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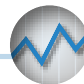
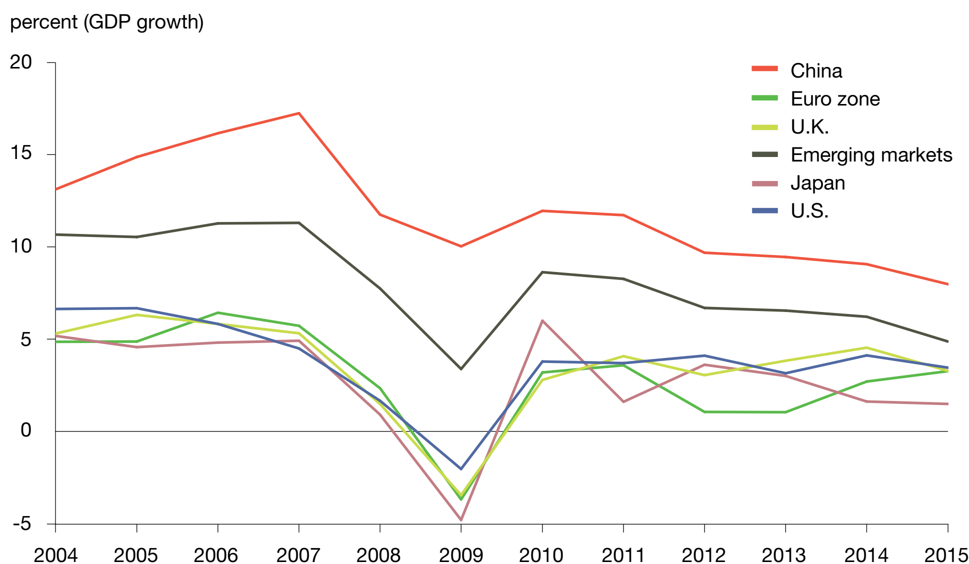


Brexit surprise adds to global economic woes

The U.K.'s surprising June 23 referendum vote to leave the European Union (Brexit) caused dramatic moves in global capital markets. In the days that followed, politicians from around the world offered a wide range of comments, from support for Brexit and independence movements in other European nations to anger and threats. In the U.K. protesters against Brexit took to the streets, while a string of political resignations left a leadership void.

Despite the quick and sometimes virulent reactions, the Brexit vote is just the beginning of what is likely to be a multi-year process to disentangle the U.K. from the EU. In the meantime, the rest of the world is still trying to figure out how to reinvigorate global economic growth (Chart 1). Seven years after the low point of the great financial crisis, the unfolding drama in Europe's political structure is just one more complication in the effort to boost global growth, strengthen the global financial system, and lift global living standards.

Chart 1. Global growth remains weak.



Note: Gross domestic product, GDP, is annual rate of change based on purchasing power pariety across countries.
Source: IMF World Economic Outlook (FactSet).

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The outcome of the Brexit vote sent shock waves through financial markets as investors sought safety.

Brexit's impact on the U.S. economy is likely to be contained.

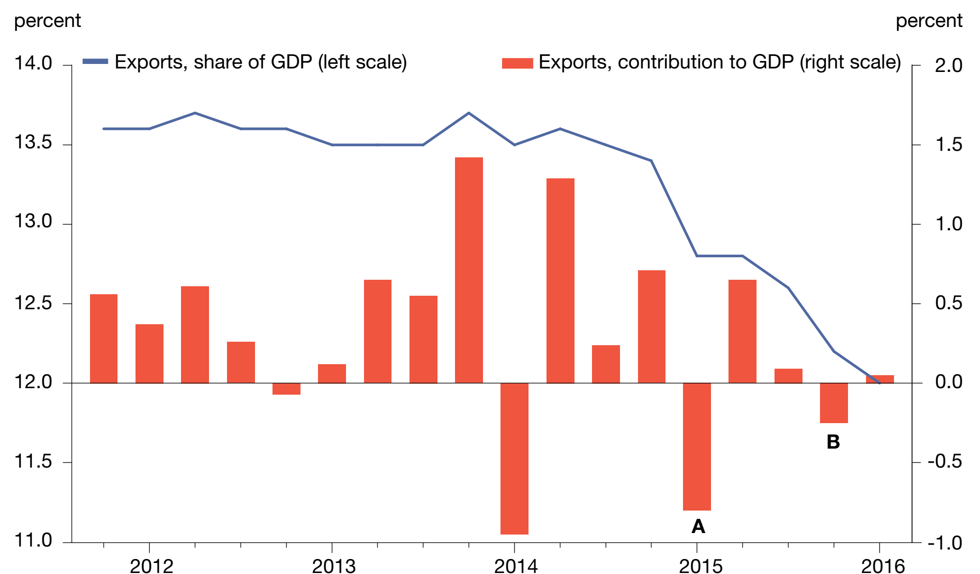
Article 50 of the Treaty on European Union allows a two-year window for negotiating a member country's withdrawal. This can be extended by mutual agreement. The window doesn't open until a member state submits a formal request (which the U.K. has not yet done). In the meantime, little has actually changed for the global economy. So far the financial markets have reacted (overreacted?), and the political system in the U.K. has begun to change to reflect the will of the people as expressed in the Brexit referendum, as it should.

For the U.S., the fallout is likely to be contained and could ultimately be constructive. In terms of the U.S. economy, the short-term impact has been volatility in the markets, a net drop in Treasury yields, a mild strengthening of the dollar, and a slight fall in equity markets.

The stronger dollar is likely to hurt U.S. exporters. However, slow global growth and a stronger dollar have already taken their toll on exports. Weak exports over the past couple of years have already pushed their share of GDP down to 12 percent from 13.5 percent. In terms of GDP growth, exports have contributed less than 0.5 percentage points to growth in five of the past seven quarters, including two quarters (A and B, Chart 2) when they subtracted from GDP growth. While exports can continue to fall, exacerbating recent performance, the U.S. economy already depends less on exports for growth, and that should soften the impact of future declines.

Finally, a nearly unanimous refrain is that a higher degree of uncertainty could delay decisions on hiring and investment. But some investors, business people, and entrepreneurs have likely already started to search for new opportunities to profit. Therein lays the strength and resilience of a free-market system. For both groups, the process is likely to be quite drawn out.

Chart 2. **U.S. exports have shrunk as a share of gross domestic product and are contributing less to GDP growth.**



Source: Bureau of Economic Analysis (FactSet).

ECONOMIC OUTLOOK

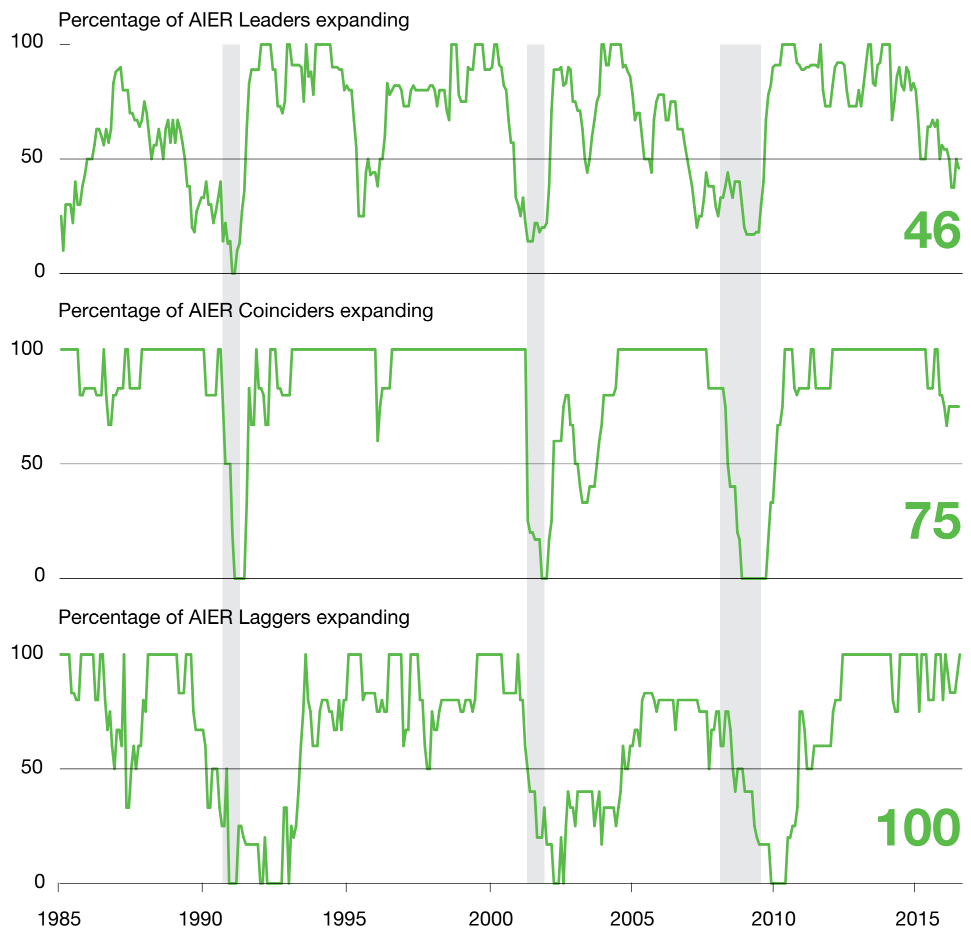
The Leaders index in our Business-Cycle Conditions model fell slightly in the latest month, with 46 percent of our leading indicators trending upward. This result follows a neutral 50 reading in the prior month.

The small decline to below the 50-percent threshold once again raises concern over the durability of the current expansion. AIER researchers judge the risk of recession to be somewhat elevated but do not see a recession as likely in the near term.

Four of our Leaders were trending higher in the latest month. Among those, two were consumer related: real new orders for consumer goods and real retail sales. This is consistent with our view that a solid labor market would continue to support consumer spending. The weak May jobs report casts a shadow over that hypothesis, but a strong rebound in the June report has since erased much of that. Still, healthy job gains will be critical for sustaining the current expansion. Two financial indicators, the Treasury-yield spread and real stock prices, were the two other upward-trending indicators last month. Among the remaining indicators, five were trending lower while three were neutral.

The percentage of expanding coincident indicators held steady in the latest month, registering 75 percent for the fifth month in a row. Among the Coinciders, four were trending higher while one was trending lower and one was neutral. The proportion of lagging indicators expanding rose to 100 percent from 92 percent in the prior month (Chart 3).

Chart 3. Indicators at a glance
Shaded areas denote recessions.
A score above 50 indicates expansion.



Source: AIER.

SCORECARD

The outlook for inflation remained neutral in May, according to the AIER's Inflationary Pressures Scorecard. Slightly more than half, or 13 out of 23 indicators tracked in the Scorecard, support upward pressure on inflation, up from 10 in the previous month. The remaining 10 indicators point to downward inflationary pressure.

The added inflationary pressure in May came mainly from faster growth of average hourly earnings and personal income, which could potentially drive up consumer demand. Significantly faster retail sales growth in recent months reinforces this possibility.

Supply forces somewhat offset inflationary pressure from demand. Capacity utilization in manufacturing fell, and the ratio of inventories to sales rose, suggesting that increased demand may be met without much risk of a rise in prices.

On the money and banking front, even with rising interest rates, the money supply and revolving consumer credit grew at a faster pace. With more money created in the economy, higher consumer prices are likely.

Inflationary pressure from costs and productivity is nearly balanced. There are no signs that inflation will either significantly rise or fall in the near future.

AIER INFLATIONARY PRESSURES SCORECARD

We track 23 indicators and evaluate their performance over the past three months compared with the prior three months. That is, we compute moving averages of the monthly changes for two consecutive, non-overlapping three-month periods. Finally, we evaluate the inflationary pressure of each indicator through the framework of supply, demand, money/credit, and costs and productivity, and show whether the monthly change points to rising or falling inflationary pressure or stability.

Table 1. Higher wage growth put upward pressure on inflation.

	3-MTH. AVERAGE CHANGE		INFLATION
	Previous	Latest	PRESSURE
DEMAND AND SUPPLY			
Demand			
Average hourly earnings (May)	1.91%	3.19%	Rising
Nonfarm payroll jobs, in millions (May)	143.34	143.83	Rising
Personal income (May)	3.24%	4.31%	Rising
Retail sales (May)	0.75%	5.77%	Rising
Supply			
Ind. prod. - consumer goods (May)	4.45%	-3.08%	Rising
Manufacturing utilization (May)	75.38%	75.01%	Falling
Retail inventory/sales ratio (April)	1.40	1.41	Falling
MONEY, BANKING, AND CREDIT			
Fed funds rate (May)	0.40%	0.50%	Falling
Interest on excess reserves (May)	0.46%	0.50%	Falling
Money supply (M2) (May)	7.11%	8.30%	Rising
Money velocity (April)	1.02%	-0.71%	Falling
Revolving consumer credit (April)	3.93%	6.32%	Rising
COSTS AND PRODUCTIVITY			
Producer price index (May 2016)			
Final demand	-0.36%	1.84%	Rising
- Food	-1.02%	-3.72%	Falling
- Energy	-37.70%	20.89%	Rising
- Goods less food and energy	1.10%	2.57%	Rising
- Services	3.68%	0.36%	Falling
Import price index (May 2016)			
Autos	-1.76%	1.79%	Rising
Consumer goods ex. autos	1.50%	-1.85%	Falling
Commodity prices (May 2016)			
S&P GSCI Commodity Index	-33.43%	122.77%	Rising
Wages and productivity			
Private compensation (Q1–2016)	5.96%	7.98%	Rising
Nonfarm business productivity (Q1–2016)	-1.70%	-0.60%	Falling
Nonfarm business unit labor costs (Q1–2016)	5.40%	4.50%	Falling

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, U.S. Census Bureau, Federal Reserve Board, Standard & Poor's, AIER (FactSet).

CONSUMER PRICE INDEX ANALYSIS

The Consumer Price Index, or CPI, advanced 0.2 percent in May from April, slower than the 0.4 percent growth in the prior month. The slowdown was due to falling food prices and a smaller increase in energy prices.

After climbing 0.2 percent in April, food prices dropped 0.2 percent in May. Over the past 12 months, food prices only grew 0.7 percent, much below their five-year average annual growth rate of 1.8 percent.

Energy prices are the most volatile component of the CPI basket. They rose 1.2 percent over the previous month and 25 percent from three months earlier but remained 9.8 percent lower compared with 12 months ago.

Core CPI, which excludes volatile food and energy prices, has exhibited a much more stable trend over time. It grew 0.2 percent in May, the same pace as April, driven mostly by strong service price growth, which was also the case the previous month.

Core goods, excluding food and energy, fell 0.2 percent from April and were down 2 percent from three months ago. A number of household goods, from new vehicles and household furnishings to recreation commodities, posted declines. But one product stood out with a significant price increase. In May apparel prices jumped 0.8 percent from April after sharply falling for the previous two months.

Core services, excluding energy, continued to grow at a steady pace. Their prices rose 0.3 percent in May, within their normal growth range of 0.2 percent to 0.3 percent each month. However, over the past 12 months, core services have grown 3.2 percent, faster than the 2.6 percent growth seen for the past five years or 2.8 percent over the past 20 years.

Among all services, medical care and shelter grew at the fastest pace over the past 12 months. But in the longer run (over the past five to 20 years) the fastest-growing service appears to be education, followed by medical care.

Table 2. Energy prices are still a major player in the monthly CPI.

Data for May 2016	Share	m/m%	3-mo.*	12-mo.*	5-yr.*	20-yr.*
Consumer Price Index	**100.0**	**0.2**	**2.9**	**1.1**	**1.3**	**2.2**
Food	13.8	-0.2	-0.9	0.7	1.8	2.5
Energy	7.1	1.2	25.0	-9.8	-5.7	2.6
CPI excl. food and energy	79.2	0.2	1.9	2.2	2.0	2.0
Goods excl. food and energy	**19.5**	**-0.2**	**-2.0**	**-0.5**	**0.1**	**0.2**
Apparel	3.2	0.8	-2.3	0.6	0.9	-0.2
New vehicles	3.7	-0.1	-1.9	-0.2	0.7	0.1
Medical-care commodities	1.8	-0.2	2.0	2.2	2.3	2.8
Services excl. energy	**59.6**	**0.3**	**3.2**	**3.2**	**2.6**	**2.8**
Shelter	33.2	0.4	3.3	3.4	2.7	2.6
Medical-care services	6.6	0.5	3.4	3.5	3.1	3.8
Transportation services	15.6	0.3	5.0	3.3	2.4	2.6
Education	3.0	0.3	2.6	3.0	3.6	5.0
AIER'S EPI	**35.0**	**0.6**	**8.9**	**-1.3**	**-0.2**	**2.5**

Notes: *= annualized rate. AIER's EPI share is the share of the CPI.
Sources: Bureau of Labor Statistics, AIER (Haver Analytics, FactSet).

Everyday Price Index

AIER's Everyday Price Index rose 0.6 percent in May from April, led by a 6.6 percent jump in gasoline prices, which were partially offset by a 0.5 percent drop in grocery prices. The EPI measures changes in prices that people see in everyday purchases such as groceries, gasoline, and admissions.

The more widely known price gauge, the Consumer Price Index reported by the Bureau of Labor Statistics, increased 0.4 percent for the month on a seasonally unadjusted basis and 1.1 percent over the past 12 months. The EPI is not seasonally adjusted, so we compare it with the unadjusted CPI.

The EPI's increase was driven by a 6.6 percent jump in gasoline prices. A downturn in U.S. crude-oil production has helped push gas prices higher in recent months. The possibility of renewed production has the potential to dampen further gasoline price hikes.

Grocery prices fell 0.5 percent, declining across all major food categories. On the other hand, restaurant prices increased 0.2 percent in May. Grocery prices have tended to grow more slowly than restaurant prices since the end of the Great Recession in 2009.

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MONETARY

The Brexit vote, weaker labor market conditions, and a stronger dollar make it unlikely that the Fed will raise interest rates again soon.

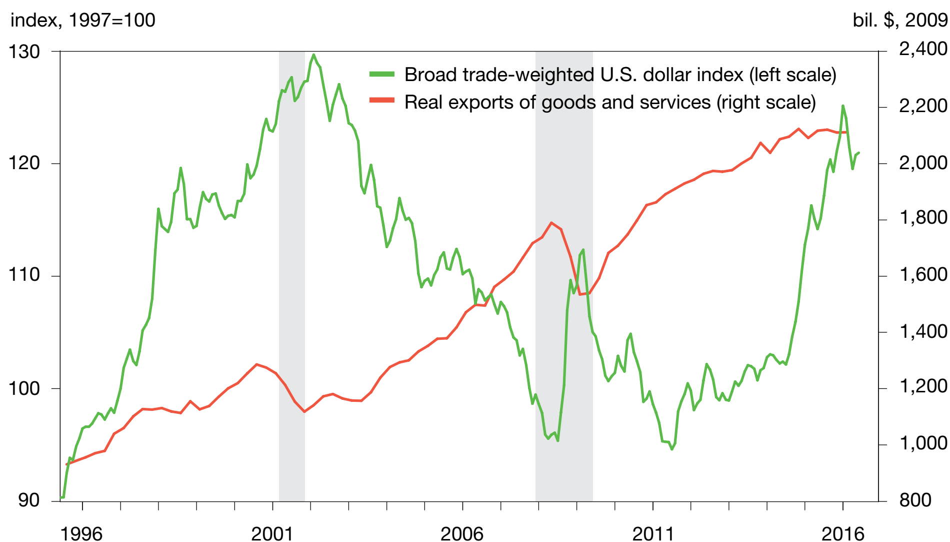
Ever since the Federal Reserve raised interest rates in December, the financial markets have eyed the possibility of another interest rate increase. But in light of the latest developments, both global and domestic, this now looks increasingly unlikely.

The Federal Open Market Committee, the policy-making arm of the Fed, kept interest rates unchanged when it met on June 14–15, and it lowered its outlook for the path of rate increases for the rest of the year. The number of FOMC participants who favored two or more rate increases in 2016 fell to 11 from 16, while the number favoring no more than one rate increase rose to six from one.

In June no one on the FOMC argued for keeping interest rates unchanged throughout 2016. This, however, may change in light of recent news and data. The extremely disappointing employment report in May, showed only 38,000 jobs added by the U.S. economy in May, and the news of the Brexit, which roiled financial markets and pushed the foreign exchange value of the dollar higher, make it unlikely that the Fed would want to raise rates soon.

In the days following the Brexit referendum, the U.S. dollar appreciated against the British pound by about 13 percent and against the euro by about 2.3 percent. An appreciating dollar is good news for U.S. tourists to the U.K., but it tends to hurt U.S. exporters. Chart 4 shows that, over the past two decades, periods when the dollar appreciated coincided with a slowdown in export growth or an outright decline in U.S. exports.

Chart 4. A strong dollar hurts U.S. exports.



Note: Shaded areas denote recessions.

Source: Bureau of Economic Analysis, FRED.

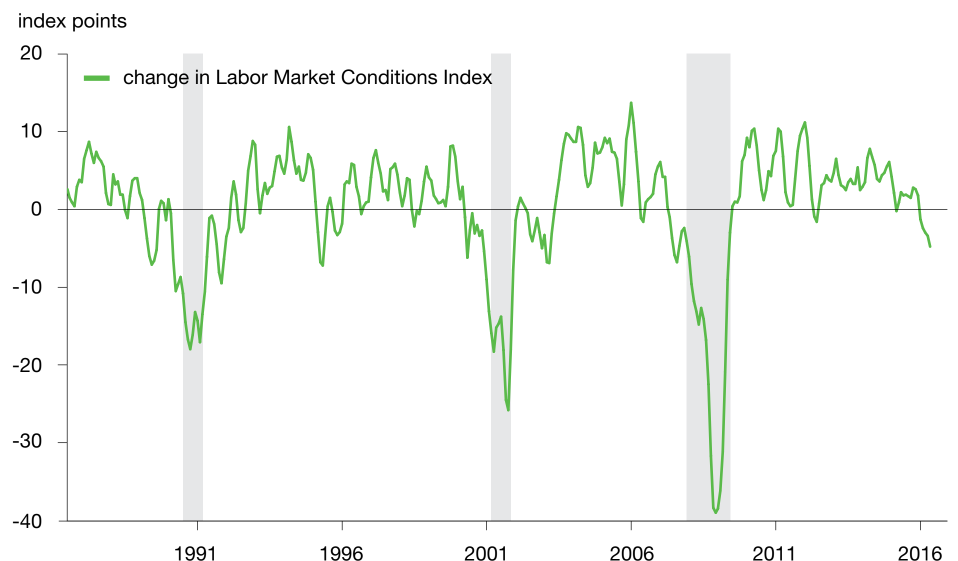
U.S. exports were already struggling because the dollar has been rising against other currencies since early 2014. The additional spurt in the dollar's appreciation following the Brexit vote pressures exports even more. This, in turn, will likely restrain output growth in the U.S., which has not been spectacular to begin with. The latest GDP estimate for the first quarter of 2016 shows that U.S. output grew only 1.1 percent (annual rate), the weakest growth in a year.

In addition, labor market conditions, which had been a positive sign in the U.S. economy, have started to show some weakness. The extremely slow job growth in May was partially offset by faster growth in June, but a broader indicator—the Labor Market Conditions Index from the Federal Reserve Board—has been stuck in negative territory since January.

The Labor Market Conditions Index captures the common movement from 19 labor market indicators, such as the unemployment rate, labor force participation rate, average hourly earnings, and others. As such, the index is a more comprehensive reflection of the state of the labor market than any individual indicator. Over the past three decades all economic downturns were preceded by persistent negative readings of the index (see Chart 5), but in a few cases negative readings were not followed by a broader downturn. Nevertheless, the negative readings of the index for the past few months are a cause for concern.

In such circumstances, raising interest rates, also known as a tightening monetary policy, is not likely to be an attractive option. Higher interest rates would further strengthen the U.S. dollar and could potentially raise the cost of capital. This in turn would depress exports and further restrain economic growth. The Fed would almost certainly not want to do this in July and maybe not even later in the year.

Chart 5. Declines in the Labor Market Conditions Index in recent months are worrisome.



Note: Shaded areas denote recessions.

Source: Federal Reserve Board (FRED).

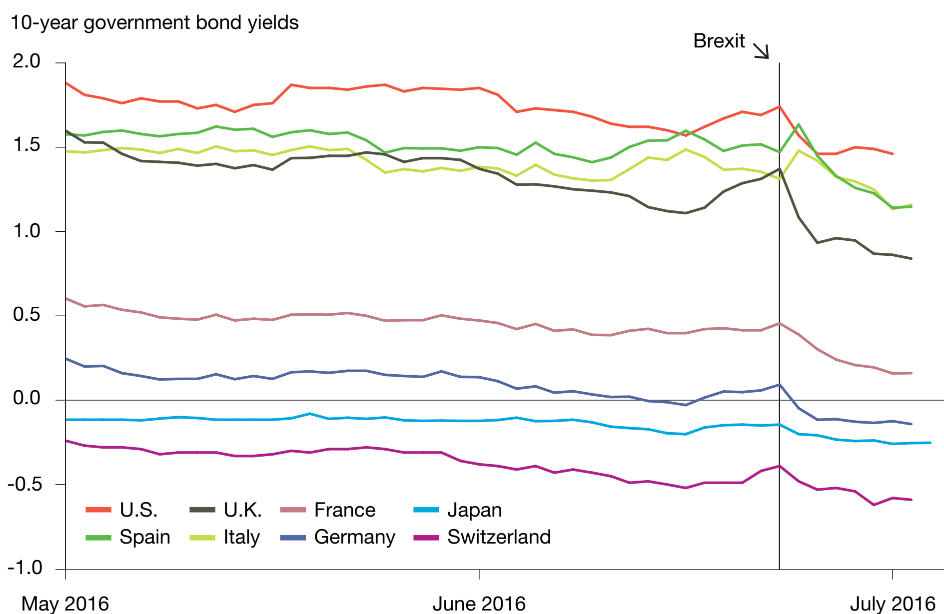
FIXED INCOME

Government bonds continue to be a safe haven for many investors. Following the surprise results of the Brexit vote, equities sold off and money flooded into government bonds around the world, driving prices up and yields down.

German, euro, and Swiss 10-year bonds are all trading at negative yields, joining Japan, whose bond yields have been below zero since early 2016. It is interesting that the initial move for Italian and Spanish bond yields was higher immediately after the vote but then fell, along with other bond yields (Chart 6).

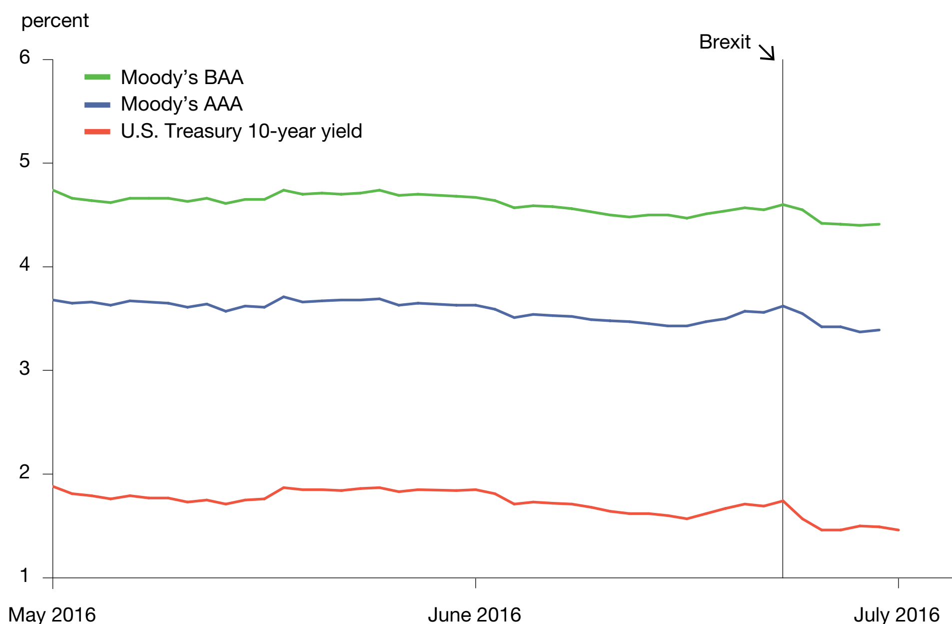
In the U.S., the benchmark bond yield fell sharply, coming close to multi-decade lows. Corporate bond yields also fell but not by as much as Treasury bonds (Chart 7), leaving spreads slightly wider than before the vote. In a yield-starved world, U.S. Treasury and corporate bond yields look attractive compared with other fixed-income investments.

Chart 6. Global bond yields fell sharply after the Brexit vote.



Source: Federal Reserve System, Tullett Prebon Information, J.P. Morgan Chase (FactSet).

Chart 7. U.S. corporate bond yields also fell sharply after the Brexit vote but remain at relatively high levels.



Source: Federal Reserve System (FactSet).

COMMODITIES

Government bonds may be the place investors turn for safety from equity-market volatility. But during times when political upheaval is at hand or inflation is a threat or risks to the entire financial system appear to be growing, investors have turned to the safety of gold. Over the past five decades, gold has gone through long, strong rallies and long periods of decline. Following the global financial crisis at the turn of the decade, gold rose to a high of around $1,900 an ounce. As fears of financial collapse and runaway inflation from quantitative easing began to slacken, gold fell to a low of under $1,100 an ounce by the end of 2015 (Chart 8).

In early 2016, gold began a new move higher and extended that run in the days following the Brexit vote (Chart 8 inset). No one can know whether the crisis in Europe will turn into a global economic and financial crisis or become a long, drawn-out, largely political quagmire, but gold can play a role in some investment portfolios as a hedge against unfavorable and unexpected developments.

Chart 8. Over the past five decades, gold has shown long declines and long periods of positive returns. It continued to gain after Brexit (inset).

Note: Shaded areas denote recessions.
Source: FactSet.

U.S. EQUITIES

The six trading days after the Brexit vote showed just how fickle markets can be. U.S. equity markets plunged in the two days following the vote and then rallied, recovering nearly the entire drop. Certainly, economic and profit prospects didn't fluctuate as dramatically over that six-day period.

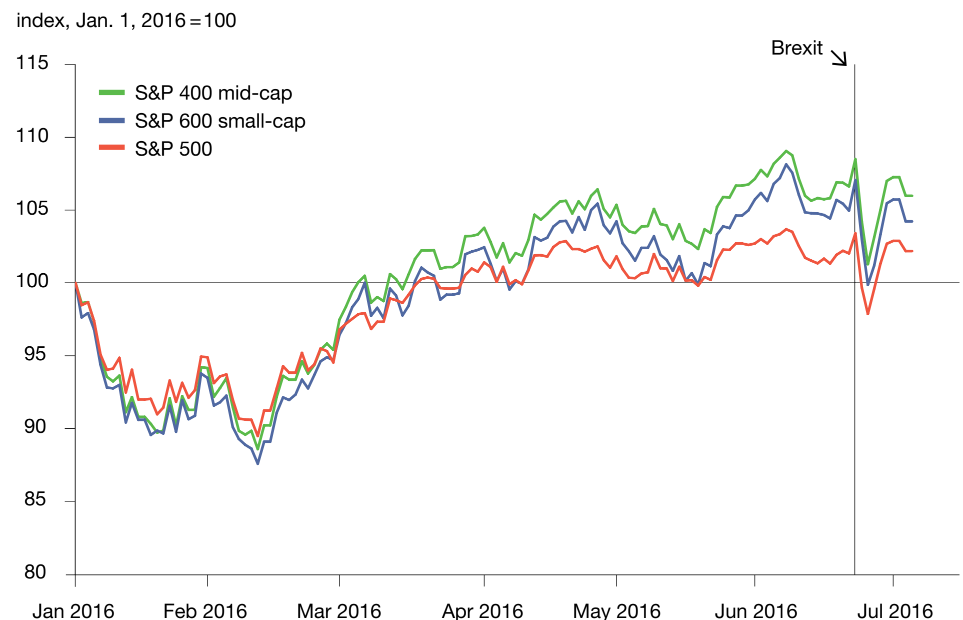
For U.S. equity markets, the challenging economic and profit backdrop has slowed price appreciation to a crawl. Major benchmarks have essentially moved sideways since the second quarter of 2015, with significant declines and rebounds in the third quarter of 2015 and first quarter of 2016.

For the current calendar year, U.S. large-cap stocks are trailing the mid- and small-cap indexes. Following the Brexit vote, all three indexes fell sharply for two days but quickly recovered most of the declines over the next four days (Chart 9).

Slow economic growth—domestic and global—is a difficult environment for profit growth, the key long-term driver of equity prices. The collapse in crude-oil prices has hurt the U.S. energy industry as well as the capital-goods companies that supply equipment to the energy industry. The combination of slow global growth and a strong dollar has hurt U.S. exports. All of these have combined to pull profits lower. Furthermore, the tightening labor market has the potential to push wage increases up more quickly and eventually could squeeze profit margins.

Despite these potential risks, U.S. equities compare favorably with most other global equity markets and with U.S. bonds. U.S. consumers, whose spending accounts for about 70 percent of U.S. GDP, are in relatively good financial shape. The tight labor market may push income up at a faster pace, supporting future gains in consumer spending.

Chart 9. U.S. large-cap stocks are trailing mid-caps and small-caps in 2016. All the indexes are back close to pre-Brexit levels.



Source: Standard & Poor's (FactSet).

GLOBAL EQUITIES

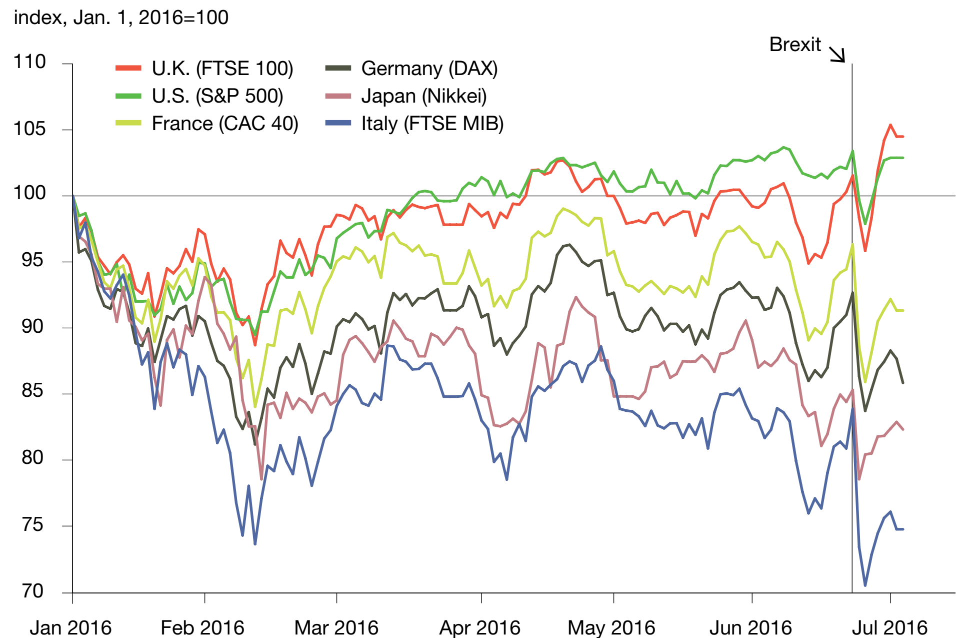
If the performance of the major U.S. equity market indexes has been less than impressive, then the performance of many of the world's other major equity market indexes has been outright disappointing. Declines in global equity markets were seemingly universal in the days following the Brexit vote. Most of the major markets managed a rebound of some magnitude, however (Chart 10).

Like the U.S., many of the world's economies and equity markets are struggling to produce sustained economic and corporate profit growth. Europe continues to delay decisive action on the banking problems of some member nations. Government fiscal positions are tenuous in a few nations, and labor market rigidities plague several countries. Recent political issues including immigration and the Brexit vote are adding to the list of difficult issues.

In Japan economic growth has been weak for years under the weight of unfavorable demographic trends and a strong yen. China is experiencing a significant slowdown in economic growth while attempting to move to a more consumption-oriented economy, develop a strong middle class, and transition its economy to more free-market principles.

Among emerging markets, the collapse in commodity prices has been detrimental to growth. Political instability continues in some places (Brazil). All in all, global prospects seem particularly challenging across the spectrum. However, a time when the outlook appears bleakest is when the best value opportunities can be found.

Chart 10. Most major equity markets fell after the surprise Brexit result. Only the U.S. and U.K. are up for the year.



Source: Standard and Poor's, Deutsche Borse AG, Euronext, FTSE, Borsa Italiana, FactSet.

THE ECONOMY…

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Core CPI, which excludes volatile food and energy prices, has exhibited a much more stable trend over time. It grew 0.2 percent in May, the same pace as April, driven mostly by strong growth in the prices of services, which was also the case in the previous month.

…POLICY…

The Federal Open Market Committee kept interest rates unchanged when it met on June 14–15 and lowered its outlook for the path of rate increases for the rest of the year. Events since the June meeting make it unlikely that the Fed will want to raise rates soon.

The U.S. dollar appreciated following the British referendum on EU membership, putting additional pressure on U.S. exporters, who were already struggling. The Labor Market Conditions Index, a broad measure used by the Federal Reserve, has been stuck in negative territory since January. These developments present threats to economic growth. The Fed would almost certainly not want to raise rates in July and may not do so even later in the year.

…INVESTING

Investors sought out safety following the Brexit vote results. Equity markets sold off as money flowed into bonds, driving prices up and yields down. Gold prices also continued the upward trend that began around the end of 2015.

On a relative basis, the U.S. still appears to be in better shape and offers better opportunities, both in equity appreciation and fixed-income yields, than most other markets around the world.

CAPITAL MARKET PERFORMANCE

(Percent change)

	June	Latest	Latest		Calendar Year			Annualized	
	2016	3M	12M	2015	2014	2013	3-year	5-year	10-year
Equity Markets									
S&P 1500	0.1	2.1	1.4	-1.0	10.9	30.1	9.2	9.6	5.3
S&P 500 - total return	0.3	2.5	4.0	1.4	13.7	32.4	11.5	12.1	7.4
S&P 500 - price only	0.1	1.9	1.7	-0.7	11.4	29.6	9.2	9.7	5.2
S&P 400	0.2	3.6	-0.4	-3.7	8.2	31.6	8.7	8.9	6.9
Russell 2000	-0.2	3.4	-8.1	-5.7	3.5	37.0	5.6	6.8	4.7
Dow Jones Global Index	-0.9	0.3	-5.8	-4.0	2.1	20.8	4.0	3.2	2.3
Dow Jones Global ex. U.S. Index	-1.9	-1.5	-11.8	-6.6	-5.5	13.3	-0.5	-1.9	-0.4
STOXX Europe 600 Index	-5.1	-2.3	-13.5	6.8	4.4	17.4	4.9	3.9	0.3
Bond Markets									
iShares 20+ year Treasury bond	6.7	6.3	18.3	-4.2	23.6	-15.9	25.8	8.1	5.1
Dow Jones corporate bond index total return	2.3	3.2	9.1	-0.2	7.7	-1.5	18.9	6.0	7.2
Commodity Markets									
Gold	8.9	10.7	15.8	-12.1	0.1	-27.3	2.6	-2.2	8.1
Silver	22.5	31.9	26.6	-13.5	-18.1	-34.9	0.3	-10.7	5.8
CRB all commodities	-0.8	2.9	-2.0	-14.4	-3.8	-5.7	-4.2	-5.6	2.1

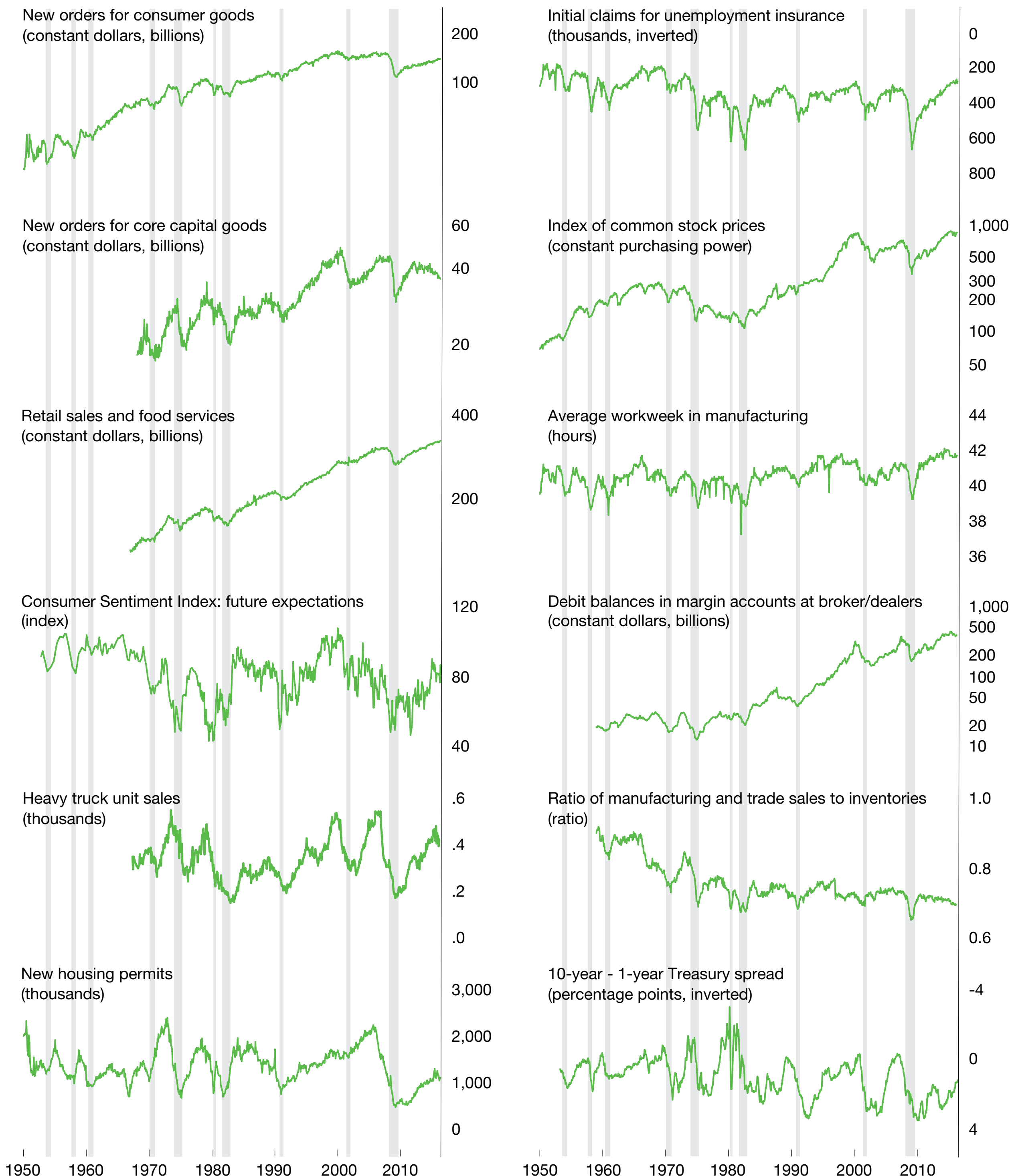
CONSUMER FINANCE RATES

(Percent)

	June	Latest	Latest		Average For Year			Average Over Period	
	2016	3M	12M	2015	2014	2013	3-year	5-year	10-year
30-yr. fixed mortgage	3.9	3.9	3.9	3.9	4.2	4.1	4.1	4.2	4.2
15-yr. fixed mortgage	3.0	3.0	3.0	3.0	3.2	3.2	3.1	3.3	3.3
5-yr. adjustable mortgage	3.2	3.2	3.2	3.2	3.4	3.2	3.3	3.2	3.2
Home-equity loan	4.8	4.8	4.8	4.8	5.4	6.1	5.4	5.7	5.7
48-month new car loan	4.2	4.2	4.2	4.2	4.2	4.4	4.3	4.7	5.9

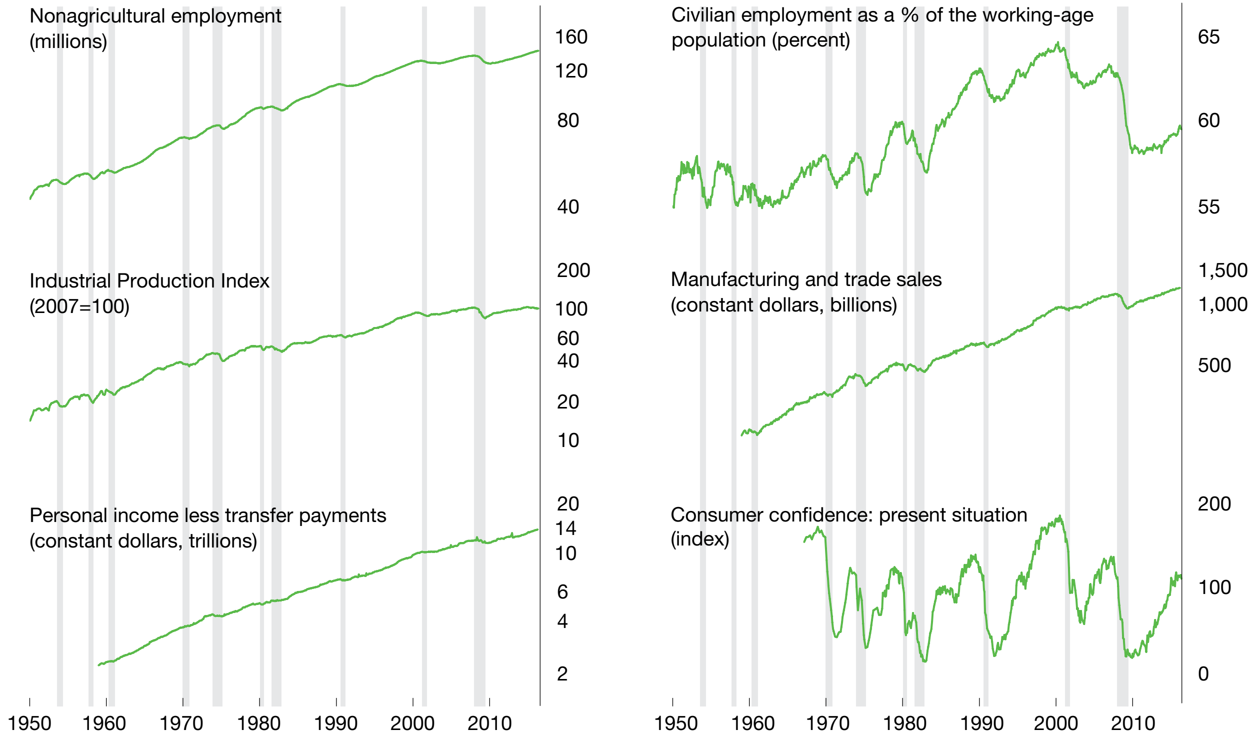
Sources for tables on this page: Bankrate Inc., Barron's, Commodity Research Bureau, Dow Jones, Federal Reserve Board, Frank Russell, iShares, Standard & Poor's, STOXX Europe 600, FactSet.

LEADERS (1950–2016)

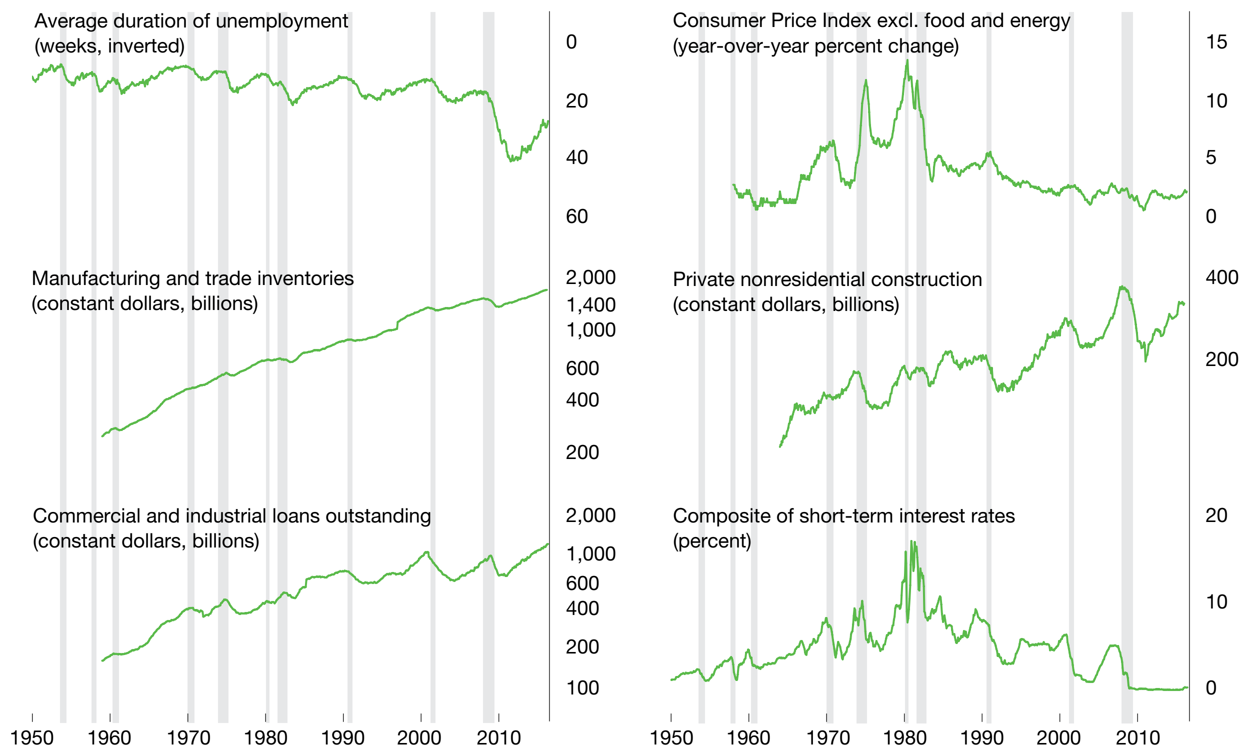


Sources for Appendix: Bureau of Economic Analysis, Bureau of Labor Statistics, Department of Labor, Federal Reserve Board, New York Stock Exchange, Standard & Poor's, The Conference Board, University of Michigan, U.S. Census Bureau.
Note: Shaded areas denote recessions (FactSet).

COINCIDERS (1950–2016)



LAGGERS (1950–2016)



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