AVALON
ADVISORS, LLC

AVALON PERSPECTIVES

Quarterly Note

Second Quarter 2016

- **The Leave campaign won a surprising victory in the "Brexit" vote. Thus far, markets have reacted in an orderly fashion.**
- **The US Federal Reserve "flip-flopped" on its plans to raise interest rates.**
- **Despite the headlines, the US economy in second half of 2016 is poised to be similar to recent years with slow but steady growth.**

Brexit was certainly an unexpected development, and its consequences are likely to reverberate for the foreseeable future. Given the drawn out timeline for negotiating the departure, Brexit will keep the Federal Reserve from moving rates higher—at the very least, rate hikes are off the table in 2016. In the US, markets now believe the Fed is more likely to cut interest rates during the next 5 meetings than hike them. The perception of backtracking has kept the US dollar relatively tame in the aftermath of Brexit, and an inactive Fed should keep downward pressure on interest rates.

Not surprisingly, the United Kingdom is expected to take the greatest economic blow, and forecasts now call for a recession to begin by the end of 2016 or beginning of 2017. Outside of the UK, the repercussions should be less severe. The European Union economy is predicted to decelerate as uncertainty sets in. Japan will be one of the most impacted due to the strengthening of the yen. A significant depreciation in the Chinese yuan could cause Brexit consequences to spread quickly in a similar manner to what occurred last summer. Though the yuan has weakened, a shock has not materialized thus far. A persistent weakening of the yuan is the path of least resistance for problems to spill-over to the US economy in a meaningful manner. At the moment, the US and the global economy can ill afford a renewed yuan shock.

Since the US economy is not reliant on exports, it is largely insulated from the direct consequences of Brexit. However, unforeseen spill-over effects from the global banking system are still a tail-risk, and could have a negative effect on the US economic prospects. But economists are only suggesting that Brexit will subtract 0.1 to 0.2 percent growth from the US economy, marginal in comparison to some countries. Growth was already slow in the US, and GDP is expected to expand in 2016 by around 2%, similar to the past several years.

AVALON
ADVISORS, LLC

AVALON PERSPECTIVES

Quarterly Note

Second Quarter 2016

Before Brexit, the US grew faster than estimated in the first quarter, but the quality of the growth was low. Personal consumption, the primary driver of growth in the US, was only 1.5%. This was actually lower than previous estimates and a disappointment. Recently, data has pointed toward a far more robust US consumer in the second quarter, and therefore better growth. Looking at the rest of 2016, the consumer may be slightly more restrained given the Brexit headlines but should remain healthy.

One of the issues left unresolved in the second quarter was the apparent slowing of the employment gains. The May payroll print of 38,000, released the first week of June, was so poor that some of the rhetoric following it pointed to an imminent recession. But this would be an unprecedented moment to enter a recession. Jobless claims tend to increase before a labor market decline, and claims are currently near 30 year lows. Combined with the high level of job openings, the labor market appears to be healthy but volatile. Simply, the May jobs report conflicts with a wide range of other employment indicators.

The UK referendum to leave was an unexpected outcome, but it only roiled markets briefly. Certainly, there could be spillover or knock-on effects that materialize as negotiations between the EU and UK progress, but asset markets have been orderly so far. There is little, if any chance, of the Fed hiking interest rates for the remainder of 2016, and this is helping keep the dollar's value in check. US and global growth will be slower due to the uncertainties from Brexit, but not too much slower. For better or worse, the second half of 2016 appears to be a repeat of recent history.

Samuel E. Rines
srines@avalonadvisors.com

Avalon Advisors, LLC
2929 Allen Parkway Suite 3000, Houston, TX 77019 | 713.238.2050
755 Mulberry Avenue Suite 200, San Antonio, TX 78212 | 210.244.2750
www.avalonadvisors.com
Publication Date: 7/1/2016