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Brexit and Beyond

Pax World investment outlook: Third quarter 2016

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What an eventful first half of 2016. At the start of the year, global equities tallied double digit losses in the first six weeks then rallied sharply to erase those losses and produce steady gains for most of the second quarter. The market's path took another sudden turn at the end of June when investors seemed singularly focused on one thing—Brexit.

A dramatic sell-off occurred on June 27, after a slim majority of United Kingdom (U.K.) citizens voted for the country to leave the European Union (EU), commonly referred to as Brexit. Investor expectations were shattered and global markets were gripped by fear and uncertainty.

A relief rally in the week following the vote was accentuated by positive news for equities. Markets were spurred on by a growing view that monetary authorities would be prepared to ease in the face of uncertainties caused by Brexit. Unexpectedly strong U.S. payroll data was also welcome news. The S&P 500 Index[1] recovered, reaching an all-time high just two weeks after the Brexit vote, despite all the initial doom and gloom.

So, what are investors to make of Brexit in the larger context of financial markets and sustainable investing?

KEY TAKEAWAYS

- At the end of the second quarter, the market's path of steady gains took a sudden turn when investors seemed singularly focused on one thing—Brexit.
- In the near term, global growth prospects and the direction of short-term interest rates continue to shape market sentiment.
- Two initial climate-related uncertainties created by Brexit include the strength of EU's pledge to reduce greenhouse gas emissions and political control over EU carbon markets.
- Secular forces that could keep interest rates low over the long-term have implications for asset allocation and equities today.

SHORT TERM FOCUS: GLOBAL GROWTH AND INTEREST RATES

Behavior in equities post-Brexit was a three-week microcosm of the first three months of the year. In January, equities plummeted on concerns that slowing growth in China would significantly impact global growth. Similarly, post-Brexit markets dropped based on concerns that a potential recession in the U.K. and disruption in the EU could slow global economic growth.

After the markets bounced back in late June as the quarter came to a close, it became clear that Brexit needs to be evaluated alongside other fundamental forces, including positive trends in U.S. employment and the ISM (Institute of Supply Management) Manufacturing Index,[2] and ongoing economic concerns of China and other emerging markets.

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[1] The S&P 500 Index is a widely recognized, unmanaged index of common stock prices. One cannot invest directly in an index.

[2] The ISM Manufacturing Index is a composite indicator of U.S. manufacturing activity and monitors employment, production, inventories, new orders and supplier deliveries. The Index is based on surveys of more than 300 manufacturing firms by the Institute of Supply Management.

Interest rates and monetary policy are also shaping current market sentiment. In the wake of Brexit, the yield on the U.S. 10-year Treasury fell to a historic low of 1.36 percent. With statements of support from EU and U.K. monetary authorities and a general consensus that Federal Reserve rate hikes are on hold, equity investor concerns about rising rates have been tempered. While most of the focus is on short-term rates, we believe there are longer-term interest rate issues that require deeper analysis.

LONG TERM FOCUS: CLIMATE CHANGE AND SECULAR INTEREST RATE TRENDS

Climate change

Brexit can have substantial sustainability consequences, and while these won't make the immediate news, the longer-term implications could be as serious as the financial impact, if not more so. It is far too early to predict what those consequences will be, and like the financial story, what will happen depends more on what actions are taken than on the initial vote. To illustrate, let's focus on one issue: climate.

The U.K. was a key player in the EU's pledge to reduce greenhouse gas emissions by at least 40 percent by 2030, and that pledge was one of the key enablers of the Paris Accords—the international agreement negotiated last December to curtail emissions of greenhouse gases sufficient to limit further warming to 2˚C. One of the biggest immediate questions: will the U.K. ratify this agreement while it's still a member of the EU? If it doesn't, the EU might not be able to ratify either, and there is potential that the target would change if the U.K. left.

The U.K.'s departure from the EU also gives more control over the EU's carbon markets to the more coal-intensive nations, including Germany and Poland. Also, British companies may dump their carbon permits if the country chooses to leave the EU's carbon market, the EU Emissions Tracking Systems (ETS). Brexit does not force the country to leave the carbon market, but it gives it no voice in making rules for the ETS. If Britain does leave the ETS, this could further push carbon prices down, which in turn erodes the impact of incentive programs for renewable or zero-carbon energy.

None of this means that carbon markets will necessarily collapse. Some hopeful things have happened since the vote. The U.K.'s then-Energy Secretary (and now Home Secretary), Amber Rudd, affirmed that Britain would not turn its back on climate change, and stated that the British government will establish a target to reduce carbon emissions by 57 percent by 2032. That doesn't necessarily mean that it's time to breathe a sigh of relief; the new British government announced on July 14 that it would dissolve its Department of Energy and Climate Change and fold its duties into an expanded Department of Business, Energy and Industrial Strategy, which may not augur well for Britain's climate leadership.

Secular interest rate trends

While we are in a period of low and even negative global interest rates, Brexit confirmed that we're operating in unchartered territory when it comes to interest rate environments.
While many investors like to speculate on the Fed's next move, we expect to be operating in a

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historically low interest rate environment for years to come, regardless of when it actually occurs. Sure, the 10-year U.S. Treasury rate has hit historic lows, but it provides a meaningful premium to the German 10-year Bund which is trading at negative yields. This premium, the potential for continued dollar strength, a benign inflation outlook and the U.S. Treasury's role as a safe haven, all place downward pressure on U.S. rates.

While these shorter-term factors receive significant media coverage, investors willing to pay a premium for yield is a secular factor that could help keep a lid on rates over several years. A secular trend, as opposed to a cyclical trend, has long-term causes, long-term effects, and can be just as important in the future as today.

Why is this a secular trend? Demographics point to a growing older population—the U.S. population over 65 has increased from 8 percent in 1950 to 12 percent in 2000, and is on the way to more than 20 percent by mid-century.[3] This aging population fuels demand for income-producing vehicles with enough yield to help meet retirement needs, which we believe should contribute to a lower interest rate environment over the long-term.

Focus on risk *and* longer term

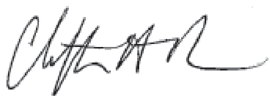
Brexit certainly left its mark during the second quarter, even if it was confined to just five volatile days in late June. The implications will be assessed and reassessed in the coming months and years. Near-term we anticipate volatility to persist amidst political and economic uncertainty. As with all such events, we believe the prudent course for investors is to focus on long-term implications while managing risk in the short term.

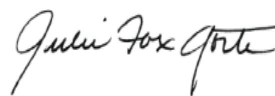
Doing so means issues like climate change and secular interest rate trends must remain in focus as near term uncertainties like Brexit move to center stage. Climate change presents an indeterminate-term risk,[4] and its implications for society and investments across asset classes and sectors remains critical.

Similarly, historically low rates and the secular forces that could keep them low have implications for asset allocation and equities. On the surface, low rates make bonds appear unattractive relative to equities. However, in periods of uncertainty like we have seen this year, they could outperform equities.

The bigger question that will play out is the degree that low interest rates over a long time horizon will support capital spending, earnings growth and stock returns. The demand for income from an expanding retired population also points to demand for higher yielding stocks which could contribute to their total return prospects.

Sincerely,





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[3] James M. Poterba, "Retirement Security in an Aging Society," NBER Working Paper 19930, February 2014.
[4] http://paxworld.com/system/storage/19/6f/7/4532/integrating_esg_analysis.pdf

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