*For the week ending 1 July, 2016*

# One and Done

The Brexit, while initially feared by financial markets, will now likely fall in line with the other current negative economic factors (risk of Chinese hard landing, weak U.S. jobs growth, deflationary forces, etc). As investors know, anything negative for the economy is positive for risk assets.

Equity investors are therefore using the Brexit volatility to add back to positions in risk assets. The equity rally back up to pre-referendum index levels has been just as powerful as the down-draft following the surprise election results last Friday. Asset managers have evoked several reasons to rationalize the purchase of equities in the wake of an unfavourable Brexit result.

- While undeniably there is a political risk, it is not yet clear if it will become a financial risk.
- The British government has not yet invoked Article 50. Some are even speculating that the U.K. will not leave. In the event that the EU exit clause is enacted, the U.K. will still remain within the EU another 2 years, so markets need not panic today.
- Central bankers have learned the policy lessons from the 2008 crisis. As a result, the Fed, ECB, and Bank of England have promised to inject enormous amounts of liquidity to calm markets.
- Lower for longer. No major central bank has any near-term or intermediate-term plans to hike rates. This is the fuel that drives equities higher. Some are even talking of a QE 4 from the Fed.

We remain skeptical at this point on any equity rally based upon factors that force central banks to ease monetary policy, as we discuss below. Brexit is nothing more than another central bank policy constraint. Betting that the Brexit will not occur after all is said and done, betting that the political fallout won't affect the financial markets, or betting that the U.K. push for independence won't lead to contagion and inspire populist movements in other EU nations is all pure speculation today. As such, **with the ebb and flow of speculation surrounding the Brexit fallout, expect schizophrenic market movements to continue**.

The bond markets, meanwhile, are not buying into the speculation of a "non-event Brexit". Traders have been driving yields towards record lows due to the uncertainty caused by the Brexit. The yield table below confirms the bond market's negative economic outlook.

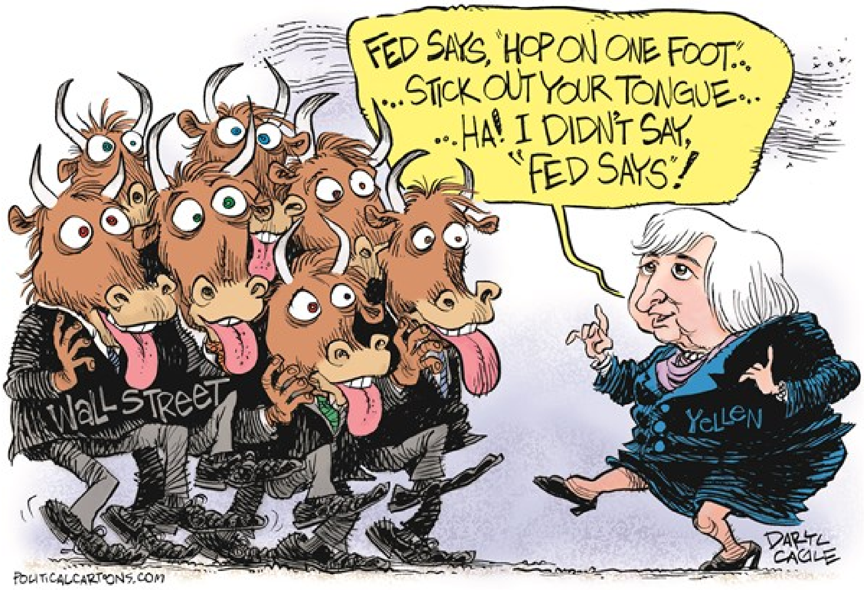
| 10-Year Government Bond | June 27, 2016 | December 31, 2015 | YTD |
|---|---|---|---|
| U.S. T-Note | 1.44% | 2.27% | -83 bp |
| German Bund | -0.12% | 0.63% | -75 bp |
| French OAT | 0.29% | 0.99% | -70 bp |
| U.K. Gilt | 0.94% | 1.96% | -102 bp |
| Italian BTPs | 1.51% | 1.60% | -9 bp |
| Japan JGBs | -0.19% | 0.27% | -46 bp |

If Brexit is indeed a longer-term issue, and the next recession is on the horizon, rates won't go up for a very long time. While Treasurys are overvalued, we see less risk in holding positive-yielding U.S. debt than risky, overvalued equities.

**Can We Please Stop Listening To The Fed?**

Last week's semi-annual testimony by the Fed Chairman to Congress (Humphrey Hawkins testimony, for market veterans) gave more confirmation to what we have been writing about for a while: the Federal Reserve has lost control of the ship. Janet Yellen made a 180 degree turn in her monetary policy forward guidance, affirming that the Federal Reserve might have to postpone any interest-rate increase due to weakness in the US economy. In prepared testimony, Yellen stated in front of the Senate banking committee that "the latest readings on the labor market and the weak pace of investment illustrate one downside -- that domestic demand might falter".

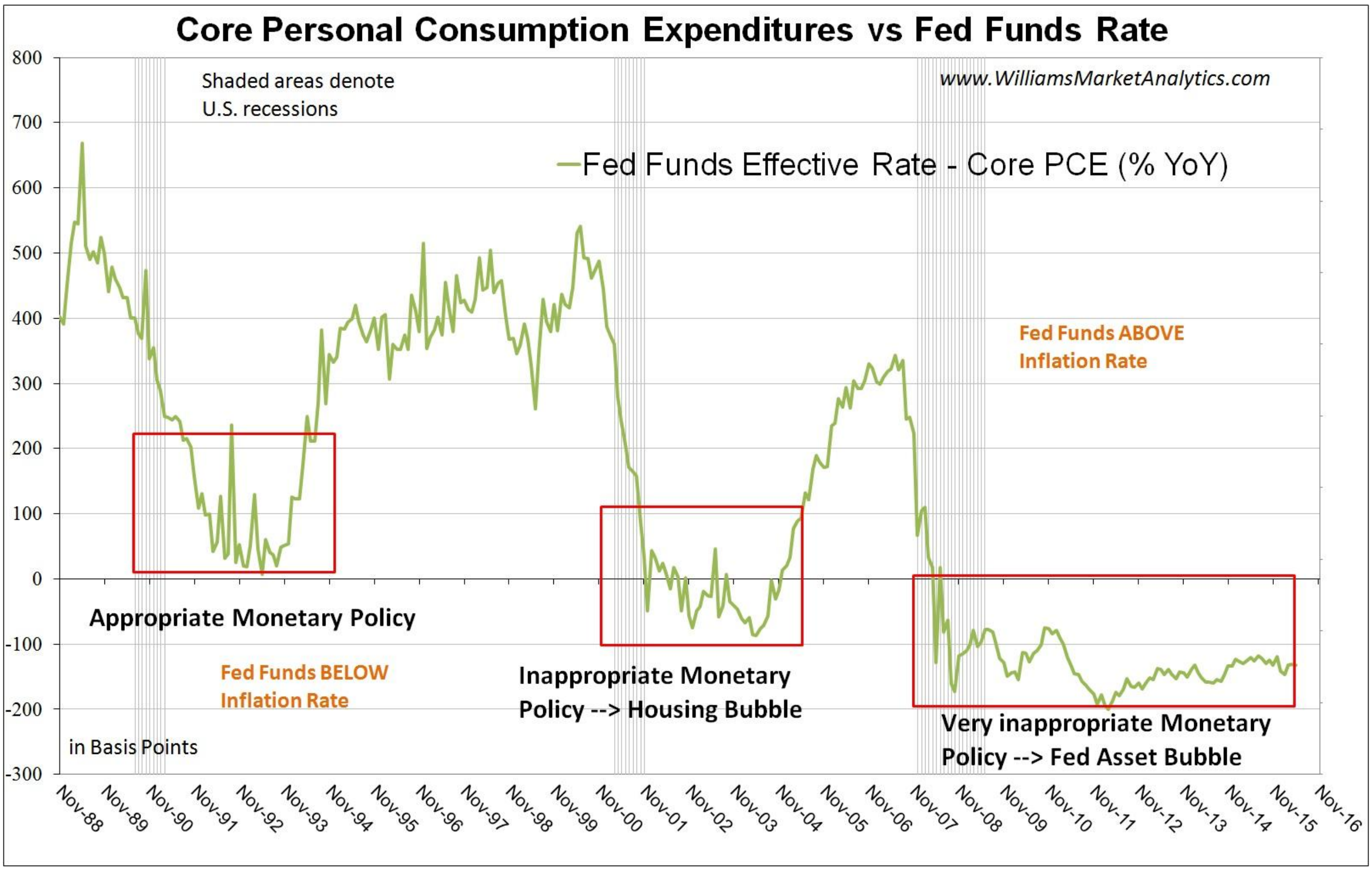
Ok, great. But in her prepared remarks she also stated that "the U.S. economy is doing well …[and] my expectation is that the U.S. economy will continue to grow." More waffle from the Fed...the economy is expected to grow, but there is a chance the economy may first weaken. Is this not a case of the blind (FOMC) leading the blind (the markets)? Yet investors are still hanging on every word and nuance Fed Governors utter.



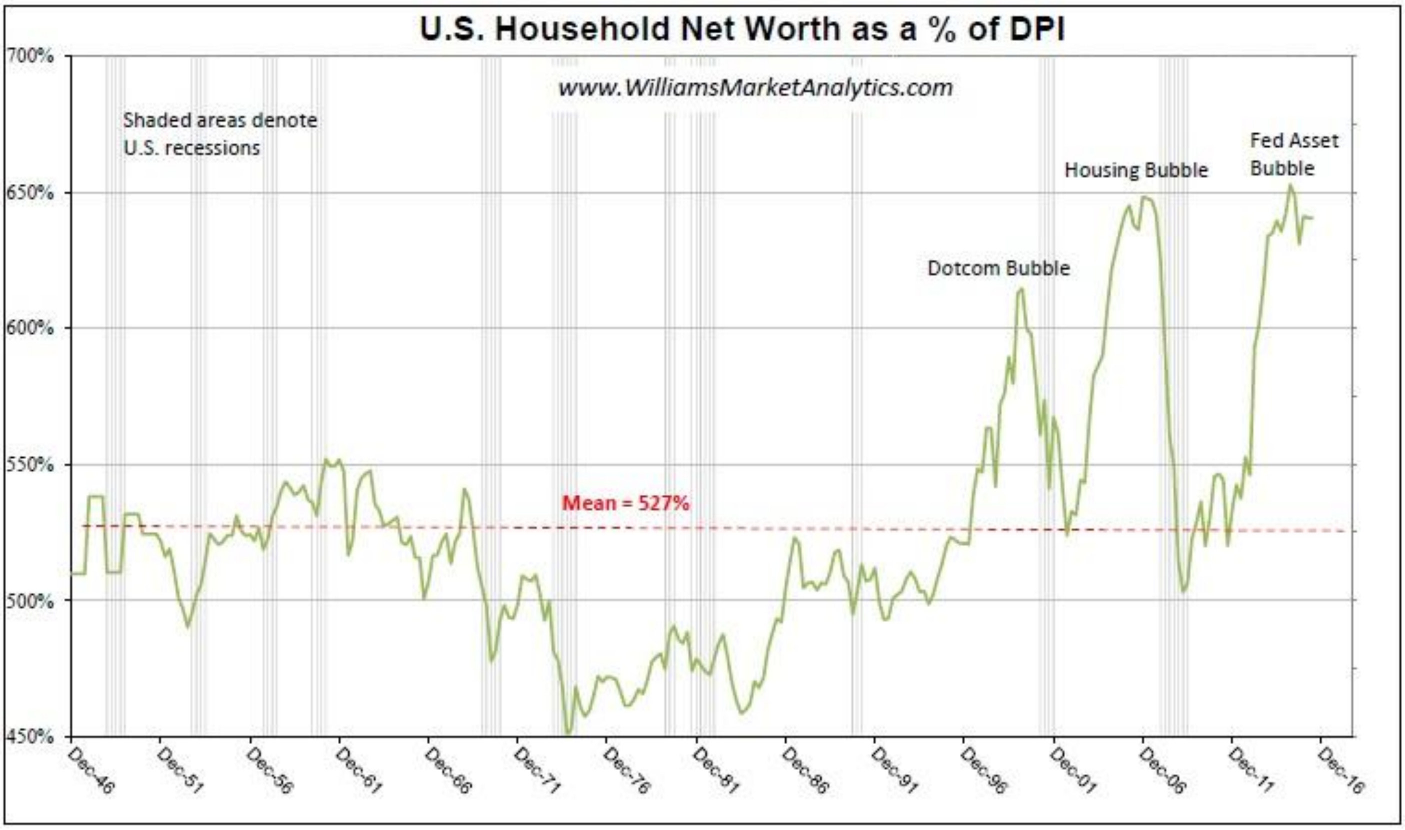

Still, a clearly tentative Fed has a long list of domestic factors it worries will hold growth to a modest pace in the months ahead. Output growth, hiring, business investment and corporate profits have stumbled or slowed in recent months, leaving the Fed unsure when it will raise short-term interest rates again.

For a while now, Yellen has argued that headwinds to economic growth would fade, allowing growth to pick up and interest rates to rise. Now, she is subtly adding qualifiers to this forecast. In her testimony, for instance, she said she expected these headwinds to "slowly fade over time." Looking back at the Federal Reserve track record of making economic forecasts, it would truly be statistically advantageous **to take the Fed forecasts and bet on the opposite scenario playing out.** In any case, the Fed has a long list of "worries" which it believes will hold growth to a modest pace in the months ahead: output growth, hiring, business investment and corporate profits are all on dovish Fed members excuse lists. And if the doves need more excuses not to raise rates, these Fed members just look abroad (weak Chinese growth, Brexit, oil prices, etc).


Some short-term, opportunistic investors are quite happy with Fed monetary policy. However, savvy investors realize that Fed policy is not fostering healthy financial markets, and that the inflated stock prices today will end up causing years of painful negative returns on risk assets. The chart below is a lovely illustration of the resulting distortions in asset prices when the Fed maintains an inappropriate monetary policy for an extended period. We took the difference between the effective Fed Funds rate (the actual rate at which banks lend to one another overnight) and the Fed's preferred measure of inflation, based on Personal Consumption Expenditures. Looking back at the 1990-91 recession, the FOMC maintained the Fed Funds rate **above** the annual rate of change of the core PCE inflation measure. The result was strong nine-year bull market. Although the bull market cumulated in the tech bubble, Fed policy can not be blamed. After the end of the recession in 2001, Fed maintained rate **below** core inflation for three long years (2002-2005). Greenspan's monetary policy is credited with spawning the housing bubble, as individuals "leveraged up" their wealth by purchasing homes with low interest loans. What really scares us today is that interest rates have been kept below core PCE inflation for over seven years. We know where low interest rates have sent money flows this time.  If three years of inappropriate monetary policy was capable of inflating housing prices, which then brought down all risk assets during the bust (recall the S&P 500 fell -56% into 2009), what can we expect in the wake of seven years of inappropriate monetary policy? Can we expect that the inflated assets prices won't blow up this time around? That somehow the Fed will engineer a "soft landing" of assets prices? What is concerning to us (and explains the persistence of inflated stock prices), is that there are many investors today who would try to rationalize these absurd rhetorical questions. Many are still oblivious to the "end game" in stocks, or believe that there is much more upside to stock prices and that they will "know" when the upside is exhausted.




Speaking of bubble blowing, our next chart shows U.S. household net worth as a percent of disposable personal income (DPI). Recall the objective of the Fed for the past several years: inflate asset prices so that households “feel” wealthier. In economic jargon, this is termed the “wealth effect”, and the hope is that households that feel more comfortable about their financial situation will spend more. The chart clearly shows the amplitude of today’s asset price bubble. Relative to DPI, household wealth (which includes portfolio holdings) has exceeded both the peaks of the tech bubble and the housing bubble. Sure, and this time it won’t end bad for investors….




**The Brexit Excuse**

The surprise vote for the U.K. to leave the European Union effectively gives central bankers a blanket excuse not to raise rates again. We expect future FOMC minutes to simply cite "global uncertainty" to justify delaying a rate hike. In fact, for the past year, the Fed has promised rate hikes but as each FOMC meeting approaches, the Fed governors conjure up a temporary reason not to hike "immediately". In this sense, the Brexit will relieve the Fed of having to come up with an excuse not to hike rates. And Fed Fund futures are pricing in the end of the rate hike cycle, "One and Done". The following table shows the probabilities of hike hikes or cuts at upcoming FOMC meetings.

Current Implied Probabilities 3) Add/Remove

Dates Meeting Calculation Calculated 06/29/2016 Based on rate 0.25-0.50

| Meeting | Prob Of Hike | Prob of Cut | 0-0.25 | 0.25-0.5 | 0.5-0.75 | 0.75-1 | 1-1.25 | 1.25-1.5 | 1.5-1.75 |
|---|---|---|---|---|---|---|---|---|---|
| 07/27/2016 | 0.0% | 0.0% | 0.0% | 100.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| 09/21/2016 | 0.0% | 2.0% | 2.0% | 98.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| 11/02/2016 | 0.0% | 2.0% | 2.0% | 98.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| 12/14/2016 | 11.8% | 1.8% | 1.8% | 86.5% | 11.8% | 0.0% | 0.0% | 0.0% | 0.0% |
| 02/01/2017 | 11.5% | 3.6% | 3.6% | 84.9% | 11.5% | 0.0% | 0.0% | 0.0% | 0.0% |
| 03/15/2017 | 16.7% | 3.3% | 3.3% | 80.0% | 16.0% | 0.7% | 0.0% | 0.0% | 0.0% |
| 05/03/2017 | 20.2% | 3.2% | 3.2% | 76.6% | 18.8% | 1.4% | 0.0% | 0.0% | 0.0% |
| 06/14/2017 | 28.2% | 2.9% | 2.9% | 68.9% | 24.8% | 3.2% | 0.2% | 0.0% | 0.0% |
| 07/26/2017 | 27.5% | 4.8% | 4.8% | 67.7% | 24.2% | 3.1% | 0.2% | 0.0% | 0.0% |
| 09/20/2017 | 34.3% | 4.4% | 4.4% | 61.4% | 28.6% | 5.2% | 0.5% | 0.0% | 0.0% |

Looking out to SEPTEMBER 2017, the markets are only betting on a 1/3 chance of seeing a 25 basis point hike. Moreover, we are starting to see markets assign a small probability to a RATE CUT. Readers know that our central forecast has been for the next recession to arrive before the Fed can normalize rate. The reality is simply that the Fed can not hike rates. Financial markets – both equity and rates – are so wound after with years of excessively simulative monetary policy that Yellen and the Fed can't make even a small move without risk of pricking the asset bubbles. A mere 25 basis point hike last December sent equities down -12% over the subsequent two months. It's a mystery why Yellen and the Fed don't just eat crow pie, tell markets that the tightening cycle was a mistake, and give markets clear forward guidance. And as the probability table above shows, markets are now beginning to come around to our view. We expect and even higher probability assigned to a rate cut in the coming weeks as economic data disappoint and the Brexit fiasco remains unresolved.

As mentioned above, we remain skeptical on playing the equity upside based upon factors that force central banks to ease monetary policy. As the Fed Fund futures show, more and more market participants are coming around to the view that rates won't rise before 2018. The problem here is that **once all (or a large majority) of market participants agree that rates won't rise, equity markets will lose this tailwind**. For the past several years, each equity uptrend has been predicated more accommodative monetary policy or promises of easy monetary policy for a longer duration. And demand for equities (which pushes prices higher) has come from investors incorrectly positioning themselves for higher rates. In other words, the market has been sucking in all the cautious investors preparing for the day we see a rate tightening cycle (which will never come). Beware of the day when investors begin pricing in zero probability of a rate hike out to 2018 --- this will likely market the peak of the central bank asset price bubble.

**Conclusion**

Equities may continue to rally on the "positive" side of Brexit, as central banks will be forced to keep financial markets awash with liquidity. The "bad news is good news" game is still on. It seems too early to speculate on Brexit being a "non-event" with a limited impact on the future of the European Union. As long as central banks keep investors mesmerized with the prospect of indefinite accommodative monetary policy, this will remain a trader's market. Whether selling rallies or buying dips, avoid having too much conviction in the durability of price movements in either direction.