from Europe as European economies weaken, but at the same time the financial shockwaves may lead the US Fed to postpone any increases in interest rates this year. In fact, capital flows out of Europe and elsewhere have driven US long-term interest rates to exceptionally low levels: the 30-year bond now yields 2.3%, near an all-time low. At the same time, these capital flows have pushed the dollar up sharply against the British pound and the euro, which will further brake the US economy, and keep inflation below the Fed's target of 2%. Both of these effects will make it more likely that the Fed will postpone interest rate increases.

Even though US real economic growth for the first quarter was revised upward to 1.1%, and the second quarter real growth rate should rebound to around 2.5%, 2016 is shaping up to be another year of subpar economic performance, which will likely stay the Fed's hand on the interest-rate tiller. While an unemployment rate of 4.7% in the latest report should stoke fears of economic overheating and rising inflation, there is no sign of either one. And the employment report showed a surprising slowdown in the number of jobs created in May, suggesting a possibly worrisome downshift in job growth.

As we said last month, the weak outlook for corporate profit growth, which puts a damper on market rallies, is in a tug-of-war with exceptionally low (and even falling) interest rates, which provide support for American stocks. Additional support for US stocks and bonds comes from the capital flowing out of Europe seeking a safe haven in the US. The tug-of-war may continue.

**World Markets and Economy**: Brexit caused more damage to stock prices in Europe, where the EURO STOXX 50 Index, a Europe-wide blue chip measure, fell 10% in just two days after the Brexit vote, and then recovered only about half of its losses by the end of the month. Paradoxically, the British FTSE 100 Index sold off less sharply than the EURO STOXX 50, and by the end of the month recovered more than it had lost. This strong British bounceback is all the more surprising since the country has been thrown into political turmoil: Cameron (Tory leader) has announced his resignation, Corbyn (Labor leader) lost a one-sided no-confidence vote among Labor MPs, and Scotland is threatening to block Brexit (unlikely) or vote again on seceding from Great Britain (likely). Some of the leading “Leave” supporters believe that the British will be able to trade freely with Europe after departure, but this is magical thinking. Europe will punish Britain for leaving.

As a result of Brexit and the concomitant economic and political uncertainty, The Bank of England (BofE) may now have to contend with a recession in Britain. The current reference rate for the BofE is 0.5%, which does not leave them much room to cut unless they are willing to go negative. The ECB, which is fully employed battling a weak European economy, is already using negative interest rates and Quantitative Easing, and must now contend with the economic costs of Brexit and the uncertainty of the exit process over the next two years. Nationalist movements in countries like France may now be emboldened to push for exit, which could spell the end of the European integration movement.

The Japanese stock market fell very sharply after the Brexit news, and the Japanese yen rallied as part of a “flight to safety.” The post-Brexit snapback rally in Tokyo was fairly weak, and left the Nikkei Index down 18% for the year. The underlying problem in Japan is that, in spite of heroic efforts, policymakers are unable to find the levers that will propel Japanese economic growth, which has been stagnant or worse since 1990. Strength in the yen, which weakens exports, will just make the task harder. Demographers will point to Japan’s rapidly aging and shrinking population, which may continue for decades, as there is almost no immigration to Japan. Although the evidence and the theories are still fragmentary, Japan may be the poster child for “secular stagnation,” a permanent slowdown in economic growth.

China’s economy will not be sharply affected by Brexit, but its internal momentum continues to slow. Slowing growth in world trade, and in particular, the possibilities of increased barriers to China’s industrial exports, like steel, could slow growth even further. **Fully half of the world’s steel production is in China.** With insufficient domestic demand and increasing stockpiles, Chinese firms must export at any price. This generates trade hostility in Europe and the US. The Chinese must cut production, close the least efficient plants, and lay off workers in all heavy industries. But this is much harder to accomplish in a state-run economy reliant on exports with no political freedom. At the same time, Chinese leaders must manage the international value of the yuan. These are not easy tasks even for market-based democracies.

**OUTLOOK:** The US bull market is still intact, having survived yet another sharp selloff. Although the corporate profit outlook in the US is cloudy, the interest rate environment will remain a strong positive for stocks. This tug-of-war will continue, and the pattern of sharp selloffs and rallies could persist at least until the November elections in the US. Meanwhile, upheavals in the rest of the world will keep US stocks and bonds the haven in times of trouble.