Monthly Newsletter
Savings and Investments
Life after “Brexit”

July 2016

Market overview

The end of 2016 Q2 was marked by highly anticipated “Brexit” referendum in the United Kingdom (UK). The UK unexpectedly voted to leave the European Union (EU) which shake financial markets and created significant political turmoil not only in the UK but throughout the EU. During the first week after referendum political questions were far more numerous than answers. Also political developments in UK implied a declining probability of the UK exiting from the EU. The questions that must be answered over the next 2-3 months will be crucial to the future and strategies of both the UK and the EU, but they are extremely complex. We are to experience central banks and governments to contribute with measures to stabilize the situation. Meanwhile, the International Monetary Fund (IMF) predicts not a big influence to global growth – global GDP growth may fall 0,1-0,2%.

Stock markets*

USA
(S&P 500 index, USD):
+0,1% in June
+2,7% YTD
+58,9% in 5 years

Europe
(MSCI EURO, EUR):
-6,3% in June
-11,4% YTD
+8,9% in 5 years

Eastern Europe
(MSCI EM Eastern Europe, USD):
+0,1% in June
+11,4% YTD
-52,6% in 5 years

Asia
(MSCI EM Asia, USD):
+2,0% in June
+1,0% YTD
-13,3% in 5 years

Latin America
(MSCI EM Latin America, USD):
+11,3% in June
+24,0% YTD
-49,2% in 5 years

Major events and expectations

The **dramatic movements** in financial markets after “Brexit” referendum were **understandable, yet exaggerated**. The sign of it – heavy decline in markets rebounded during the week after referendum. What happens next is naturally hard to say. “Brexit” will negatively **impact economic growth** mainly in the UK, but also elsewhere in Europe and to some extent globally. However, the impact will be **marginal**; **the IMF predicts** that global GDP may fall 0,1-0,2%. The **central banks** and **political leaders** are likely prepared to activate **stimulus measures** to help sustain economies and markets as needed, which may **stabilize** the situation.

From political point of view, there will be great **political turmoil**, not only in the UK but throughout the EU. Obviously there is confusion about what strategic direction the EU should take. Last year’s “road map” for achieving full EU economic and monetary union by 2025 will now be shelved, In practice; this means that the euro project will remain without the final infrastructure needed to give the Eurozone long-term stability. The **extra EU summit** in mid-September will be an attempt to find a common platform. The areas mentioned so far in which cooperation can be deepened include **defence and security policy as well as labour market policy**, with a special focus on jobs for young people. This platform must be established at the same time as the EU is also **struggling with other challenges**: the refugee crisis, weak economic growth, weak capital spending and ageing populations. EU political leaders will be forced to express themselves clearly about such issues as internal mobility and immigration.

There are a lot of uncertainties; however **there seems to be political clarity on a few points**. **The UK** and no one else **will decide the timetable** for when and if exit negotiations with the EU will start. The earliest date for this is beginning of September. This implies that withdrawal from the EU will not occur until January 1, 2019 at the earliest. Until then, the UK will still be a **full EU member**. And in future if the UK wants access to **EU single market**, it must **accept all the EU’s four freedoms**: freedom of movement for goods, services, capital and people.

The **European political agenda** (on the right) is dominated by events that have potential to reduce tension and uncertainty as well as fuel new worries. Meanwhile, we are approaching a presidential election in US, while China is grappling with its economic growth model and debt restructuring. All of this increases the need for policy coordination at the global level and within G20 framework.

Our **main scenario** is that global growth will not undergo any major downturn, the risk of recession remains low. We expect the world economy to grow at a decent pace, with room for slight acceleration in 2017. This would mean positive sign for equities in longer term. In shorter term, greater uncertainty and a poorer earnings outlook suggest rather turbulent stock markets. To ensure a more lasting upturn for equities, the political situation in Europe probably needs to become clearer, which may take time.

Date	Event
2016 07 14	Bank of England (BoE) – interest rate announcement
2016 07 21	ECB monetary policy meeting
2016 08 04	BoE – interest rate announcement
2016 08 25-27	Central bank conference, Jackson Hole, US
2016 09 04-05	G20 summit, China
2016 09 08	ECB monetary policy meeting
2016 09 09	Election of new Conservative party leader, UK
2016 09	UK may activate the “exit clause” (Article 50)
2016 09 15	BoE – interest rate announcement
2016 09 16	Extra EU summit, Slovakia
2016 09/10	Hungarian referendum on EU refugee quotas
2016 10	Italian referendum on the constitution
2016 10 20	ECB monetary policy meeting

* More information regarding indexes’ performance can be found at the end of the document

SEB

Impact on investments of different risk categories

Product group	Impact during the last month and expectations looking forward
Low risk (conservative)	Even before the "Brexit" referendum, the historically low interest rate climate was challenging for fixed income investments. After the referendum, government bond yields have fallen further; among fixed income assets, we still have a negative view of government bonds.
Medium risk (balanced)	Our balanced medium risk portfolios managed to generate positive return during June even in the environment of declining asset prices after "Brexit" referendum. Until the referendum date we continued to stay at reduced risk level, but few days after the referendum the risk was increased a bit with the argumentation that central banks will serve as a supportive factor in case we see any deterioration in the markets; also tactical macroeconomic momentum in the US has improved over June; and we do not expect to see a material decline as a consequence of "Brexit".
High risk (aggressive)	The first half of 2016 was characterised by large market movements. The year began very weakly, followed by a powerful rebound. Early in the second quarter, the rebound was followed by a flatter market trend. This has been replaced by a new downturn, due to the unexpected news on British voters want their country to leave the EU. In the near future, discussions of the impact of Brexit are likely to continue dominating markets. However, we expect the impact to be substantial but manageable. We also expect central banks to take steps to ease negative effects, which will help sustain risk assets. Apart from Brexit we see signs of economic acceleration, especially in the United States and in the previously depressed manufacturing sector. Assuming this situation persists, it may become a much-anticipated signal to markets that long expected increases in corporate earnings may materialise. In the short term, however, there are clear risks to this scenario. One is that consumption is not increasing at the pace we might have expected. Another is indications of an unexpectedly weak US labour market. A third is lingering concern about debts in China – aside from the risk that Brexit will have a bigger effect on growth than feared, via lower confidence, consumption and investment appetite.

Monthly theme

Helicopter money

Developed and rich countries of the world continue to stumble along in an environment of low inflation and weak economic growth. The weakness persists despite central banks' vigorous attempts to get their economies moving, by cutting rates into negative territory and printing money to buy government bonds and other assets (a policy known as quantitative easing, or QE). Therefore, more and more discussions emerge about what else can be done, and many observers have started to consider more radical options. One that has been gaining ground is called "helicopter money" – an idea of giving people cash or reducing taxes for people to have more after-tax money, or some form of additional government spending. In March Mario Draghi, the president of the European Central Bank (ECB), described helicopter money as a "very interesting concept", however hardly implementable. What exactly is helicopter money, how would it work and what would it do to economy?

What is helicopter money?
Helicopter money is a reference to an idea made popular by the American economist Milton Friedman in 1969. In his famous paper "The Optimum Quantity of Money", Friedman included the following parable: "Let us suppose now that one day a helicopter flies over this community and drops an additional $1000 in bills from the sky, which is, of course, hastily collected by members of the community. Let us suppose further that everyone is convinced that this is a unique event which will never be repeated."

Helicopter money has been proposed as an alternative to QE when interest rates are close to zero or even negative and the economy remains weak or enters recession. Helicopter money implies free and irreversible distribution of money to the end consumers. It can be achieved by literally transferring money to individuals' accounts for free or by reducing taxes universally to all households enabling more disposable money in their hands. The end aim of helicopter money is to boost consumer demand and spending, increase broader economic activity and increase inflation to optimum levels, thereby leading to economic recovery.

Quantitative easing versus helicopter money
Current QE programmes undertaken by central banks since the financial crisis involve large-scale purchases of assets from financial markets. These have predominantly been targeted at government bonds, but also a range of alternative assets, including corporate bonds, mortgage-backed securities and even stock market exchange traded funds. QE allows for eliminating limitations on available reserves in the financial sector, and reduces the cost of borrowing as more money is made available in the financial system. However, its impact remains indirect and often not effective to expected levels as it takes time for the benefits to appear in different economic sectors.

By contrast, helicopter money does not involve central bank asset purchases. Rather, it involves permanent central bank financing of a government cash grant to the general public. As such, the aim would be that money directly reaches the end consumers who would increase spending. The same can be achieved by reducing tax rates, where the end consumer gets the benefit of having more after-tax money.

Also, QE is usually reversible, which means central bank could later sell government bond or other assets bought before. Therefore the main differences between the two are:

- helicopter money goes direct to consumers and households – rather than central banks who can sell off the purchased assets once economic recovery is achieved;
- helicopter money is irreversible, as it increases the base money available in the hands of end consumers.

Challenges with helicopter money
While theoretical considerations suggest that helicopter money is especially effective under extreme economic circumstances it may also create difficulties and instabilities. Few of them are mentioned below:

- political versus regulatory – in order to get a helicopter money-based stimulus, it would be first needed to coordinate the responsibilities of a government and the independent central bank. While this doesn't present much of a barrier in theory, in practice the two may operate on different short-term and long-term strategies to achieve economic growth. For example, coordination would be extremely difficult in the Eurozone, if possible at all, between the ECB and national fiscal authorities, due to diverse fiscal policies with different policy objectives and one single monetary policy for the whole area authority;
- spending versus saving – once the money reaches end consumers, they may decide to save instead of spending and in such behavior disrupt the end aim of helicopter money;
- effects on currency – economists also fear that printing more money may lead to currency devaluation in the international markets, which would hamper economic recovery;
- inflation could increase more than expected and central bank could lose the power to control inflation as there are concerns about weakening central bank independence in helicopter money-based stimulus policy.

Switzerland example
Lately helicopter money idea was seriously considered in Switzerland. The idea was to give everyone in society free money – a universal basic income (UBI). After initiators of this idea collected the necessary 100 000 supporting signatures, Switzerland became the first country worldwide to hold a national referendum (on 5 June 2016) on the introduction of an UBI. The initiative had suggested a radical plan of paying CHF 2 500 (EUR ~ 2 300) a month to each adult, and CHF 625 (EUR ~570) for each child. Authorities have estimated an additional CHF 25 billion (EUR ~23 billion) would be needed annually to cover the costs, requiring deep spending cuts or significant tax increases.

The main arguments for introducing UBI were related to Switzerland's suffering economy from an overrated currency, ineffective negative interest rates policy, etc. Supporters also provided that such an income would help fight poverty and inequality in a world where good jobs with steady salaries are becoming harder to find.

Critics of this initiative warned about sky-high rocketing costs and people quitting their jobs massively (arguing that if you pay people to do nothing, they will do nothing) harming the economy. There were also fears of a loss of industrial initiative, along with a sudden mass immigration by outsiders, occurring to take advantage of such helicopter money scheme. Finally, critics tried to persuade that free and guaranteed basic incomes will only accelerate government default rather than strive to stimulate an economy. The Swiss government, businesses and many trade unions did not support the idea of a UBI and had urged voters to reject it.

The day of referendum showed that the people of Switzerland have rejected a proposal to introduce UBI to every citizen, with almost 77% saying "no" vs 23% in favor. Even it was a little chance of the initiative passing through, just getting a broad public debate gained traction among economists not only in Switzerland and Europe, but worldwide as well.

Switzerland could become a pioneer in this area. It could break a taboo, helping other countries, where such a measure might arguably be more difficult to implement, to consider it seriously. However, Switzerland could be the first but it won't be the last. The idea is also under consideration elsewhere. In Finland, the government is considering a trial to give basic income to about 100 000 people from low-income groups. Four Dutch cities will probably run trials this summer. And several other cities and states, from Canada to Spain, are interested.

Bottom line
In 2002, following coverage of concerns about deflation and economy recession in US, Ben Bernanke, the former US Federal Reserve chairman, gave a speech where he mentioned: "Helicopter money could prove a valuable tool. Under extreme circumstances such programs may be the best available alternative. It would be premature to rule them out." However, it was never implemented in US. Bernanke's critics have since referred to him as "Helicopter Ben".

While the concept of helicopter money seems attractive and right in theory, there are challenges with implementation. How effectively helicopter money is distributed, whether individuals will save it or spend it and if the supply will lead to inflationary pressures are some of the concerns in its implementation. Cases of combined economic zones, like the EU, complicate matters further. However, no matter whether it is ever seriously considered, bottom line is that even talk of helicopter money is just a sign of the times that central banks may consider anything to reboot the global economy.

Sources: *World Economic Forum, Centre for Economic Policy Research (CERP), Milton Friedman "The Optimum Quantity of Money", The Economist, Financial Times, basicincome2016.org, Investopedia.*

Terminology explanation

Terminology used	Explanation
Fiscal policy	Fiscal policy relates to government spending and tax collection. Fiscal policy refers to the use of the government budget to influence economic activity. For example, when economic growth is slowing down, the government can step in and increase its spending to stimulate demand and economic growth. Or it can lower taxes to increase disposable income for people and businesses.
Gross Domestic Product (GDP)	The monetary value of all the finished goods and services produced within a country's borders in a specific time period, though GDP is usually calculated on an annual basis. It includes all of private and public consumption, government outlays, investments and exports less imports that occur within a defined territory.
Group of twenty (G20)	A group of finance ministers and central bank governors from 19 of the world's largest economies, and the European Union. The G20 was formed in 1999 as a forum for member nations to discuss key issues related to the global economy. The mandate of the G20 is to promote growth and economic development across the globe.
Investment grade bonds, high yield bonds	Investment grade bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively low risk of default. High yield bonds – bonds (sovereign or corporate) with credit ratings that indicate a relatively higher risk of default than investment grade bonds. Because of the higher risk of default, these bonds pay a higher yield than investment grade bonds. Two main credit rating agencies Standard & Poor's (S&P) and Moody's, use different designations consisting of upper- and lower-case letters 'A' and 'B' to identify a bond's credit quality rating. S&P designations of 'AAA' and 'AA' (high credit quality) and 'A' and 'BBB' (medium credit quality) are considered investment grade. Credit ratings for bonds below these designations ('BB', 'B', 'CCC', etc.) are considered low credit quality, and are commonly referred to as high yield or "junk bonds".
Monetary policy	Monetary policy is the process by which the monetary authority (usually the central bank) of a country controls the supply of money (the size and rate of growth of the money supply), for the purpose of promoting economic growth and stability. For example, if the money supply grows too fast, the rate of inflation will increase and the economy will "overheat". If the growth of the money supply is slowed too much, then economic growth may also slow. The main tools to control money supply include open market operations (buying or selling assets), changing interest rates and changing reserve requirements for commercial banks.
Quantitative easing (QE)	An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.
Yield	The income return on an investment. This refers to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

Stock market indexes performance information covering the immediately preceding 5 years till 30 June, 2016

Region	Index	Currency	Performance						
			2011	2012	2013	2014	2015	12 months	2016 YTD
USA	S&P 500	USD	0,0%	13,4%	29,6%	11,4%	-0,7%	1,7%	2,7%
Europe	MSCI EURO	EUR	-16,5%	15,6%	19,6%	2,3%	6,1%	-14,7%	-11,4%
Eastern Europe	MSCI EM Eastern Europe	USD	-23,3%	13,2%	-2,9%	-40,0%	-8,1%	-11,4%	11,4%
Asia	MSCI EM Asia	USD	-19,1%	18,1%	-0,2%	2,5%	-11,8%	-14,2%	1,0%
Latin America	MSCI EM Latin America	USD	-21,9%	5,4%	-15,7%	-14,8%	-32,9%	-9,9%	24,0%