International Stocks Off to a Strong Start in Q2 Despite a Heavy Fog of Uncertainty

Global stock markets are continuing to advance following one of the best first-quarter performances in years, with the global iShares MSCI ACWI ETF, ACWI, gaining 14.9% year-to-date April 5th.

That increase includes strong advances in US stocks. Excluding the US market, the gains in international stock markets have also been impressive. The iShares MSCI ACWI ex US ETF, ACWX, is up 12.9% on a total-return basis. This continued equity market strength is occurring in the face of the heavy uncertainty clouding the outlook for the second quarter and beyond. Important issues for investors include the outcome of the convoluted Brexit drama, the US-China trade talks and other trade disputes, and the dimensions of the moderation underway in global economic growth, in particular growth prospects for China, the US, and Germany. Positive outcomes for these issues would validate recent market gains and provide a tailwind to stocks. Downside risks, however, are significant. Until the fog clears, we can expect volatile markets.

We, of course, do not know how these matters will develop, but recently we have noted some favorable signs. The White House and Chinese sources are signaling that a trade agreement between the two countries may result during the coming weeks, with a signing event involving Presidents Trump and Xi looking increasingly likely. Both parties appear to want a deal. This agreement, which President Trump suggests will be “very monumental,” will most likely have to leave some of the more difficult issues to further negotiations. There are other trade disputes that create uncertainties for investors. The administration’s agreement with Mexico and Canada on revisions to NAFTA is under challenge in Congress, and the US and Europe have yet to resolve their trade disputes.

With respect to the economic outlook, concerns about the slowdown in China have been eased by some positive data. The Chinese government’s efforts to stimulate the economy appear to be having productive effects. If the Chinese economy, the globe’s second largest, does manage to advance at a still-robust 6%-plus pace, this momentum will deliver an important boost to the global economy. It would certainly help the largest economy in Europe, Germany, where the recent slowdown is due in part to weakness in exports to China. Concerns about the strength of the US economy, including some predictions for a recession, also appear to be overdone. Recent data suggest continued strength. Another reason for cautious optimism is the accommodative stance of US monetary policy, which is being followed by the world’s other major central banks.

No one knows how the three years of uncertainty since the June 2016 “Brexit” referendum in the UK will be resolved. The situation changes daily, and it now appears that this uncertainty will likely continue for months and maybe longer. The inability of United Kingdom’s politicians to agree how to leave the European Union has already seriously harmed the British economy. Investment decisions have been deferred or redirected. Britain's reputation as a desirable host for foreign investment has been damaged, and financial institutions are moving staff and operations to other EU countries.

The date of April 12, when the UK could be forced by legal default into a no-deal departure, is getting perilously close. The effects of such a break would likely push the UK economy into recession, and European Union economies would also suffer. Realizing this danger, both sides are seeking to kick the can down the road. Prime Minister May has written to the EU requesting a delay until June 30. She indicates that this postponement will mean the UK will have to prepare to participate in the EU elections on May 23–26 with the provision that the UK could withdraw from the elections if a deal can be finalized earlier.

The European Council president, Donald Tusk, is proposing a much longer extension that would be "flexible" in that the UK could leave earlier if the UK Parliament reaches an agreement on a deal. Any such extension would have to be agreed by all 27 remaining EU members at their emergency summit meeting next Wednesday, April 10th. The EU has said they would need to see some real progress in the UK's development of a separation deal to be willing to grant an extension. It is looking likely that an extension will be agreed. If indeed significant progress on reaching a deal can be demonstrated, the EU may be willing to agree to the shorter extension requested by the UK. Otherwise, the EU may insist on a longer delay. The possibility of a disagreement on this point presents an additional risk of an unintended no-deal Brexit.

It is difficult to follow the daily developments in the disarray in Britain's Parliament over Brexit. This is particularly the case for most US readers who are unfamiliar with the UK's parliamentary system, which is very unlike the US system, even though the inability to reach decisions may sound familiar. The European Union's political system is also quite different from that of the US. The deadlock in the UK Parliament reflects sharp divisions within both major parties, the ruling Conservative Party and the opposition Labour Party. The lawmakers of both parties in the House of Commons include both strong proponents of leaving the EU (some of whom are willing even to suffer crashing out with no arrangements for what follows) and strong proponents of a “soft” Brexit that involves maintaining a close trade relation with the EU, perhaps in the form of a customs union. Some of the latter would like to cancel the decision to leave. Many would like to see a second referendum held to check the current preferences of the public. Efforts to find a plan that could gain a majority vote have failed, including the plan of Prime Minister Theresa May, which she had negotiated with the EU.

In desperation and against the wishes of some fellow Conservative Party cabinet members, May last week entered into discussions with the leader of the Labour Party, Jeremy Corbyn, attempting to find a compromise withdrawal deal that the House of Commons could support. Following an initial meeting between the party leaders, Conservative and Labour teams are engaged in intensive negotiations aimed at developing a compromise withdrawal agreement that will include a political declaration. It is the latter, nonbinding declaration that might contain the idea of a customs union or a Norway-model option. It may well also contain the idea of a second referendum. If these talks succeed, the plan would be presented to the EU at the Union’s emergency summit Wednesday, April 10th. If there is no progress before the April 10 summit, May will likely be forced to accept a lengthy delay to avoid a no-deal crash-out. Investors and businesses would then face an extended period of continued uncertainty about the UK’s future relations with the EU countries.

Despite the continued uncertainties about the eventual outcome of Brexit, which involves far more complexity than we could summarize above, investors appear to be increasingly optimistic. The iShares MSCI United Kingdom ETF, EWU, is up 2.4% over the past five market days and 15.1% year-to-date April 5th. This performance is better than the Eurozone's, as the iShares Eurozone ETF, EZU, has gained 13.4%. We are more hesitant with respect to UK stocks at this time. The possibility of a no-deal exit still remains. In addition, the harm already done to the UK economy does not appear to be fully appreciated. The New York Times reports that economists estimate that the British economy is 1.0–2.5% smaller than it would have been without the referendum vote. One can question this analysis, but the 1% decline in business investment expected this year will be evident to all. The financial jobs already lost to Europe will not likely return. The longer Brexit uncertainty persists, the more damage will be done to the UK economy and its reputation. Certainly, a smooth separation process followed by continued strong trade relations would be an important plus for the UK and EU markets, but this outcome is not yet assured.

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Sources: Financial Times, New York Times, Action Economics, cnn.com, BBC News, CNBC.com

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