British voters’ surprise decision to leave the European Union (Brexit) generated a surge in anxiety at the end of June. The pound remains low, but the wave of market panic was short-lived, and stock indexes rebounded quickly in the weeks that followed. They continued to trend up in July despite other worrisome events, including a spike in concern over Italian banks, another attack in France, and an attempted coup in Turkey. The S&P 500 thus recently set another record high and even Britain’s stock market has shot up from pre-referendum levels. Why?

One reason for the stock markets’ recent strong performance is that the immediate consequences of the Brexit victory seem much less catastrophic than could have been feared. A political crisis was avoided in the United Kingdom: Prime Minister David Cameron was quickly replaced by Theresa May, a seasoned politician who seems to be succeeding at building consensus by promising to see Brexit through while attempting to maintain good relations with the rest of Europe. Also, encouraging economic numbers in the United States, including June’s big job creation rebound, seemed to confirm that Brexit would not take the global economy into recession.

Although Brexit’s short-term impacts now seem to be fairly limited, outlooks for global growth appear to be slightly lower and downside risks have increased. In this context, we can expect monetary policies to remain highly accommodative, and additional monetary easing could be announced shortly in some countries. The combination of more uncertain economic outlooks and highly accommodative monetary points to bond yields remaining very low in the coming quarters. Given the growing proportion of government bonds in advanced nations that are posting negative yields, and the fact that some businesses are now managing to get financing at negative rates, it can be no surprise to see investors in search of returns flocking back to the stock markets as soon as the worst worries dissipate.

Implications: Beyond the Brexit issue, the stock markets’ resilience in recent years seems to be largely due to highly accommodative monetary policies and the resulting very low interest rates. As nothing indicates that this will change anytime soon, the risk of a sharp, lasting stock market index correction seems small in the coming quarters, though it is never nonexistent. The substantial support for the stock market being provided by monetary policy can, however, raise some concerns for the future. Among other things, we can be concerned about the stock market reaction to an alternate scenario, in which accelerating inflation would force central banks to normalize monetary policy more quickly than now anticipated.

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Sources:
Datastream
and Desjardins, Economic Studies