ALL EYES ON THE UNITED KINGDOM AS THE JUNE 23 BREXIT VOTE DRAWS NEAR

UNITED KINGDOM: The approach of the June 23rd referendum on whether the U.K. should leave the European Union (the “Brexit” vote) is rattling global foreign exchange markets. Polling data through the middle of this week showed the share of voters leaning toward Brexit growing as fewer potential voters described themselves as undecided. The pound sterling depreciated to a low of $1.41 per pound overnight Wednesday before recovering above $1.43 today. Sterling is most recently being buoyed by tragedy: On Thursday, a Brexit sympathizer murdered pro-remain Labour Party Member of Parliament Jo Cox. Capital markets, assuming that MP Cox’s horrific murder will dampen enthusiasm for Brexit, are pricing in a lower risk of a pro-leave vote. Risk appetite in global financial markets has waned in June on the vote’s approach: Long-term U.S., British, German, and Japanese government bond yields have fallen since June 1, and the cost of insurance against stock market volatility and exchange rate volatility has risen. However, the premium of Libor rates in major currencies over risk-free interest rates has held fairly steady. These data collectively suggest that financial market participants are hedging against stock market volatility, but that there is little risk of a serious disruption to the global financial system priced into capital markets.

A majority vote for Brexit would not trigger a sudden regime change in the U.K.’s relationship with the E.U. Instead, an extended period of uncertainty would be likely, one that could conceivably end with the British government finding reasons to ultimately remain an E.U. member. In the event of a pro-Brexit vote, the U.K. government would notify the E.U. of its intention to withdraw. Under the Treaty of Lisbon governing E.U. membership, this would trigger a two-year negotiation of the U.K.’s post-Brexit economic relations with the E.U. (the U.K. and E.U. would have the option to extend these negotiations if two years are not enough). The terms of negotiation would cover whether nationals from other E.U. member states residing in the U.K. could stay, whether British nationals living in other E.U. states could keep their foreign residency, and the terms on which British companies could provide goods and services to customers in the E.U. (and vice versa). If British voters came to see those negotiated terms as inferior to E.U. membership, their government and the E.U. could conceivably reach a mutual agreement allowing the U.K. to rescind its decision to withdraw, echoing the Greek government’s decision to accept the E.U.’s austerity terms after the referendum rejecting them in July 2015. There is a meaningful possibility that the pro-E.U. Scottish National Party would call a new referendum on Scottish independence from the U.K. during a two-year Brexit negotiation, potentially weakening public support for following through on Brexit. If the U.K. were to actually follow through on a Brexit, the long-term economic effects are unknown and unknowable. The costs of Brexit would largely depend on the terms of British market access to the E.U. economy, an outcome of negotiations that are still just hypothetical. The potential benefit of Brexit (British euro-skeptics argue that an independent U.K. could foster faster economic growth by cutting through E.U. bureaucratic red tape) is also unquantifiable: There is no guarantee of what economic policies the U.K. government would implement post-Brexit since euro-skeptic politicians could be out of government by then.

The consensus view of foreign exchange market participants is that the pound could depreciate sharply following a pro-Brexit vote or appreciate sharply following a pro-remain vote. The broader economic impact of Brexit-related uncertainty is a drag on British growth and hiring. This headwind became apparent in the first half of 2016 and will likely persist after the vote. Weaker growth in 2016, in turn, will likely motivate the Bank of England to hold the bank rate unchanged at 0.5 percent in the second half of 2016. PNC Economics
forecasts that short-term U.S. interest rates will rise above comparable British benchmarks in the second half of this year, likely limiting the strength of the pound against the U.S. dollar in the second half of 2016 and in 2017 even if British voters choose to remain in the E.U.

UNITED STATES: As expected, the Federal Open Market Committee left the federal funds target range unchanged at 0.25 to 0.50 percent at the conclusion of their meeting June 14 and 15. Chair Yellen noted in the press conference following the meeting that the Fed is cognizant of downside risks to the global economy from the Brexit vote, and sounded dovish on the U.S. economic outlook. Before raising the federal funds target again, the Federal Reserve will wait for economic data showing stronger job growth. The Fed will also want data to continue showing stronger real GDP growth in the second quarter of 2016 than the first, and signs that inflation is on a trajectory to return to the Fed’s target. After the disappointing May jobs report and Chair Yellen’s dovish comments at the June FOMC meeting, a July rate hike seems highly unlikely, but a September hike is conceivable if jobs data improve in the summer months.

JAPAN: As expected, the Bank of Japan left its monetary stance unchanged at its June 16 decision. The Bank of Japan will continue to buy assets at an ¥80 billion yen annual rate, and will impose a -0.10 percent interest rate on a portion of commercial banks’ excess cash reserves. Like the Federal Reserve, the BoJ noted downside risks to the global economy from the Brexit vote. The BoJ also made explicit mention of its easing bias, saying that they could “take additional easing measures in terms of three dimensions – quantity, quality, and the interest rate – if it is judged necessary for achieving the price stability target.” The BoJ could increase purchases of riskier assets like ETFs if it wanted to intensify its asset purchase program.

EUROZONE: Eurozone employment rose 0.3 percent, not annualized, in the first quarter of 2016 from the prior quarter. From a year earlier, employment grew 1.4 percent in the first quarter. Employment grew 1.3 percent from a year earlier in Germany, 2.3 percent in Greece, 3.2 percent in Spain, 0.7 percent in France, 1.2 percent in Italy, and 1.1 percent in Portugal. By industry, employment in the first quarter grew fastest in trade/transport/accommodation/food services, up 1.7 percent on the year, in information/communication, up 2.8 percent, in real estate, up 1.6 percent, in professional/support service activities, up 3.1 percent, and in arts/entertainment/other services, up 1.8 percent on the year. Manufacturing employment grew 0.8 percent from a year earlier in the first quarter, lagging the economy’s aggregate, and construction employment fell 0.4 percent, the third consecutive quarter in which it fell from a year earlier. The Eurozone’s service sector and domestic demand are offsetting weak foreign demand in 2016 and providing most of the currency area’s employment growth. This is lowering the Eurozone’s unemployment rate, but labor market slack and slow productivity growth are still muting domestically-grown price pressures.

MEXICO: Inflation picked up slightly to 2.6 percent in May in year-ago terms from 2.5 percent in April. Food prices rose 3.8 percent from a year earlier in May, faster than April’s 3.4 percent increase, while energy prices fell 1.8 percent on the year, a larger drop than April’s 1.1 percent annual decline. Energy prices are falling in peso terms in 2016, but by much less than in U.S. dollar terms, since low global oil prices and aversion to emerging market risks have caused the peso to depreciate almost 20 percent over the last 12 months. Mexican core services prices rose 2.4 percent on the year in May, unchanged from the prior three months. Inflation is below the Bank of Mexico's 3.0 percent target, and core services prices have held under the target for 17 consecutive months, the longest such stretch since Mexico's statistical agency began reporting core service price inflation in 1983. Meanwhile, in the most recent release for April 2016, the Mexican unemployment rate fell to 3.9 percent, the lowest since September 2008. The Bank of Mexico is likely to hike its interbank interest rate objective from 3.75 percent to 4.00 percent at its June 30 monetary policy decision to support the weak peso.

AUSTRALIA: The Reserve Bank of Australia will likely hold the cash rate at 1.75 percent through the end of 2016, despite an uninspiring jobs report for May. The latest employment figures show Australia’s labor market continues to improve—employment rose 17,900 from April to May after rising just 10,800 in the prior month. On the downside, the labor market’s strength is leaning heavily on part-time employment and this is dampening wage growth. In May, all job gains came from part-time employment (full-time employment was flat). In April, full-time employment fell 9,300 while part-time employment rose by 20,200. Also, the labor force participation rate held steady at 64.8 percent between April and May while the unemployment rate also...
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held at 5.7 percent. These weak details are leading markets to increasingly expect an additional rate cut after May's surprise reduction. Futures prices are implying a slightly greater than 50 percent probability of a rate cut by July and an almost 73 percent chance of at least one cut before the end of the year. These are higher odds than what markets were expecting a few weeks ago. Markets may be overestimating the RBA’s easing bias. According to GDP statistics, the economy is growing at a reasonable rate, thanks to low interest rates and a competitive currency. Also, domestic consumption, credit and real estate have all been growing moderately, giving hope that the labor market recovery's less-than-ideal composition will improve. Looking ahead, the jobless rate will likely remain a little less than 6 percent throughout 2016.

CHINA: Strong real estate sales and infrastructure investment are cushioning slumping private business activity. Commercial real estate sales surged 50.7 percent by value and 33.2 percent by floor space sold in the first five months of 2016 from a year earlier. Despite strong housing demand, investment in fixed assets grew just 9.6 percent from a year earlier in the first five months of 2016, the slowest since 2000 – private investment grew just 3.9 percent, while state controlled investment grew 23.3 percent. With investment demand weak, value added of industrial production grew a modest 6.0 from a year earlier, unchanged from April. Retail sales of consumer goods grew 10.0 percent in May, only slightly changed from April’s 10.1 percent increase.

INDIA: Industrial production contracted 0.8 percent from a year earlier in April after rising 0.1 percent from a year earlier in March. Manufacturing production fell 3.1 percent on the year in April, after a 1.2 percent annual decline in March. Mining grew 1.4 percent on the year in April, while electricity output surged 14.6 percent after 11.8 percent growth in March. Industrial production could have risen on the month if not for a 96 percent annual plunge – a near total shutdown – in rubber insulated cable production. This product comprises only 0.1 percent of Indian industrial production, but still lowered the annual change in the industrial production index by 3.7 percentage points in April. As a result, India's manufacturing is probably not as weak as the headline number. In addition, April’s strong electricity growth is a sign that the broader economy, and in particular the service sector, continue to grow. CPI inflation was 5.8 percent (5.76 percent before rounding) in year-ago terms in May, the highest since August 2014 and up from 5.4 percent in April. Higher inflation is due to faster increases in food and beverage prices, rising 7.2 percent from a year earlier in May, up from a trough of 2.8 percent inflation in July 2015. Fuel and light prices rose a modest 2.9 percent on the year in May, little changed from April's 3.0 percent annual increase. CPI excluding food and energy was 4.8 percent in May, down from 5.0 percent in April. The Indian statistical agency does not explicitly report an index of inflation excluding food and energy, but it can be backed out of the CPI component data. With Indian growth holding up and core inflation steady, the Reserve Bank of India is likely to leave interest rates on hold for the rest of 2016 after its 25 basis point cut in the repo rate to 6.50 percent on April 5. The RBI remains concerned that further U.S. interest rate hikes could revive global financial volatility and risks to emerging markets, potentially triggering a capital outflow that would weaken the rupee.

BRAZIL: No turning point visible yet for Brazil. The IBC-BR index, the central bank’s monthly proxy for real GDP, was unchanged after rounding in April from March, and fell 5.8 percent from a year earlier – a terrible decline, albeit a smaller contraction than March and February’s 6.7 percent annual plunges.

CANADA: The unemployment rate fell to 6.9 percent in May from 7.1 percent in April, and was the lowest since July 2015. In the household employment survey, employment rose by 14,000 on the month in May after rising 6,500 in April (originally reported as a 2,100 decline). From a year earlier, employment grew a modest 0.6 percent in May after 0.8 percent in April. The number of hours worked grew 0.8 percent on the year in May after 0.9 percent in April. While labor force participation declined 22,900 on the month in May, much of this was due to the Alberta wildfires, which caused the labor force in Alberta to drop by 9,800. The evacuation of Fort McMurray prevented Statistics Canada from collecting survey data there in May, so the true impact on the region's employment is likely more severe than the May jobs report estimates. Other details of the jobs report were solid. Full-time employment rose 60,500 on the month, more than absorbing the 46,800 decline in part-time employment. Canadians working as employees rose 24,800 on the month, and self-employment fell by 11,100. Employment in goods-producing sectors rose a solid 19,000, with monthly gains in construction and manufacturing offsetting declines in resource sectors. And while service
sector employment fell 5,200 on the month, this was due to a 41,200 decline in employment in wholesale and retail trade. Most of the workers leaving the wholesale and retail sector likely found higher-paid jobs in other industries. Public employment rose 30,200 on the month in May, and is up by 69,800 or 2.0 percent from a year earlier. Canada’s fiscal stimulus program is adding to public payrolls and providing jobs to some of the workers displaced by the energy sector downturn. Canadian CPI inflation slowed to 1.5 percent in year-ago terms in May from 1.7 percent in April. Core CPI also slowed slightly to 2.1 percent in year-ago terms from 2.2 percent. The Bank of Canada targets 2.0 percent. Goods prices rose 1.1 percent on the year in May, held down by a 3.6 percent annual decline in energy prices. Services prices rose 1.9 percent on the year in May. In seasonally-adjusted terms, both headline and core CPI rose 0.2 percent in May from April, in line with the Bank of Canada’s inflation target. The outlook is for muted inflation in the year ahead. While the May jobs report looked favorable for income growth, the energy downturn will likely continue shifting workers out of higher-paid jobs in energy and ancillary industries into lower-paid service sector jobs, muting wage growth and inflation pressures in the year ahead. This is showing up in weak average weekly earnings, up just 0.7 percent on the year in the latest release for March 2016 and lagging inflation.