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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

Global Risk Watch Newsletter

Concerns for Brexit Reveals some Weaknesses in the Japanese Economy, etc.

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1.Overview Macroeconomic and Financial Risks (Trends & Topics)

 # Concerns for Brexit Reveals some Weaknesses in the Japanese Economy (Tsuyoshi Oyama, Partner/Head of Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)
***This article is written on June 19th, 2016.**

In last month's article, we referred to the recent stability of global markets as a "castle in the sand". Soon after, we have seen parts of the base already beginning to collapse. The biggest factor is the outlook of Brexit (UK exits from EU) referendum to be held on June 23rd, seemingly pro-exit supports has suddenly took the lead in the opinion polls. Up until this turbulence, however, the once volatile global market had started to begin settling down to relative calm. This is mainly due to a resurgence in uncertainty over the strength of the US economy. Since the middle of May, the US had seen resilient economic indicators, such as increased personal consumption and improving price trends. The FRB Chair Yellen and other FOMC members' proactive stance towards interest rate hike have naturally changed the view in the market that an interest rate hike in June is inevitable. If this were to occur, Chinese and emerging currencies could face further turmoil in the market and hence gradually spiked tensions in the market during the month of May. That is until the beginning of June, which revealed surprisingly low employment figures in the US, thereby completely overturning the scenario of interest rate hike. The fact that the world economy was hugely influenced by a swing of this volatile indicator of single month, signaled the nervousness in the market as the world economy is facing rising uncertainties ahead as well as a problem in the policy formulation process of FRB.

And now, the market is trolled once again by the Breixt turmoil. The world is not simply fearing the impact of Brexit on the UKs economy, of which trade and financial hub will be under threat as well as potential political outfall resulting in the breakup of the Conservative Party. More importantly on the financial market side, for example, a UK downgrading could significantly impact the stability of financial system. Moreover, in the medium-long term, Brexit will further push forward the momentum of populism across Europe, while the dominant position of Germany in the EU may also bring backlash from neighboring countries adding further to the risk of the total breakup of the EU. Such scenarios will likely trigger another sovereign debt crisis.

Considering the market reactions to possible Brexit, a major area of concern closer to home is the magnitude of its impacts on the Japanese currency and stock prices. As of June 16th, the impact of Brexit on Japanese economic indicators is becoming noticeably larger, even compared to the epicenter in Europe. The reason it has such a large influence on Japanese currency and stock prices, which should not be directly impacted by Brexit, is the market mindset to purchase 'safe-assets' such as Japanese government bonds during the risk-off environment. As Pavlov's dog, the market reaction of buying Japanese Yen and selling Japanese equity under the increasing uncertainty have long been embedded (or pre-programed) in the mind of speculators or AI program based on their past experiences. Regardless of the reality facing Japanese economy, if market participants share the same mindset or Pavlov's conditional reflex, then the market will follow the same direction and entail a large swing of prices. For some time, the market has been surprised by the unconventional polices of Abenomics and the large scale quantitative easing measures applied by the Bank of Japan, which revised their mindsets and led to the reaction of selling Yen and buying equity.

However, the existing fiscal and monetary ammunition is now running dry, and the market mindset begins to shift back to the original state. If the new ammunition (structural reforms) cannot be built up at an early stage to once again change the market mindset, the existing ammunition will completely dry out in a few years, and the end results might lead to a violent collapse of markets view that Japanese government bonds are safe assets. By the time this e-Newsletter reaches you, the results of Brexit might be already clear. If the UK referendum can avoid Brexit, the expectation of strong Yen/low stock prices sentiment will be sharply rewound and thus enable to save the remaining ammunition in the arsenal. Nevertheless, there are many uncertainties ahead for Japan to face, including the US Presidential election in November, next year's general election in Germany and France, as well as the Communist Party meeting to select the next generation leaders in China. At this rate is, it is only a matter of time before ammunition would run out altogether.