Brexit: Investing Implications

Posted: 6/27/2016 by Jurrien Timmer, Director of Global Macro, Fidelity Viewpoints

Brexit may be a sign of deglobalization, could help keep rates low, and lead to more fiscal stimulus.

I see the United Kingdom's decision to exit the European Union, known as Brexit, as one theatre in a larger referendum on globalization, or rather anti-globalization. The U.S. presidential election is another example. I see it as a backlash against the persistent sluggish economic growth of the post-financial crisis era. When growth is strong, imbalances (such as excessive debt and wealth inequality) can be more easily papered over (the rising tide lifts all boats), but when growth disappears the problems bubble up to the surface.

If globalization is peaking, then it seems likely that global growth will remain sluggish for some time. At the same time, as the labor arbitrage (shifting of jobs to lower-cost regions) of the globalization era goes into reverse—or at least diminishes, we could see inflation pick up and productivity growth decline.

Slow growth plus inflation is also known as stagflation. It's safe to say that stagflation could be a serious headwind for both corporate profit margins and stock valuations.

Deglobalization and the stock market

It's hard to see how deglobalization would be bullish for price-to-earnings (P/E) multiples or earnings growth. If earnings growth slows, profit margins shrink, and inflation rises, the market's P/E-multiple will have to come down without much offset from earnings.

Therefore, it's hard for me to see how the market can make much progress to the upside over the near term. So, my base case is that the S&P 500® Index will remain in its trading range of 1,800 to 2,130 for some time to come.

Fortunately for U.S. investors, the fallout is likely to be more limited than for investors in Europe. After all, the U.K. economy is only 4% of global gross domestic product (GDP) and the U.S. economy is relatively closed with the export sector comprising only 13% of GDP.

The S&P 500, of course, is much more global, with more than 40% of earnings and revenues coming from outside the U.S. So, as has been the case lately, the stock market has been more sensitive to global shocks than the U.S. economy.

Many are also wondering if Brexit will lead to other similar referenda across Europe. If so, it could lead to questions about the viability of the euro. Another question is whether Brexit will change the dynamic of the U.S. election, in favor of the anti-establishment movement.

The end of the Fed cycle?

A positive offset to the Brexit shock is the likelihood of a more dovish Fed. In fact, the Fed funds futures curve is now pricing in an equal probability of a rate cut and a rate hike in December. It's amazing how quickly and dramatically the odds of a Fed rate hike can get rerated. Basically the market is declaring the Fed rate-hiking cycle over and done.

If the Fed listens to the market, this rerating should decrease the risk of a policy error, that is, overtightening. Of course, a policy error could also happen if the Fed doesn't ease quickly enough. But at this point, I don't see how Brexit will lead to a U.S. recession. And without a recession there is no need for the Fed to ease policy.

A more dovish Fed should keep a lid on the dollar, which should be bullish for stocks. However, if the market starts worrying that the euro will eventually come under attack if referendum fever goes viral throughout Europe, then that would be dollar bullish, which would be bearish for stocks because it leads to a tightening of financial conditions.

So, the currency side is tough to figure out here. Either way, gold could do well, as well as other forms of inflation protection, such as Treasury inflation-protected securities (TIPS).

Encouraging intermarket signals

Looking at the market reaction to Brexit on June 24, I am encouraged by how well the commodity complex did, as well as U.S. corporate bonds (which barely budged).

Energy and corporate bonds were the leaders on the way down and the way up. So the fact that crude oil and high-yield bonds are near the very top of their 50-day range, while the S&P 500 is at the absolute bottom, is a constructive sign.

Global fiscal stimulus

Amidst all the uncertainty, one thing is clear to me: We are heading towards a period of increased fiscal stimulus, that is, federal government spending and/or tax cuts. With monetary policy (Fed rate cuts) having done most of the heavy lifting over the past seven years, and with central banks increasingly out of ways to stimulate further, I believe the focus will shift increasingly to fiscal policy, especially if the political pendulum swings further towards populism.

The U.K. may well be the first country to go down this route, with the U.S. not far behind regardless of who gets elected in November. Increased fiscal stimulus (if done right) should provide a boost to nominal growth, and could offset the negative headwinds of deglobalization to some extent.

An opportunity for active management

To me this kind of regime shift should be an opportunity for active management, since there should be more dispersion in performance between industries with pricing power and those without.

Either way, for the typical investor it is important to stay the course: Have a plan and stick with it. Don't be your own worst enemy by reacting emotionally. Your investment mix should be based on your time horizon, financial circumstances, and risk tolerance.

So, my suggestion for the typical investor is this: If your plan was the right one the day before Brexit, it is still good the day after.

About the expert

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