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:	**14 July 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

July 2016

Markets completely wrong footed by Brexit outcome

Members will be well aware of the violent moves in both currency and security markets on 24th June, the day of the Referendum result announcement. My own view is that such extreme volatility is explicable with the realisation that that markets had become committed, by the time the polls closed on polling day, to the virtual certainty that the Remain vote would prevail. Remember too that a number of investment banks and hedge funds had commissioned their own private exit polls - which presumably were similar to the public polls announced after voting closed. If almost the whole market were thus wrong footed, irrational and extreme price and currency moves should have been expected. Since the increase in financial regulation following the Lehman crisis, the amount of market making capacity is much smaller, thus exaggerating price moves – in either direction.

That said, when viewed over the week as a whole, most major securities markets around the world were not greatly changed, being in a range of roughly up 2% to down 2%. No real issue there. The stock markets of southern Europe and

Emerging Markets were among the worst affected. The single exception was the value of sterling, which fell sharply and failed to recover the bulk of its fall. The fall in sterling is, of course, beneficial for most FTSE 100 companies (with their large overseas interests) and for UK exporters.

Writing so soon after the result was announced (27th June), risks making comments, which could soon be shown to be unwise or just wrong. Large price swings in short time periods can generate losses for short term investors (who may be using borrowed money) and lead to their insolvency. The coming days will see if any such failures emerge – which could further damage market sentiment.

Uncertainty and markets

Markets traditionally hate uncertainty – from whatever quarter, especially economic and political. The re-negotiations under Article 50 of the Treaty of Lisbon will probably be measured in years rather than months. And then there will be the two years during which the actual withdrawal takes effect. Perhaps more problematic is politics. Certainly UK politics; it is not clear to me that a Conservative "Brexit dominated" government can secure a durable working majority in the Houses of Parliament. The Lords is even more problematic. I have little doubt that the will of the people will be respected. But both the Conservative and Labour parties are divided. And the Scottish National party has a sizeable number of MPs. Another coalition government may be the way forward? And what about European Union politics of the remaining 27 member states: how might they develop?

Hence, markets will need to come to terms with the lower levels of clarity about future trends. Traditionally, the greater the uncertainty, the lower are equity prices and the higher are government bond prices (i.e. yields lower). None of this, of course, is favourable for pension schemes and other long term investors. This is a huge and largely unexpected change in prospects for which markets will have to come to terms, in the coming weeks and months.

What has not changed?

Global economic growth continues to be lacklustre, almost everywhere except the USA. There, Q1 2016 was below par, perhaps reflecting seasonal factors, but the second quarter seems to have seen stronger growth, prompting suggestions that the US Federal Reserve may feel able to increase short term interest rates during the second half of 2016. Surprisingly, Japanese growth has exceeded admittedly pessimistic expectations. But elsewhere, including the important Chinese economy, the news has disappointed. Amongst the investment community (and no doubt elsewhere as well), this is generating an air of pessimism. Eight years after the Lehman crisis, a concerted and unprecedented effort by Central Banks around the globe has not succeeded in producing robust economic growth in the developed world. The head winds have been too strong – in the main due to deteriorating demographic trends and to debt levels (both government and consumer), which are too high and seemingly intractable.

What could change?

It is common knowledge that the UK economy has seen a significant slowdown in economic growth in the last six months; most commentators attribute this to the heightened uncertainty caused in the run up to the Referendum. This factor certainly seems to have led to capital investment decisions being postponed, awaiting the outcome of the vote. It seems unlikely that the UK economy will now regain its healthy growth rate of over 2.5% per annum that was seen in 2014 and early 2015. If the vote had been to Remain, no doubt there would have something of an economic “rebound”. That now seems unlikely. A significant number of investors and economists now expect a recession in the UK in 2017. That seems to me to be pessimistic. But there is little doubt that the UK exchequer finances, which were already under pressure before the vote, will deteriorate under the increased uncertainty.

Could the European Commission, the Brussels bureaucracy and the European Parliament be so shocked by the referendum vote into initiating changes to make the EU more efficient, more capable of competing in world trade and more democratically accountable? Perhaps not. Their efforts are likely to be focussed on ameliorating the refugee crisis and to resolving (if they can be) significant philosophical differences around austerity between Germany and northern Europe on the one hand and Greece, Spain, Italy etc on the other. And there is the Greek financial crisis still lurking in the background.

What has changed?

Quite the most significant feature has been the rebound in the oil price, recently trading as high as $50 a barrel; it was briefly below $30 in January. Other commodity prices have also been firmer. There are signs too that inflation in the USA and the UK is picking up, with 2% inflation possible in 2017. This would be welcome turn of events, especially if it reflected more robust labour markets and higher wages. It would also commence the long road to reducing the real value of the debt mountain referred to earlier. In normal circumstances, fears of rising inflation would lead to a sell off in bond markets, i.e. rising yields. So far, this has not been the case. In 2016 to date, bond markets have risen and are holding onto their gains.

Market prospects

Equity markets around the world are quite close to their all time highs, despite post Brexit falls. With the possible exception of the USA, this hardly seems justified by the relevant economic prospects. And bond markets look fully valued, especially if inflation is moving upwards, albeit modestly. I do not see much upside to any market and continue to see them trading in quite narrow bounds. The downside risk is surely the greater.

Peter Jones
27th June 2016

Conclusion

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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