MONTHLY BAROMETER
PRESCIENT & SUCCINCT ANALYSIS OF WHAT'S OUT THERE

June 2016

- Britain's decision to exit the EU may constitute the first step on a **"stairway to Hell"**, throwing up a tangle of economic, financial, societal, legal, political and other issues of unfathomable complexity. **The divorce will take years to play out and its consequences are unpredictable**, ranging from the destruction of the EU to its exact opposite: a strengthening (more likely). Irrespective of how it evolves - including the remote possibility that it is reversed by a general election and a 2nd referendum or that Article 50 is never invoked -, Brexit is: (1) A major blow to Europe that puts 60 years of integration and expansion into reverse; (2) A warning to established political parties across liberal democracies; (3) The expression of a revolt against globalization and austerity.
- Having asserted in February that the Brexit risk was underestimated, we changed our view in May as prediction and betting markets were giving the "remain" camp a 70+% chance of success. *Mea culpa*! The fact that the markets, experts, politicians and all (including us) got it wrong calls for much humility. This caveat in place, what can we anticipate with a reasonable degree of confidence? (1) **Protracted uncertainty** (which investors hate) and market volatility, (2) The **EU stance vis-à-vis the UK will not be punitive but unforgiving** (so as not to encourage others), (3) The EU will do everything it can to prevent financial and political contagion (as it did in 2010 - 2012 when there was a quasi-absolute consensus that the Eurozone would implode), (4) **The next UK government risks being overwhelmed by the scalability problems** of negotiating the exit terms, dictated by the EU.
- The main economic and market consequences of the Brexit are the following: (1) a much weaker GBP – a stimulative safety valve that won't prevent deteriorating economic growth and current account deficit, **with a UK recession likely as soon as in Q4 of this year**; (2) a weaker EUR and a stronger USD; (3) a boost to $ assets in general; (4) a negative shock for European banks; (5) flattening curves for sovereign bonds – with the exception of peripherals; (6) **likelihood of a Fed hike in 2016 sharply diminished.**
- **The World Bank just downgraded its global growth forecast for 2016 to 2.4% from the 2.9% estimated in January**. This is due to (1) low commodity prices, (2) sluggish demand in advanced economies, (3) weak trade and diminishing capital flows; and more generally to an enduring sense of global uncertainty and retrenchment. This is reflected in decreasing global FDI (foreign direct investment) flows. In the first 4 months of this year, the value of cross-border M&A fell by 21% compared to the same period last year.
- Over-optimism is not the preserve of international organizations. It exists among central banks as well. Two years ago, for example, the median projection among Fed officials put the interest rate at 2.5% at the end of 2016. A year ago, they revised it down to 1.68% and now to 0.9% (while the markets expect a bit more than 0.4%). **It seems like the US is moving towards a chronic low inflationary, if not deflationary, outcome.** The return to normality (higher interest rates) may not happen because normality is a thing of the past…
- The point above and the recent Fed decision not to hike interest rates show how hard reversing QE will be. This is not plumbing – fixing a few pipes here and there and reversing the flow, but a **fiendishly complex process fraught with uncertainties and affected by market emotions**. When it takes place, it will lay bare the dislocations created by easy money and will assert the **primacy of investing in real assets rather than financial ones**.
- The Brexit decision revealed and reinforced the societal rift between generations, fuelled to an extent by **inter-generational inequality – now an extra layer on top of income inequality**. A majority of older voters supported "leave" while a majority of younger voters supported "remain". In an increasing number of countries around the world (not only in the West but in China and elsewhere too), ageing means that there are fewer working-age people to support retired citizens. This in turn lowers consumption growth and restrains aggregate demand.
- In a recent testimony to US Congress, Janet Yellen (the Fed Chairwoman) confided that **slow productivity growth is a major economic headwind that could endure**. On many occasions, we've expanded on the possible economic reasons behind declining productivity, but haven't yet mentioned a contributing psychological factor. Evidence from research shows that **our tech addiction and social media dependency increase our stress at work** and negatively affect our productivity. Put simply: our "always-on" culture is distractive and counter-productive. Measures to address the problem range from companies' strategy (such as including wellbeing policies in the workplace) to simple measures (like checking emails only a few times during the day).
- **Automation, robotics and 3D printing fuel the emerging trend of "inshoring":** Western companies abandoning global supply chains by bringing production back home (or close to home). Consequences are far-reaching. This will: (1) cause "premature deindustrialisation" in some emerging economies dependent on exports' manufacturing to prosper; (2) impact employment, and possibly social stability, in low-income countries like Bangladesh or some African nations such as Nigeria, Kenya or Madagascar.
- Fintech is now penetrating the conservative realm of central banking. For the first time, non-bank providers of payment services like PayPal or Apple Pay will be able to access the RTGS (Real-Time Gross Settlement Service) of the Bank of England, which is also looking at how the distributed ledger technology (used for Blockchain) can make the RTGS more resilient. This is one further concern for commercial banks at risk of being disintermediated: **the days when a central bank introduces a digital currency are coming closer.**
- In the coming weeks, "must-watch" issues include: (1) Brexit – with the ramifications of buyer's remorse, the possible "EU populist exit" contagion (overstated in our opinion) and the many downside risks it entails (chief among them: a stronger $ and its negative impact on EM and commodity prices), (2) China: another, less visible, epicentre of global economic and financial stress whose corporate debt (at 237% of GDP in Q1) continues to grow; (3) continued pressure on overleveraged EM; (4) the extent to which structurally lower commodity prices affect resource-rich countries, (5) the vast array of growing, market-moving, geopolitical and societal risks. **For real-time and in-depth analysis on any of these, please contact us.**