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# Looming Brexit vote keeps markets on edge

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**Article Highlights**

- European and U.S. stock indexes falter amid intensifying Brexit fears.
- Reduced risk appetite and the search for yield benefits Treasuries.
- U.S. economic data is broadly positive, providing further evidence of a stronger Q2.
- Although the S&P 500 Index would likely fall sharply if U.K. voters choose to leave the EU, a recovery to new highs this year remains in scope.
- The Fed's lack of action and dovish rhetoric lead us to believe that only one interest-rate hike—in December—will occur in 2016.
- "Lower-for-longer" rates should support U.S. high-yield corporate bonds and emerging-markets debt.

## Equities

With the Federal Reserve holding the line on interest rates at its June 14-15 meeting and expressing uncertainty about when it will raise rates next, fears of a British exit ("Brexit") from the European Union (EU) continued to grip equity markets. Additional TIAA perspective on the Brexit vote is available **here**.

In the U.S., the S&P 500 Index was on pace for a loss of about 1.1% in a volatile week. Europe's broad STOXX 600 Index fell 2.1% in local currency terms, its third consecutive one-week decline. Eurozone economic data releases were mostly positive, however, industrial output rose in April for the first time this year, led by robust demand for consumer goods, and exports jumped in April. On the down side, inflation remained stubbornly low.

Japanese stocks fared far worse. Amid the Brexit-fueled uncertainty, investors rushed to buy yen—considered a safe-haven currency during times of economic stress—driving it to a two-year high of ¥104/dollar. This weighed on the exporter-heavy Nikkei 225 Index, which plunged 6% in local terms. In China, equities lost 1.4% for the week. Chinese markets were disappointed by the news that MSCI will not include China “A” shares in its widely tracked emerging markets index.

Current updates to the week’s market results are available here.

## Fixed income

This risk-off environment drove higher demand for U.S. Treasuries. After starting the week at 1.64%, the yield on the bellwether 10-year U.S. Treasury note moved lower as Brexit opinion polls suggested the “leave” camp was gaining traction ahead of the June 23 vote. The 10-year yield ended the week at 1.61%, just above a four-year low. (Yield and price move in opposite directions.) Treasury buyers included Japanese insurers and asset managers seeking alternatives to the ultra-low yields available in Japan.

Returns for most non-Treasury “spread sectors” were broadly, albeit modestly, positive for the week through June 16. Fund flows into high-quality U.S. bonds, specifically investment-grade corporate securities, were positive, while outflows and a drop in oil prices (spurred by concerns over weak global growth) hurt high-yield corporate bonds.

## Generally positive economic data continues to point to an improving second quarter

U.S. data releases were mostly positive, with both consumption and inflation gathering pace. Meanwhile, manufacturing posted mixed results. Among the week’s releases:

- **Retail sales** exceeded expectations by rising a solid 0.5% in May. Importantly, April’s impressive reading (+1.3%) was not revised downward. This report provides additional evidence that second-quarter consumption growth is holding up, and that the first quarter’s boost in wages has translated into stronger consumer spending.

- **U.S. consumer** prices increased 0.2% in May and 1.0% compared to a year ago. Stripping out volatile food and energy costs, so-called “core” inflation rose 0.2% in May and a healthier 2.2% over the past 12 months, suggesting that underlying pricing pressure exists.

- **Small-business sentiment** edged up in May, as measured by the National Federation of Independent Business Optimism index. Confidence about business conditions was tempered by declining expectations for capital outlays.

- Following four straight months of unchanged readings, **homebuilder confidence** improved in May, according to the NAHB/Wells Fargo Index. Overall, builders believe that job and economic gains should keep the housing market moving forward at a modest pace for the remainder of the year. **Building permits**, a forward-looking indicator, jumped 0.7% in May, while **housing starts** dipped 0.3%.
- **Regional manufacturing** gauges rebounded in May after slipping in April, with both the Philly Fed and Empire State manufacturing indexes topping forecasts. Disappointingly, **U.S. industrial production** fell 0.4% in May.
- **First-time unemployment claims** climbed by 13,000, to 277,000, while the less-volatile four-week moving average was essentially unchanged.

## Outlook

We expect equity market volatility to persist leading up to the Brexit referendum. If U.K. voters elect to leave the EU, the S&P 500 Index will likely move sharply lower in the near term but then recover, as other markets appear to have priced in the perceived risks of a Brexit. In currency markets, for example, the British pound fell to 1.38 versus the dollar in March, the same level seen at the height of the financial crisis in 2008, and continues to trade at low levels.

Europe’s continuing recovery and Japan’s surprising first-quarter GDP growth (+1.7%) have contributed to a weaker dollar, a boon to U.S. exporters and the S&P 500. A weaker dollar also reduces the likelihood that Beijing will engineer another round of currency depreciation, which led to market turmoil and instability earlier this year and last summer. For these reasons, we still expect the S&P to reach new highs over the next 12-18 months.

In terms of the U.S. economy, wages are finally rising, consumption has picked up, and inflation is starting to increase, all of which are prerequisites to stronger economic growth and to further Fed rate hikes. At the same time, we have yet to see a confirming trend in the data suggesting that GDP will accelerate beyond the current recovery’s 2% average annual rate.

As for the Fed, we were surprised by Fed Chair Janet Yellen's dovish tone at her post-meeting press conference on June 15. She seemed less confident about economic growth, in contrast to the optimistic view expressed in the Fed's April meeting minutes. Yellen's focus on the slowdown in labor markets and preliminary wage increases during the first quarter—which she is not convinced will continue—suggests that the Fed is now emphasizing near-term data and sentiment in its policy decisions, rather than longer-run data trends. Against this cautious backdrop, we do not expect a rate hike until December.

Bond markets should also experience increased near-term volatility. Longer-term, the Fed's decision to dial back its tightening timetable should be bullish for U.S. high-yield corporate bonds and emerging-market securities, as companies can refinance and service debt denominated in U.S. dollars more inexpensively.

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