Financial market turmoil continues in wake of Brexit vote

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28 June 2016

Global financial markets continue to be battered by the fallout from the British referendum decision last Thursday to quit the European Union, with the pound sterling dropping still further after recording its biggest one-day fall on Friday. Sterling has fallen 14 percent against the US dollar after reaching $1.50 on the day of the referendum, and is now down to below $1.32, with predictions that it could go as low as $1.10.

The plunge in the pound is the biggest two-day fall for the currency since the ending of fixed exchange rates following the decision by US President Nixon in August 1971 to remove the gold backing from the dollar.

Overall, global share markets have lost a record $3 trillion in the past two days of trading, with the S&P 500 in the US shedding nearly $1 trillion, its third-worst two-day fall, in value terms. The sell-off on Friday was characterised as the unwinding of short-term positions related to the expectation that the Remain camp would win the referendum vote. Monday's sell-off was more about the longer-term situation.

Hedge funds, which have control of hundreds of billions of dollars, are reported to be targeting the British currency as well as stocks in the expectation that the economy will dramatically worsen. The rating agency Standard & Poor's has removed Britain's AAA credit rating, lowering it two notches. It said the referendum result was a "seminal event" resulting in a less predictable and less stable policy framework in the UK.

The fall in the currency has been matched by the drop in equity markets. The FTSE 250 index, which reflects the domestic economy, fell by 7 percent on Monday, while the broader-based FTSE 100 index lost 2.6 percent. The FTSE 250 index has lost 14 percent over two days in its worst decline since the share market crash of 1987.

The falls in share and currency markets came in the face of statements of reassurance by outgoing Prime Minister David Cameron and Chancellor of the Exchequer George Osborne. Cameron said Britain wanted the strongest possible economic links with its European neighbours, while Osborne said the government's resolve should not be underestimated and that "we were prepared for the unexpected." It was all to no avail, as markets fell in Britain, Europe and the US.

British banks were hit hard, with shares in the Royal Bank of Scotland and Barclays down by 26 percent and 18 percent respectively. Both firms had their trading suspended briefly in the course of the day.

European bank shares were also badly affected, after recording an 18 percent fall on Friday, with the Euro Bank Stoxx index dropping by a further 6 percent on Monday. European bank stocks have lost 22 percent of their value over two days and are close to the all-time lows they reached during the sovereign debt crisis in 2012.

There has been a flight to safety as investors move into UK government bonds, sending the yield on ten-year bonds (which move in inverse relationship to their price) falling to below 1 percent for the first time in history, hitting 0.94 percent at one point. German bonds, which recorded below-zero yields before the Brexit vote, went further into negative territory on Monday.

Economic forecasters have significantly reduced their forecasts for British economic growth for 2016 and predict even bigger falls for 2017. The chief economist at Investec, Phillip Shaw, told the *Financial Times* the economy might enter a period of "near

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stagnation," and that recession was a "realistic possibility."

The investment bank Goldman Sachs said it now expects growth in Britain to be just 0.2 percent in 2017, compared to its pre-referendum forecast of 2 percent. Credit Suisse has advised its clients to expect a British recession next year.

In the longer term, major companies are revising investment plans. According to a report in the *Financial Times*, a significant proportion of employers in the UK said they were freezing hiring and cutting their investment plans. Two-thirds of business leaders surveyed by the Institute of Directors said the referendum result would be "negative" for them. Financial firms are also reported to be shifting their base of operations out of the City of London.

Besides the falls in equity markets, one of the main transmission mechanisms of the Brexit shock wave is currency values, as vast amounts of money move to what are regarded as safe havens.

Over the past three years, the Bank of Japan has been trying to lower the value of the yen as part of the program of "Abenomics," aimed at lifting the economy out of deflation. Even before the Brexit vote, the yen had risen significantly, with international financial analyst Mohamed El-Erian, chief economic adviser at the financial firm Allianz, describing the rate of 106 yen to the US dollar as a "total nightmare." A higher yen value increases deflationary pressures and hits major Japanese firms in export markets.

Following the Brexit vote, the yen hit 99 to the dollar at one point before moving back to above 101. The rapid increase in its value has all but wiped out all the efforts of the Bank of Japan to bring down its value. Further stimulative measures are expected, and there is a possibility that the government will intervene directly in currency markets. When such a move was mooted some weeks ago, it brought sharp opposition from the US.

The Brexit decision has been described as a so-called "black swan" event--a development with seemingly low probability but having vast consequences if it occurs. It is expected to provoke a further expansion of quantitative easing measures by Japan's central bank.

Two major Asian-based financial firms have been hard hit, with shares in HSBC Holdings and Nomura Holdings, Japan's largest brokerage firm, falling sharply. Nomura shares dropped a further 6.3 percent on Monday, after falling by 11 percent on Friday. It was the biggest two-day fall since the March 2011 earthquake and tsunami. HSBC shares have dropped more than 9 percent over two days.

The United States is also being impacted via the rise in the value of the dollar, another product of the search for a safe haven. The dollar index, which measures its value against other major currencies, has risen by 3 percent since Thursday's vote, bringing its rise to 20 percent over the past two years. The dollar rose not only against the British pound, but also against the euro and the yen.

The rise in the currency hits US exporters, making it more difficult for them to compete in international markets. It has all but removed any possibility of an increase in the Federal Reserve's base interest rate in the short term. A rise in the dollar's value not only has consequences for the US, but also threatens "spillover effects" in emerging market economies by increasing the burden of their dollar-denominated debts.

The turmoil set off by the Brexit decision is reflected in US bond markets. When the Fed raised interest rates by 0.25 percent last December, the yield on ten-year Treasury bonds was 2.3 percent. It stood at 1.74 percent on Thursday, but in the two days of trading since then has fallen to 1.44 percent.

In much of the media commentary on the Brexit decision, the reassurance is being offered that it is not a "Lehman event"—a reference to the collapse of the US investment firm that set off the global financial crisis of 2008. But it could well turn out to be even more significant. While the demise of Lehman Brothers set off a chain reaction, with far-reaching consequences, it was a financial storm. The Brexit decision has struck a devastating blow to the entire structure within which the global financial system has operated over the past four decades.

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