The View From The Outer

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BREXIT: WHAT NEXT? INVESTMENT IMPLICATIONS

SYNOPSIS OF INVESTMENT IMPLICATIONS:

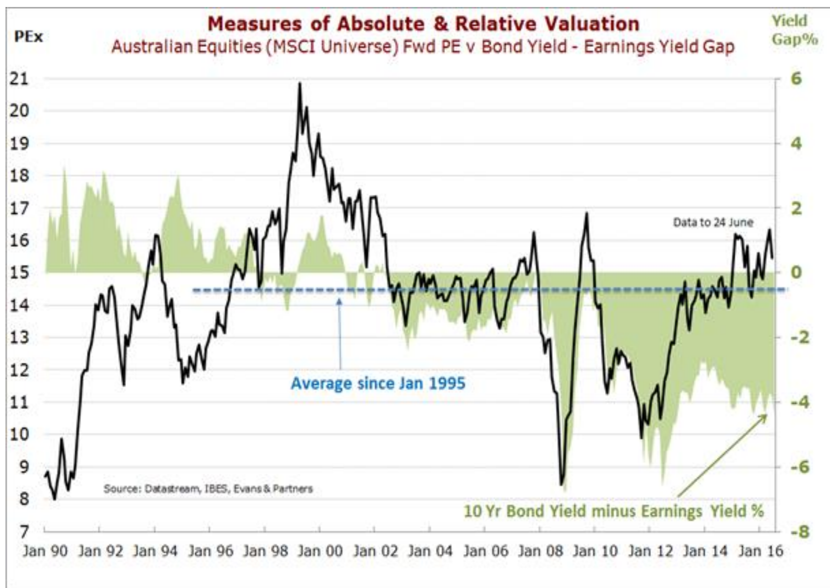
- **This is a political crisis with substantial economic consequences, largely for the UK. In our view, it is not a systemic financial crisis** and is most unlikely to degenerate into one. Central banks are well placed to meet liquidity needs if required.

- A shallow recession is expected in the **UK economy**, despite the weakness in the Pound. The UK is 4% of world GDP, but its current contribution to global growth is around half that. The spillover impact is most apparent in Europe. The world is light on for aggregate demand growth and any reduction will impact at the margin but the aggregate impact to world growth is not expected to be severe. We do not expect much impact on growth in a more services oriented, domestically driven economy like the US, or for that matter in most of Asia (including Australia). Japan, however, clearly needs to quickly ease monetary and fiscal settings, but that is largely related to the need to offset or reverse the corrosive impact of recent strength in the Yen.

- **Monetary policy / official interest rates**: The Bank of England (BOE) is likely to reduce the base rate from 0.5% as evidence of economic weakness becomes apparent. Policy easing is also expected from the European Central Bank (ECB) and Bank of Japan (BOJ). We now expect no change in the US Fed Funds Rate over the rest of 2016. Subject to the June quarter CPI release in late July and the global environment, the prospect of another RBA rate cut at the August 2nd Board meeting has increased. While the Fed is now firmly on hold through 2016, given the policy outlook elsewhere in the world, a risk-off environment could still lead to US dollar strength. This would not be welcomed by China or Emerging Markets (or we suspect the Fed for that matter).

- **Pound Sterling** reached 30 year lows against the US Dollar. This does look attractive from a long term perspective, but is burdened by a myriad of nearer term uncertainties including the outlook for the economy and potential interest rates declines. The UK Current Account Deficit stood at 7% of GDP in Q4 2015, so they remain very dependent on foreign investment /capital inflows. If as implied by the UK Treasury, real assets such as property decline in price during the assumed UK recession, UK real assets priced in US Dollars may provide some attractive entry points in the years ahead. Weakness in the **Australian dollar** was warranted on Friday in a risk-off environment where global growth concerns increased. We expect the Australian dollar to be lower by year end.

- Required **risk premia on UK and European assets** have structurally increased in our view. Like the issues the UK and Europe are facing, this is unlikely to change quickly. Among the **global equity markets** to weaken most sharply Friday were Europe and Japan. Japan's weakness also reflected safe haven demand pushing the Yen sharply higher. The narrower FTSE100 declined less by day's end reflecting its greater bias to international companies and overseas earnings given the dramatic decline in the Pound. In the face of rising equity risk premia, **Treasury bonds** rallied, while **credit spreads** widened.



The S&P500 fell 3.6% to late March levels, while the ASX200 fell 3.2% to mid-April levels. **Australian equities:** At 5113 on the close Friday, the ASX 200 was trading at around 15.5 X rolling 12 month forward consensus EPS.

While valuations have certainly improved (see chart left) and heightened volatility will no doubt provide stock specific opportunities, overall valuations are not compelling. The current uncertain environment may yet provide better entry points for the market as a whole.

Q. Why was BREXIT so unexpected and such a surprise to markets?

A. A fair question given the polls were so close in the last two weeks. Indeed by the time the polls closed, the bookmakers odds on Remain were a staggering 12 to 1 on. Essentially, any market good news from a Remain vote was almost fully priced in.

Whilst we had expected a Remain vote in the end, we did feel it was too close to call with any conviction. Most assumed that the undecideds would break disproportionately to the status quo; perhaps so, but they still need to turn-out and vote. The non-compulsory voting system added an additional layer of complexity to predicting the outcome. After all, the bookies and the polls were both well wide of the mark in the last UK General Election when David Cameron won easily.

In retrospect, it seems easy to reconcile why Leave won, albeit narrowly (51.9% to 48.1%). The Remain argument was essentially economic, whereas the Leave argument appealed far more to emotions (sovereignty and immigration) and tapped into the disenchantment with the political establishment, globalization and perceptions of widening inequality. It should hardly be a surprise if Leave supporters were more inclined to turn out and vote.

Q. What is the likely political fall-out from BREXIT? How will BREXIT be implemented?

A. Domestically, David Cameron has indicated he will have stepped down by October. He is likely to be succeeded by a pro-Leave Conservative; former Mayor of London Boris Johnson being an early favourite. David Cameron will leave to his successor the decision on the timing of formal notification of intention to withdraw under Article 50 of the Lisbon Treaty. Two years after this, existing EU Treaties no longer apply (unless extended by the EU). Note the final terms of Britain's departure are set by a majority vote of the EU's other 27 members. The process is not there to make it easy for a country to leave!

Political uncertainty over BREXIT will remain high for the next two to three years. The Referendum is only advisory but surely will be respected, despite the Parliament's pro Remain composition. The nature of the future relationship between Britain and the EU remains uncertain. The so-called "Norway option" of limited change and EEA Membership, however, looks untenable to the Leave camp as it still requires the compliance with EU trade rules, acceptance of freedom of EU labour movement, and net payments to the EU for effective membership of the single market. Given that, the negotiations look set to be protracted and messy, with the eventual outcome unclear. An adverse scenario would be failing to reach agreement and trading with each other under World Trade Organisation (WTO) rules. Two to three years of political uncertainty is to be expected; possibly more.

Q. Will other countries in Europe be encouraged to leave the EU? How will the Scots respond?

A. There is an intrinsic contradiction of a Union with a common currency and monetary policy but different fiscal policies and debt burdens, but one could have said this at any time since the launch of the Euro in 1999. Political and monetary union - the grand European project - however, looks further away than ever. The Referendum result will provide encouragement to the growing support base for the ultra-nationalist / populist movements that are making headway across a surprising number of European countries. The UK should not expect any display of generosity from Brussels, who would not want to encourage the so-called independence movements elsewhere on the continent. The EU will want to make it clear there is no benefit in leaving. It is even more complex for other members to leave due to the common currency. Rising geo-political concerns (for example Russia) is also a deterrent. We doubt any of the other 27 countries will vote to exit the EU over the next couple of years, but we do not underestimate the strength of disenchantment with the political establishment and perceived elites. Doubts about the long term viability of the structure and operation of the EU are likely to linger for years.

Scotland's First Minister Nicola Sturgeon is moving for a second referendum on Scottish "independence" and wants Scotland to remain in the EU. (The Scots voted 62% Remain and the Scottish Nationalist Party (SNP) control the Scottish Parliament.)

Q. Is this Europe's "Lehman Brothers moment"? Will this degenerate or morph into another Global Financial Crisis (GFC)?

A. <u>In our view no. This is a political crisis which brings uncertainty and economic weakness; not a financial crisis.</u> Central banks are surely well prepared to add liquidity if required. Credit spreads and bank funding costs have increased somewhat, but not alarmingly and the current situation is unlikely to impinge upon confidence in the integrity of the financial system.

Q. How severe are the risks to growth in the UK?

A. For perspective we note the UK is 4% of global GDP. The two scenarios modelled by the UK Treasury both imply a technical recession and a meaningful loss of economic output versus potential. Businesses will initially postpone or cancel investment decisions, employment will suffer, while the decline in sterling increases import prices and reduces real incomes.

The IMF's forecasts are based on two scenarios. The "Limited" impact scenario assumes Britain manages to forge a Norway-style relationship with the EU (as a member of and meeting the conditions of the European Economic Area (EEA). Economic output will probably be around 1.5 percent smaller by 2019 than if it stayed a full member, according to this IMF "limited" Brexit impact scenario. For the reasons discussed earlier, we view this as optimistic. Under the IMF's "adverse" scenario - long and unsuccessful negotiations between London and Brussels followed by Britain having to trade with the EU under World Trade Organisation rules - the economy would be 5.5 percent smaller by 2019. Of course the result may also lie somewhere in between, but maintaining current access to the single market seems most unlikely.

Q. What are the key items on the UK's "to do" list once notice to leave the EU is given under Article 50 of the Lisbon Treaty?

A.

1. Agree UK terms of withdrawal.
2. Agree UK terms of a new trading relationship with the EU.
3. Agree UK terms of a new trading relationship with the over 50 countries where trade was previously covered by their agreements with the EU.
4. Change the UK's domestic regulatory and legal framework where required due to withdrawal from the EU.

This will be a huge and costly distraction for the UK Government in the years ahead.

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