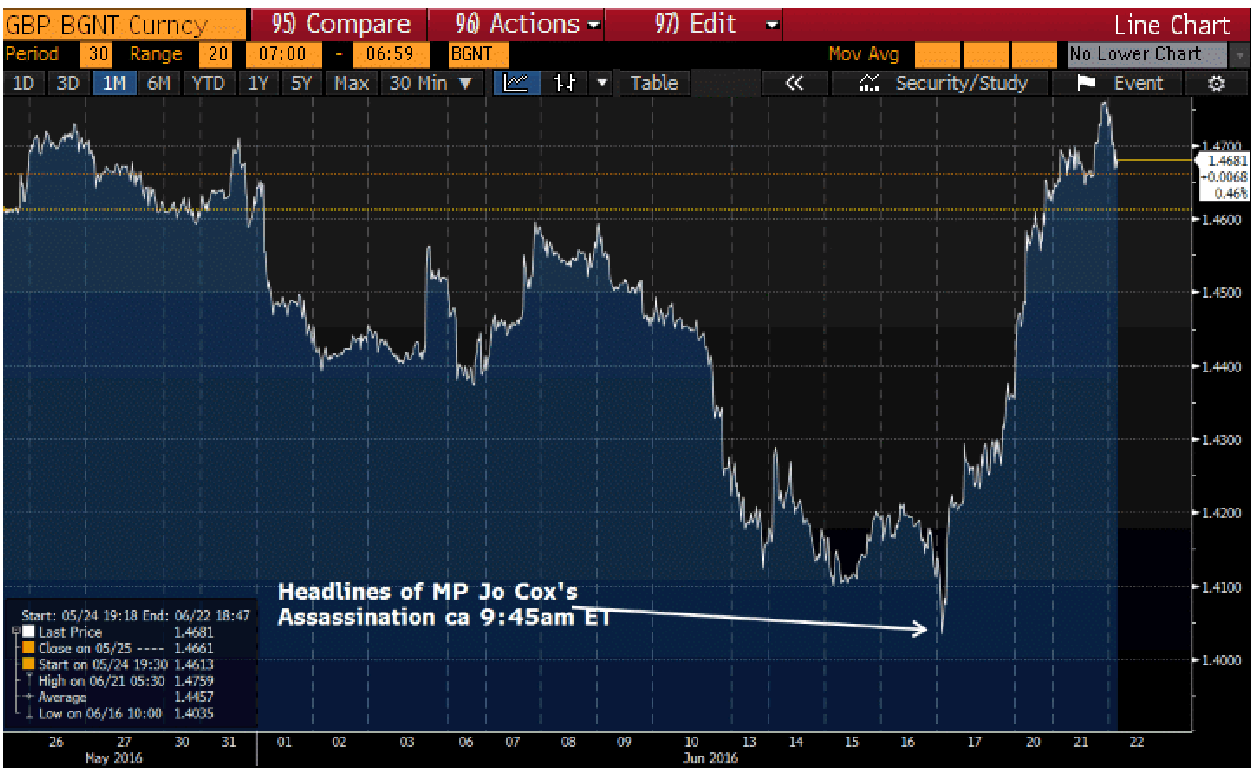
**June 22, 2016**

## Brexit, Fed, Trade & Market Outlooks

**Brexit:** According to the latest polls, Thursday's UK referendum on its EU membership is a toss-up. Although financial markets have been relatively dull and stagnant in recent months Brexit momentum beginning in late May, fueled by worries over immigration and security, have unnerved investors in recent weeks. But the assassination of MP Jo Cox last Thursday led to a resurgence in Remain odds, which then stunted the momentum of the Leave camp and helped return global markets to a more risk-on footing.

As one can see in the chart below, risk-taking appetites re-emerged in the pound within minutes of the news, sparking one of the pound's biggest intraday rallies in modern history.




Betting markets now suggest a 71% probability of Remain winning tomorrow's referendum. We believe the Remain camp will prevail; in which case we expect the trends in place since June 16 are likely to continue, namely Treasury prices to sell off (yields will rise) with the 10-year yield jumping to 1.80%, gold to fall to $1220, and the S&P 500 to jump by 1-2%. This risk-taking adjustment in markets would probably occur within the span of one to three trading days.

We would not be surprised, however, to see Leave pull off the upset. Odds-makers acknowledge that most of the bets side with Leave, as “the average stake on a bet to remain was £450, compared to £75 on a bet to leave."

The two positions now boil down to this. Remain: the experts say Leave will lead to recession. Leave: this is about sovereignty and controlling immigration.

Certainly watching Sunday’s townhall in Britain where audience members savaged Prime Minister Cameron, Remain has no good answers on immigration. While Cameron said on Monday that he does not see Turkey joining the EU for 30 years or during his lifetime, Agence France Press reports that EU accession talks with Turkey are set to commence on June 30. Meanwhile, former Prime Minister John Major admits Turkey could join within a decade. Such last minute revelations have the power to swing voters in the other direction.

If the Leave camp succeeds we imagine a quick retracement of the risk-on move in global markets since June 16. We would likely see the pound weaken below $1.40/£. But we are not buying the doom and gloom scenarios of a Brexit, such as a 20% equity sell-off suggested by George Soros.

First, we expect the BOE to work with the ECB and all other major central banks to avoid any liquidity crunches. Secondly, a pro-Brexit outcome does not mean that a divorce will occur overnight. Technically, it only begins once the UK formally notifies the European Council of its intention to leave the union, at which point a two-year process will begin. Even Brexit leaders are not envisioning wrapping up negotiations before 2019. Some in the EU have suggested seven years or more. And the negotiation period could be extended for an indefinite period with the agreement of the other 27 EU members. With such a long lead time, it’s fairly obvious that a Brexit vote does not mean the UK is on an irrevocable road on the way out.

In fact, Brexit would be just the sort of rebuke Chancellor Merkel needs to force her to amend her open-borders, austerian policy leadership for Europe. Any such shift would boost the Remain side over time.

**Yellen Testimony:** The most important “reveal” from Chairman Yellen’s testimony before the Senate Finance Committee yesterday was her statement that the Federal Reserve is watching to see “whether”, rather than “when”, the economy would show clear signs of improvement. This is further evidence that the FOMC is not in a rush to raise the federal funds rate.

We lambasted the FOMC and its hawkish policy trajectory in late 2015, early 2016 blaming it for the market turmoil and threatening to push the economy into a deflationary recession. And we forecast that the Fed would ultimately relent and concede to the market, leading to a major market rebound. There is no question that the Fed, which is full of economic voodoo technocrats who have countless models and policy prescriptions, ultimately operates under a "market standard."

The most important revelation to investors and markets from the Fed this year has been the acknowledgement by St. Louis Fed President Bullard that he (and really Fed policymakers at large) underestimated the market's reaction to the two to four rate hike telegraph for 2016. Given the lessons learned about the fragility of the global economy and the degree to which markets will allow Fed rate increases, the near-term modus operandi for the FOMC will be to only telegraph the possibility of single rate hikes. A slow and steady, truly data-dependent rate hike regimen is the approach for the time being. Or we should say, market-dependent rate hike regimen.

**Trade Outlook:** It is abundantly clear from the popularity of Donald Trump and Bernie Sanders, the opposition to the TPP from the top four contenders to become the next U.S. president (Clinton, Trump, Sanders and Cruz), and the Brexit referendum and discord within the EU, that trade policy and global integration policies will shift in the coming years.

To varying degrees, whether we emerge with a Democratic or Republican White House, we believe U.S. trade policy will shift from promoting integration to managing its consequences. International trade agreements will be gradually replaced by international harmonization agreements, where labor and environmental protections will be the focus rather than empowering foreign producers. This may also include surcharges on countries dumping goods, running excess trade surpluses, or egregiously providing subsidies to domestic industry (e.g. tax holidays, free land, and training and capital grants). We expect to also see more pressure to punish or counter perceived currency manipulation. The upcoming years for trade policy could very well be a non-event, but certainly they create risks and uncertainties for financial markets if policymakers do not handle with care.

**Stock Market Outlook:** Our outlook remains the same: neutral equities. We went neutral on the S&P 500 on April 6 near 2067. Since then, the S&P has traded within a -1.25%/+2.3% range.

**Bretton Woods Research**