Lincolnshire
COUNTY COUNCIL
Working for a better future

:
Regulatory and Other Committee

Open Report on behalf of Executive Director of Finance and Public Protection	
Report to:	**Pensions Committee**
Date:	**07 April 2016**
Subject:	**Independent Advisors Report**

Summary:

This report provides a market commentary by the Committee's Independent Advisor on the current state of global investment markets.

Recommendation(s):

That the Committee note the report.

Background

INVESTMENT COMMENTARY

April 2016

Market panic over – or worse yet to come? Brexit a factor?

As members will be well aware, 2016 started off with the equity markets around the world falling sharply. The FTSE 100 Index fell over 10% from its year end value to its low point in mid-February and the US market almost as much. Why was this? The trigger point seemed to be growing anxiety about the state of the Chinese economy – though this was hardly a new thought. A consequence of weaker Chinese growth, the argument went, would inevitably be reduced demand – and hence prices – of commodities, such as oil, iron ore and copper. And there would an impact on global economic growth generally and anxiety about the financial health of some highly geared global companies such as mining and oil stocks. Some international banks also came under scrutiny. In the UK, the increasingly frantic “debate about Brexit” – Britain withdrawing from the European Union – was clearly also a negative factor.

And yet, in mid-February, equity markets turned on the proverbial sixpence and have recovered sharply. They are still down, year to date. But Wall Street, for example, is now down only about 3% for the year. The assault by banking regulators on global banks, especially their market making activities in equities and

bonds, has made prices of even the very largest stocks more volatile. Probably, the initial trigger for equity price weakness in early January was short selling by hedge funds, which was not matched by buying from long term "long only" funds. The fall then became self-feeding - as has the subsequent recovery. Some very large mining stocks have almost doubled since their low point. Commodity prices have also seen a significant recovery; oil, which was at $27 per barrel at one stage, has recently been over $40.

On the economic and financial front, the news has been mixed; but the US economy still seems to be growing as anticipated. Elsewhere around the world, the economic news has tended to disappoint. Central Bankers, with the exception of the US Federal Reserve, are thus likely to err on the side of caution and keep markets adequately supplied with liquidity. The European Central Bank, for example, recently announced another generous package of easing measures to help banks and boost the European economy. Global equity markets could well trade within quite narrow bands. It is doubtful that they can breach the high points of the first quarter of 2015, absent a flow of optimistic news; the sharp turnaround of equities in mid-February this year, is likely to provide a floor at that level. The major uncertainty that remains, especially for the UK markets, is around Brexit, the debate leading up to the June referendum, the result of the vote, and then (supposing the vote is to withdraw) the two years allowed for a renegotiation with the EU.

Brexit – some thoughts

Recent opinion polls, taken after the conclusion of the Prime Minister's renegotiations with the EU and the calling of the June referendum, point to a "neck and neck" outcome in the referendum, but with a large number of undecided voters. The betting market (which has a better track record than opinion polls, especially recently) puts the likelihood of UK withdrawal as low as 25%.

Any renegotiation following a no vote would centre around terms of trade. Interestingly, the UK is more important as an export market for the EU than the EU is to the UK (as a percentage of GDP). Germany has a particular bias towards the export of cars to the UK. The UK's largest individual export market is the USA. So, the UK would have some negotiating strength. The biggest hurdle to UK exports would be agricultural products where the Common Agricultural Policy imposes high tariffs on EU imports. There is probably little leverage here.

Some commentators have advocated the adoption of one of the two existing trade models with the EU: that of Norway in the European Economic Area ('EEA") and Switzerland in the European Free Trade Agreement ("EFTA"). Neither seems attractive. Both demand the payment of some contributions into EU budgets. They require adherence to many EU regulations whilst providing no part in influencing new ones. Crucially, free movement of labour is required – surely a line in the sand for the UK?

As to the impact on the UK's rate of economic growth, were it to withdraw from the EU, there is no unanimity amongst economists. The range appears to be from minus 2% to plus 1% per annum, and heavily dependent on the exact outcome of

the negotiations over exit, during the two year period after the referendum outcome. What is clear is that uncertainty, both for equity and bond markets and for the £ sterling, would increase. This in itself must have negative consequences, at least for a year or two.

As to individual companies, the effect is very stock specific. Multinational companies with large interests in Europe obviously favour the status quo. Smaller companies, especially those whose business is entirely UK, are more like to consider exit.

The minds of voters, when they come to the ballot box, are likely to be focussed on immediate issues; the most important is likely to be immigration. What might well be absent from discussion are the long term prospects (ten years, say) of the EU on the one hand and the UK on the other. Some factors are probably enduring: the EU (especially southern Europe) has a population that is ageing more quickly than the UK and will result in its long term economic prospects being worse than the UK. The EU is less competitive and shows a greater reluctance to change and innovate. It is committed to a generous social security model, when the rest of the world is not. No less a personage than Angela Merkel has commented that the EU has 7% of the world's population, 25% of world current GDP (and falling) and around 50% of global social security payments. The potential for the UK to grow faster in the long term outside the EU (even though it is not in the euro currency) is probably indisputable. Is the decision to be purely decided on economic merits or on wider social factors? Every voter will have his or her own views.

How the balance of advantages of exit and disadvantages (for there are both) will work out in the coming years is impossible to judge at this stage. Unless the vote is to stay in, it will be many years before voters and stock markets can reach a definitive conclusion.

Peter Jones
12th March 2016.

Consultation

a) Policy Proofing Actions Required

n/a

Background Papers

No background papers within Section 100D of the Local Government Act 1972 were used in the preparation of this report.

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