Market Insights - Brexit

27 June 2016

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Investment Strategy Group

A Messy Break-up

- The Brexit result caught us, financial markets, pollsters and odds-makers by surprise. Either way, we see the outcome as irreversible. We believe the 1.3 million vote win to “Leave” is comprehensive enough to ensure politicians (who overwhelmingly supported “Remain”) feel compelled to implement Brexit.
- Brexit will be a messy Break-up. The UK will want to maximise strong trade access to Europe while regaining control of regulation and the movement of people. Core Europe will want to make Brexit a painful process for the simple reason that it might serve as a deterrent to others. If the EU allows Exit to be a quick, clean, potentially prosperous route, then the European Union will be over.
- The outcome of the referendum substantially changes the macroeconomic backdrop for the UK and Europe. We expect a significant reduction in UK growth and the Pound, along with weaker Eurozone growth. This should elicit easing from the Bank of England, and keep the European Central Bank on its toes for some time. We see the timing of the next US rate hike being pushed out.
- Brexit is a significant shift in the geopolitical landscape, with an associated step-shift in uncertainty. Investors will need compensation for this with lower share prices. We believe a 15% global equity sell-off over the next 6-8 weeks is a reasonable base case. That said, Brexit is not, in our view, the start of another Global Financial Crisis.

The two i’s haunt Europe

Immigration and inequality = political instability

The Brexit result caught us, financial markets, pollsters and odds-makers by surprise. On the day of the vote, the betting odds implied that the probability of Brexit was ~15%, reflecting the most recent polling which indicated a reasonable margin to “Remain”. Similarly, the UK Pound rose briefly to a six-month high as financial markets anticipated a victory to the status quo.

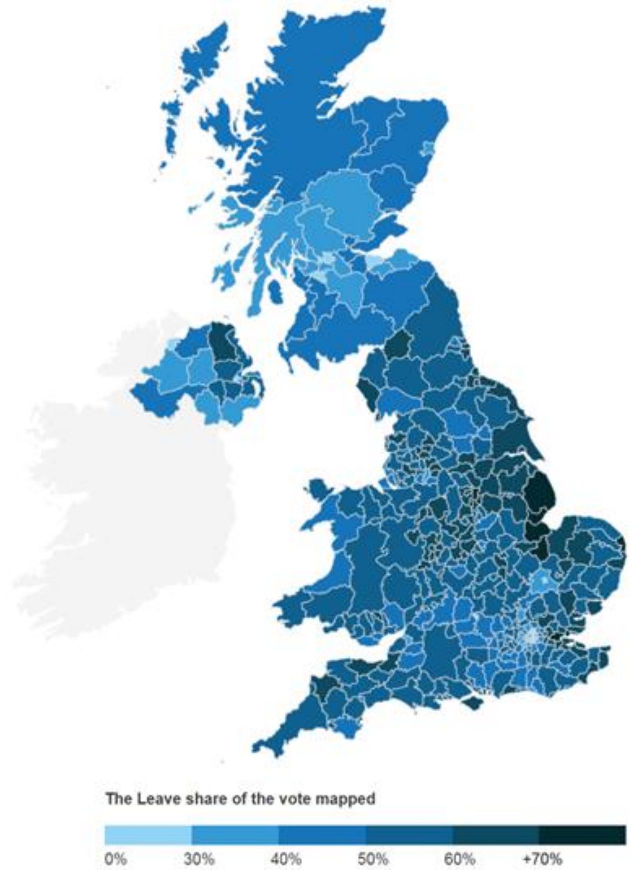
Surprise or not, Brexit is here and, most likely, irreversible. If the referendum were line-ball, there would be questions over its validity. However a ~4%, 1.3 million vote win to Brexit is comprehensive. In our view, two i's are at the heart of this result: immigration and inequality.

- Around the world, Immigration has become a politically toxic issue that is feeding populist politicians from Trump in the US to Le Pen in France. The political mainstream is struggling to respond. As much as anything else, the Brexit vote appears to reflect a desire for the UK to retake control of its borders.
- Rising Income inequality in the developed world is leading to a less stable political environment. Poor wage growth, falling homeownership rates, and narrow participation in financial markets create fertile ground for voters to try “something else”. In the Brexit vote, the support for “Leave” outside of London, and particularly in the North of England, is representative of this trend (see diagram left overleaf).

What Next: The Brexit Process

Make no mistake; Brexit will be a messy Break-up. On the one hand the UK will want to maximise strong trade access to Europe while regaining control of regulation and the movement of people. Core EU will want to make Brexit a painful process for the simple reason that it might serve as a deterrent to others. If the EU allows Exit to be a quick, clean, potentially prosperous route, then the European Union will be over.

The Leave Vote: London versus Rest



Source: BBC

Brexit: A Possible timeline

June
Brexit Win
David Cameron Resigns

June – October
New UK PM chosen
UK invokes Article 50
EU exit begins

June – December
UK and EU outline Exit timetable

2016-2018
Political fallout: elections in France, Germany, Italy

2016-2018
Separatist tensions: Catalonia? Scotland?

2016-2018
Negotiations over trade, security, border control

2018-2025
New normal in relationship between UK and Europe

Source: Citi, JBWere

Brexit: Invoke Article 50, wait two years

A potential Brexit timetable is outlined above (right). The clock begins ticking once the UK invokes Article 50 of the EU Treaty. It is likely this will be done by the UK Prime Minister. However, the constitutional framework for the Parliamentary procedures the UK may have to meet to invoke Article 50 are unknown. In that respect the overwhelming parliamentary support for “Remain” is worth noting. However, we would expect Article 50 to be invoked relatively quickly, by October at the latest. Once Article 50 is invoked, concrete exit negotiations will begin, which are limited to two years unless the EU provides unanimous extension.

For global investors, the minutiae of trade, security and immigration negations will not be the critical dynamic to watch. There area of greatest significance remains in the political sphere, where Brexit has made *dis-integration* a credible threat. From 2016 – 2018 elections will be held in France, Germany and other parts of Europe. Support for parties that are advocating either reduced European integration or outright Exit will be watched by investors. The French elections (April through June 2017) are a potential flashpoint here.

Brexit: Economic Implications

Growth will slow in the UK and the Bank of England will respond…

We take it as given that UK economic growth will slow sharply as Brexit uncertainty plays out. We expect UK GDP growth to fall substantially over the coming 12-18 months (see chart overleaf, left) as uncertainty is at its peak, and trade agreements and regulatory frameworks are renegotiated. A key question here is the ability for the UK to access its major export markets. As a result, our research partners see a real risk of the UK entering a technical recession over the coming 12 months. Given this, we expect significant stimulatory action from the Bank of England (BoE), likely beginning in July, in

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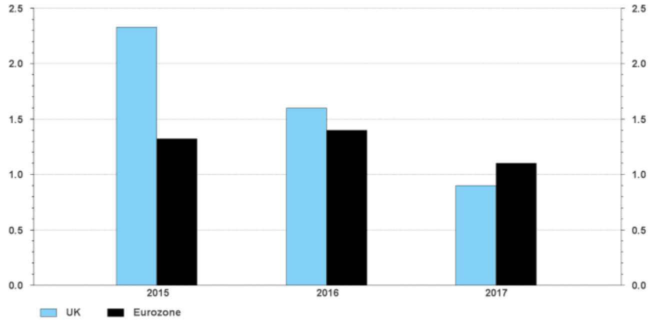
order to stabilise the economy's growth outlook. We would expect response in the form of both rate cuts (potentially two, taking policy rates to zero), and increased asset purchases. Following this, as uncertainty abates, we should see a gradual recovery in economic growth.

Eurozone growth will also slow…

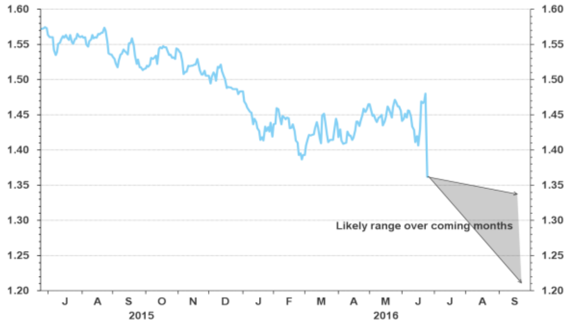
In Europe, we expect that the uncertainties created by Brexit will shave around 0.4% off Eurozone growth over the near term (see chart below, left), and lead the European Central Bank (ECB) into more dovish territory. That said, we don't expect a knee-jerk reaction from the ECB – rather the reiteration of their long-standing commitment to doing "whatever it takes" to return Europe to growth and their inflation target. This may mean an extension to the ECB's asset purchase programme beyond March 2017, the current target end date.

UK and Eurozone GDP Growth
Percentage annual changes



Source: Thomson Reuters Datastream and JBWere Investment Strategy Group

British Pound to US Dollar
Exchange Rate



Source: Thomson Reuters Datastream and JBWere Investment Strategy Group

Fed hikes likely to be delayed…again

While the US is one step removed, and its economy remains in relatively good shape, the US Federal Reserve will not be ignoring the fragility that Brexit will place on the global sentiment. We expect the Fed to take some time to regroup and monitor how the implications of the referendum result play out on the global stage. In our view, a July rate hike (which was previously a possibility) is now off the table. While we see a delay until December as more likely, should US economic data prove robust over the coming months, we believe the September meeting remains "live" – only just. We will be closely watching US labour market data and inflation expectations. Given the positive implications for the US consumer of lower rates for a bit longer, we don't see a material downward shift in US economic growth expectations at this stage. That said, we will be closely watching US economic data and the impact on the US dollar.

Expect further pound weakness

Despite ~10% weakness already, we expect the British Pound to weaken further on the back of lower economic growth, reduced inflows into the UK from overseas investors, and ongoing uncertainty. Using our research partners as a guide, a fall as low as 1.20 against the US Dollar (above, right), and parity against the Euro, is not out of the question. While a weaker Pound should help the UK's export sector, this is likely to be muted by ongoing distractions from the renegotiation of trade agreements, as well as the impact on import prices. Where the Pound trades from there will, in part, depend on central banks' response and emerging economic data. On the back of "safe-haven" appeal, we see continued strength in the US Dollar.

Market Implications

What Brexit is…

Brexit represents a significant shift in the geopolitical landscape. Moreover it portends the threat of more to come. Eurozone break-up, for example, has gone from an extreme scenario to something that cannot be reasonably ignored. Investors will want compensation for these heightened risks. Consequently, we expect markets to push lower over coming weeks until investors feel appropriately compensated for these heightened risks. We see post Global Financial Crisis share market sell-offs as a useful guide for what is likely over coming weeks, in particular, the first Greek debt crisis in 2010 seems a reasonable benchmark (overleaf). This saw a ~15% decline in the Standard & Poor's 500 Index over 10 weeks. The first day of trading post Brexit has seen a 3.6% decline in the Standard & Poor's 500 and 5.4% in International Equities. We would be surprised if this single day of weakness is the end of matters.

What Brexit isn't

We don't see Brexit as the spark of a second Global Financial Crisis. It is a Political event with Financial consequences. The GFC was the reverse. The UK, while a large economy, is less than 5% of World GDP, slower growth or a temporary recession there has limited consequences for other countries. Against that, the US economy, which is the engine of global growth, is in reasonable shape and US consumers now can look forward to low interest rates for even longer as a consequence of Brexit. Finally, the GFC caught policy makers and Central Banks by surprise. The Brexit referendum was a known event, allowing the Bank of England, the ECB and the US Federal Reserve to plan in advance.

S+P 500 Sell-offs 2009 - 2016

12-Jun-2009	-7.1%	28 days
19-Jan-2010	-8.1%	20 days
23-Apr-2010	-16.0%	70 days
04-Aug-2010	-7.1%	22 days
18-Feb-2011	-6.4%	26 days
29-Apr-2011	-7.2%	47 days
07-Jul-2011	-18.8%	88 days
27-Oct-2011	-9.8%	29 days
02-Apr-2012	-9.9%	60 days
14-Sep-2012	-7.7%	62 days
21-May-2013	-5.8%	34 days
15-Jan-2014	-5.8%	19 days
18-Sep-2014	-6.8%	27 days
20-Jul-2015	-12.3%	36 days
29-Dec-2015	-12.0%	44 days
Average	**-9.4%**	**41 days**
23-Jun-2016	**-3.6%**	**1 day**

Source: Datastream, JBWere ISG

Impact on Australian economy

Brexit impacts Australia's economy primarily through our financial markets, equity markets, official interest rates and the Australian Dollar. If the outlook for global growth softens over the next few months, due to the uncertainty around the break up of the European Union, or falls in the equity market and tighter financial conditions lead to less consumer and business activity, then the Reserve Bank of Australia (RBA) would revise down its Australian growth forecasts. Such a scenario would also see the Australian Dollar test its recent lows of around US$0.60 given how it typically behaves in a risk-off environment. In this scenario, the RBA might consider a cut to official interest rates in July or August, as it did during the Global Financial Crisis.

Australian equities may be considered a safe haven

The ASX may ultimately be considered a safe-haven equity market, with our economy more tied to China. We would expect to see some fund-flows on the back of this, although would highlight that a close watch on the China credit cycle and any Yuan devaluation should be maintained. Sectors that should outperform in this environment include REITs and Utilities, driven by a re-focus on high yielding stocks as global monetary policy remains ultra-easy. Other beneficiaries of this theme should be Sydney Airport and Transurban, with their defensive, monopoly flows. Healthcare should also outperform, although we would be more stock specific given a number of stocks' exposure to Europe (Ramsay Healthcare and CSL of note). On the flip-side, our Banks are at risk as funding costs may increase, and we would suggest closely monitoring the iTraxx index. Similarly, Resource and Energy stocks will be hostage to a slowdown in global GDP, and are likely to also underperform.

International equities favour a higher weighting to the US

Slower global GDP growth from Brexit and heightened uncertainty are likely to weigh on global equities in the near term. Valuations remain relatively full compared with history (albeit cheap compared with bonds) and slowing economic growth will be a headwind to company earnings. Regionally, we prefer the US to Europe as we view US economic growth as more robust and policy makers have more scope for stimulus. Economic growth in Japan remains sluggish, and may soften further due to currency appreciation. Emerging markets appear cheap in some regions, but are vulnerable to capital outflows should the US Dollar appreciate further and strain interest coverage ratios.

A softer global economy will weigh on the earnings of cyclical stocks, and the perception of slower growth will likely suppress the consumer sector and prompt companies to defer investment spending. We remain cautious toward banks, particularly in Europe. Interest rates are likely to remain low (or negative) for some time, compressing net interest margins, while slower nominal GDP growth will hinder improvement in nonperforming loans. Furthermore, European banks remain vulnerable to the tail risk of a broader disintegration of the EU. Defensive sectors such as utilities and consumer staples are likely to outperform if volatility remains elevated, but we remain concerned about rich valuations for defensive sectors. With weaker economic growth, stocks that can deliver structural earnings growth should outperform the broader market. Advances in information technology (such as big data, cloud computing, and artificial intelligence) will underpin earnings growth of well-positioned companies, even if the broader economy slows.

Foreign exchange rates will be a key swing factor for global equity returns. Domestically-focused UK stocks have sold off sharply, but exporters have been more robust due to improved competitiveness from the weaker currency and lower exposure to the domestic economy. Multinationals reporting in US Dollar or Japanese Yen will face earnings headwinds from currency translation, given the recent appreciation of these 'safe-haven' currencies.

Financial hybrids likely impacted most by higher bank funding costs

The initial impact of the Brexit vote is expected to differ across fixed income asset types rather than across specific market segments or sectors. Not surprisingly, with markets gripped by uncertainty, government bonds have rallied on safe haven flows, highlighting the role and purpose these instruments play in investor's asset allocations. While there has been notable tightening in government bond yields already, further moves lower are possible. The uncertainty is expected to put pressure on the RBA to further lower its cash rate, and for the US Federal Reserve to push back potential rate rises. A lower cash rate and/or delay in the Fed's Funds Rate increases will be supportive of government bond valuations and likely delay any meaningful sell off in valuations, particularly if the Fed kicks its rate hike down the road. In addition, potentially supporting Australian Commonwealth Government Bond (ACGB) valuations is the UK's likely loss of its 'AAA' rating. Standard & Poor's, which already had its rating on the UK on 'Negative' outlook, has signaled more than one notch downgrade. The dwindling number of 'AAA' rated sovereigns augurs well for AGCBs, which remains one of only a handful of 'AAA' rated sovereigns globally, also offering one of the highest bond yields relative to its peers. While supportive of current valuations and possible capital upside, the expensive levels (and record low yields) at which bonds are currently trading suggest capital preservation, reduced volatility and higher yields could best be found in domestic term deposits.

Cash credit markets (bonds and hybrids) are expected to be adversely impacted by the Brexit outcome, but less so vis-à-vis equity markets. Supporting domestic corporate bond valuations to some degree is the market's dearth of new issuance. The relatively stable credit profile of Australian corporates and limited bond supply points to potential buying opportunities should there be a material sell off. We continue to advocate clients target high quality issuers and issues. The more liquid credit default swaps market (Aus iTraxx) is expected to exhibit greater volatility and see greater spread widening reflective of the uncertainty created by the Brexit decision and its aftermath.

Reflecting the 'equity-like' features of hybrids, the valuations of listed major and second tier financial hybrids have already been adversely impacted, albeit marginally, by the Brexit decision and could be further impacted if the flow-on impact of the decision pushes bank share prices materially lower. The adverse impact on financial hybrids is likely to be greater than that on corporate hybrids. As with corporate bonds, the strong credit profiles of domestic banks suggest buying opportunities in the hybrid market could present themselves should there be a dramatic sell down.

Modest downside possible but don't panic

All in all we don't think this is a time to be brave, but nor is it a time to panic. We believe a 15% global equity sell-off over the next 6-8 weeks is a reasonable possibility. That said, Brexit is not, in our view, the start of another Global Financial Crisis. We suggest that investors remain cautiously positioned over the next few months, as the risks appear to be skewed to the downside, until we see how the financial market and political reaction to Brexit is likely to play out.

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