

Brexit Risk Indicators: One Week Later

July 1st, 2016



Although Britain's decision to leave the EU was a shock to markets globally, we believe that since last Friday, the markets have been telling us it is not a crisis. The Fed, ECB, and the Bank of Japan are taking action to immunize the world financial system from contagion, and we believe that the economic outlook remains stable – even if uncertainties abound.

- Risk indicators rose following the Brexit vote, but they did not rise to levels consistent with either crisis or more sustained market correction:
 - The CBOE Volatility Index (VIX), a measure of the implied volatility of the S&P 500, rose immediately after the vote. Although this reflected rising volatility and investor fears, it did not exceed levels seen in the early 2016 equity slump or the August 2015 market crisis induced by China's currency devaluation. It has fallen rapidly back to levels consistent with stable to trending markets.
 - Likewise, the MOVE Index, which reflects volatility in the Treasury market, rose after the vote. But it too has fallen from the peak levels of last week. It has settled to the bottom of a trading range that has existed since March 2015. Like the VIX, the surge in the MOVE was meaningful after the vote, but did not even come close to the early 2016 or 2015 levels.
 - Emerging Markets (EM) are often the weak link in the capital markets chain, and movements in Emerging Market currencies are often very telling about the character of risk-on and risk-off episodes. The JP Morgan Emerging Markets Volatility Index, which measures the implied volatility of these movements, made a very faint effort at a rally after the Brexit vote but has already fallen back to pre-Brexit levels.
- If risk indicators remain stable or begin to fall, we will increasingly expect that spread will outperform in debt markets, commodities will be stable to buoyant, and equity markets will likely be stable to ascendant.
- Falling rates, engineered by central banks (the bond marketplace is no free market), support current price to earnings ratios and continued economic growth. Stocks are like long duration instruments and rates are falling, which should support price appreciation as long as the earnings outlook remains stable.
- The US is near full employment, wages are beginning to rise, and consumers have the strongest balance sheets in years with ammunition to spend.
- We believe that the Fed will delay raising rates through the end of 2016. This will likely have the following consequences:
 - The safe haven rally in the dollar was brief. With the Fed on the sidelines, the dollar has begun to fall again.
 - A falling dollar mitigates the strain on EM economies that repay debt in dollars.
 - A weaker dollar should enhance the value of foreign earnings to large cap global franchise companies.
 - Commodity currencies will likely outperform.
- In fact, since the vote, 3 of the 4 best performing G-10 currencies are commodity-linked: The New Zealand dollar, Canadian dollar, and Australian dollar. They are all up in recent days. Given the likelihood that the British pound will fade ever more rapidly as a world reserve currency, we would expect these strong balance sheet, free market nations to be big beneficiaries of global reserve currency diversification.
- The market for Treasury Inflation Protected Securities is meaningfully outperforming nominal Treasuries today.
- Suddenly, inflation expectations are back on the rise. The market has finally come to anticipate a firehose of liquidity about to hit the markets

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