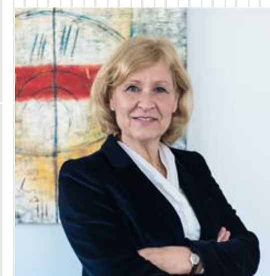
Global Investment Framework
Brexit update



For professional investors only
June 27, 2016

Marie-Christine LAMBIN

What's new ?

Brexit, a nasty surprise

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- **Against our base case and the betting market odds**, the British have voted to leave the European Union, ignoring Cameron's appeals to stay in the EU by 52% to 48%.The negative initial response of currency and equity markets indicates that the UK vote is a clear surprise for many observers and participants and a global risk event with long-lasting political and economic consequences.
- Capital markets around the world reacted strongly to the news, fleeing into safe-haven assets. The British Pound fell to a 30-year low against the U.S. Dollar, the Euro declined, and the Japanese Yen rose sharply. The 10-year US treasury yield fell 17bp and the German 10-year yield fell deeper into negative territory. The Euro Stoxx 50, FTSE 100, and Nikkei 225 fell 9%, 3%, and 8%, respectively. In the U.S., the S&P 500 declined by 3.6%.
- The Leave vote represents **a significant shock to the global outlook.** Although the post-referendum negotiations will take some time and the impact on the real economy will be felt over time, the uncertainty surrounding how the UK will negotiate its departure from the EU, and the negative impact this will have on growth in the wider European economy, may hamper economic activity around the world.
- **The UK vote is dealing a big blow to the EU integration process, with a potential contagion effect**,. We are already evidencing throughout Europe a gain in strength of populist anti-establishment movements all having one common denominator: they are notoriously anti-Europe
- The Brexit vote is expected to bring **a lot of volatility in financial markets** given the increased economic and political uncertainty. There is additional risk from a potential adverse feedback loop between market sentiment and real activity. An extended period of market volatility will prevent a rebound in labor markets and contribute to a broader economic downturn.
- David Cameron has announced he will resign as UK Prime Minister by October and made clear that **Article 50**, the formal mechanism by which a Member State may leave the EU, will not be triggered until his successor is in post in at least three months' time. After Article 50 is triggered, there will be a period (expected to be at least two years) during which the constitutional and legislative arrangements will be negotiated and the effective date of the UK's exit from the EU will be agreed.
- It is difficult to predict the precise arrangements that will exist at the point of exit. Assumptions range from a 'soft' to 'hard' Brexit: Soft' Brexit: UK preserves access to single market and freedom of movement. 'Hard' Brexit: UK loses out from loss of trade in goods and services; drop in net migration.
- European leaders have started to react and reassure about the future of the rest of the EU but they did not announce anything new.
- Rating agency S&P has already confirmed that the UK is likely to lose its final AAA credit rating.

What's new ?

Brexit, a political risk event

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- One of the main dangers is a **contagion effect** from the UK to other EU countries as the outcome of the referendum mean potentially higher levels of success for politicians elsewhere campaigning on anti-establishment, anti-globalization platforms. The UK decision triggered immediate reaction from leaders of populist parties elsewhere in Europe to follow their lead: Geert Wilders and Marine LePen, leaders of Dutch and French anti-immigration far right parties, were first to react on Friday morning, calling for a referendum in their respective countries.
- The natural candidates to hold a referendum after the UK vote are non-euro area countries with special ties to London (**Sweden**, **Denmark**) and some eurosceptic CEE countries (**Hungary**, **Czeck Republic**).
- A debate could also arise in some euro area countries, in particular the **Netherlands** and **Finland** as we wrote last week, where a referendum is possible at the initiative of citizens.
- The October Referendum on constitutional reform in **Italy**: The critical importance of this referendum is that, if it does not get approved, PM Renzi has stated that he would step down. Should Italian citizens reject the constitutional reforms, Italy is likely to experience a political crisis and an extended period of political instability, putting an end to the reform agenda and undermining the economic and fiscal outlook
- the degree to which the EU will "punish" the UK post-Brexit will depend on complex—and **potentially fractious—negotiations between the remaining EU member states.** Different countries in Europe have varying levels of trade dependency with the UK, which could make negotiations within the EU very complicated. Disagreement is already appearing with most leaders willing to trigger Article 50 as soon as possible while German Chancelor Merkel not in a hurry do so.
- The psychological channels should not be underestimated with a possible contagion to the rest of the world. US Markets could link the outcome to a rising risk of Donald Trump winning the **US presidential election.** As Anatole Kaletsky warned in an article that the UK referendum is part of a global phenomenon: the rise of nationalist sentiment and populist revolts against established political parties. The demographic profile of Brexit supporters is found to be strikingly similar to that of American Trump supporters

What's new ?

Brexit, a economic risk event

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Europe

- Macroeconomic consequences of the UK exit will crucially depend on the reaction of European authorities, political developments in some key member states and the extent of the market stress.
- Companies with significant UK exposure and assets may cut back on investment until uncertainty about the UK's future EU engagement eases. Uncertainty may also have some negative impact on EU trade with the UK. While the value of exports from the rest of the EU to the UK is only 3% of the rest of the EU's GDP, the UK's position as a global financial hub leaves the rest of the EU much more exposed to the UK in terms of financial and investment linkages. For example: One-third of the UK's financial and insurance services exports are to the EU. More than half of the UK banking sector's cross-border lending is directed to the EU. Almost half of the foreign direct investment received by the UK comes from the EU (Nomura sources).
- The most exposed countries to UK trade are Ireland, Malta, Cyprus, Belgium and the Netherlands, according to the IMF.
- Another market concern is what happens to **EU structural funds.** Here, the largest impact again falls on CEE countries. Based on the latest available data (from 2014), the UK's net contribution was EUR 5bn. The European Commission could run a deficit and borrow to fund it, or it could ask richer member states to contribute more. If the fund is scaled back, Poland stands to hurt the most, as it was previously the largest beneficiary of the fund, with net receipts of EUR 14bn in 2014. Hungary follows with EUR 5.7bn in funding, and then the Czech Republic with EUR 3.1bn (UBS research)
- **The Bank Stress tests** to be released in July could unveil material requirements fore some credit institutions (Italy, Portugal).
- **To reduce the threat of "exit contagion**," the EU is likely to adopt a tough negotiating stance with the UK. In practice, this will mean propping up the European market using any means at its disposal in order to make life rosy for the remaining members, also meaning making life hard for the UK. European leaders are expected to focus on fending off domestic populist movements and on preventing the entire EU edifice from falling apart. This points to a tough negotiating stance toward the UK and **less focus on much-needed structural reforms.**
- Barclays economists have revised their baseline scenario significantly down and we now expect growth of 1.4% in 2016 and 0.4% in 2017. This baseline assumes a weak European political response. Barclays expect a downgrade to the ECB staff forecasts by September .

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Brexit, a economic risk event

UK

- The Leave vote will probably exacerbate current elevated levels of uncertainty and thus amplify already slowing economic momentum. This will likely result in negative economic growth in H2 16 and 2017, driven primarily by a sharp decline in investment as firms hold back on spending decisions, with potentially higher borrowing costs due to higher risk premia. Households, too, will be increasingly more cautious with their purchasing habits, especially given that job creation is likely to contract. A weaker pound is likely to support exports and the Bank of England may cut interest rates, mitigating the overall adverse impact.
- The UK must now brace itself for lengthy, difficult and costly negotiations with the EU. The UK divorce involves unpacking UK and EU laws, and striking trade deals with a spurned EU and the rest of the world. Potential losses in services exports and investment flows may overwhelm any benefits of lower payments to EU.
- However, the degree to which the EU will "punish" the UK post-Brexit will depend on complex—and potentially fractious—negotiations between the remaining EU member states. Individual members have their own trading relationships with the UK, with some countries more dependent on British consumers than others. France will probably want to make it very difficult for UK financial services firms to operate on the Continent. However, Germany might be inclined to be more flexible because its car industry is heavily reliant on exports to the UK, and it would not want to lose that trade.

US

- The economic impact on the U.S. is expected to be modest. The UK accounts for less than 4% of US goods exports, provides an even smaller share of US imports, Europe, including the U.K., is the largest foreign market for S&P 500 companies, accounting for approximately 15% of sales, A 2% reduction in expected GDP growth in 2017 could lower potential sales growth for the S&P 500 by about 30bp. Every 1% increase in the USD would lower potential sales growth by another 30bp.
- Still, a prolonged market volatility could weigh on US activity in piling pressure on an already weaker labor market. Rising house sales point to a solid household sector but the May durable goods report was weaker than expected across the board. Core orders and shipments both moved lower on the month in an indication of tepid Q2 equipment investment. Inventories of durable goods also declined and were revised lower in April. This global risk event as coming at a time when the US economy is less robust to shocks than in previous years. We will be alert to signs of deteriorating confidence and labor market softness that could presage a broader slowdown

Japan

- The adverse effect that the likely additional yen appreciation will have on an already fragile growth and inflation outlook. Barclays expect the yen to appreciate to 95 versus the dollar with real GDP growth to trend around 0.5-1.0% qoq saar in the quarters ahead (GDP growth of 0.6% in CY16 and 1.2% in CY17).

What's new ?

Brexit, an economic risk event

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Emerging Europe

- Economies of the CEE, notably the **Czech Republic, Poland and Hungary**, are most at risk in terms of their trade exposure to the UK and the Eurozone. The UK is **Turkey's** second- and South Africa's fourth-largest export destination, but their economies are relatively less dependent on exports, so the overall economic impact would be less than it would be for CEE countries. Russia's export exposure to Europe is significant, at 12.5% of GDP, but its gas exports should not be impacted, in our view.
- In Latin America, direct trade impacts should be more limited than in the EMEA region

China

- The UK is a small trade partner for China (2.6% of total China exports in 2015). However, the impact of the Brexit decision could be quite significant, primarily via its role in weakening external demand from Europe.
- Nomura estimates that the drag from the Brexit is likely to cut euro area GDP growth by at least 0.5pp. As the EU accounts for some 16% of China's total exports, this can be expected to exacerbate China's already-sluggish external demand. Nomura expect the Brexit to cut 0.2pp off China's real GDP growth in 2016, taking their growth forecast to 6.0% from 6.2%.

Emerging Asia

- the impact will be negative for growth, with the shock likely Emerging Asia's trade links with the UK and EU are relatively small relative to the US and China. Consequently, the negative growth shock is expected to emerge largely from more moderate growth in China. The shock will likely be felt primarily through financial market volatility, Nomura analysts lowered their aggregate GDP growth forecast for Asia ex-Japan to 5.6% in 2016 from 5.9%.
- **Singapore** and **Hong Kong** are likely to be the first affected due to their financial exposure. **Korea and Taiwan** are small, open economies and therefore vulnerable to a Brexit.
- **India, the Philippines and Indonesia** would be the least affected by the growth slowdown.
- As India's economy is largely driven by domestic demand, the economic impact of a Brexit should be small relative to other open economies in Asia. While India has sizeable trade links to the UK and the EU (13.5% of India exports) they are relatively small in terms of GDP. An improvement in monsoon rainfall is expected to support domestic demand, and help offset downside risks from slowing external demand. While Governor Rajan's decision to leave the Reserve Bank of India in September came as a surprise to markets, most economists do not see this impeding India's growth or inflation dynamics materially

What's new ?

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Brexit, an economic risk event

Central banks ready to act

- A globally coordinated central bank response to a global financial market meltdown is quite likely, such as liquidity support through FX swap arrangements and possible FX intervention, but with policy credibility at such a low it is unclear how successful these emergency measures would ultimately be when there is extreme market risk aversion.
- UK rates markets are already pricing in a 25bp interest rate cut by the **Bank of England.** A return to quantitative easing rather pushing rates into negative territory looks more likely.
- If the adverse economic impact looked significant, **the ECB** would likely expand its asset purchases beyond March 2017, reducing the risk of a worse-than-expected economic outturn
- **The Fed** had already turned more dovish ahead of the UK referendum. While the direction of the Fed policy is still one of higher base rates, further hikes are likely to be delayed, with the central bank erring on the side of caution in light of the elevated volatility and heightened macro uncertainty.
- Nomura expect significantly more policy easing in **Asia.**

What's new ?

Brexit, the initial market impact

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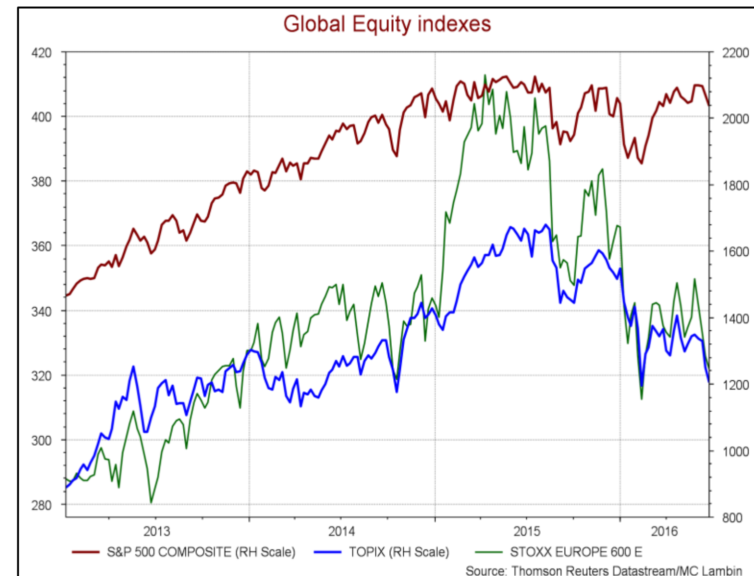
- The surprising outcome of the UK vote resulted in roiling financial markets globally as there has been a sharp repricing of the now higher political and economic challenges that both the UK and Europe will face going forward.
- **Currencies** are dramatically affected with the GBP losing 7% against the USD and the Euro losing 3%, while the safe haven yen is rising 3.6% against the dollar. The uncertainty over the future of the UK means investors can be expected to demand a higher risk premium for holding UK assets, which coupled with the need to finance a 7%-of-GDP current account deficit, should result in a large – and persistent – depreciation of GBP.
- **Crude** is down by 4%.
- At the opposite, perceived **safe heavens** are up with Gold price up 4% and government bond prices shooting upwards.
- **Downward pressure is evident on UK equities**, especially financial sector stocks and those most reliant on EU migrants (e.g. construction, hospitality sectors). Less pressure on UK companies with large FX earnings
- **Upward pressure on UK corporate bond yields** owing to increased uncertainty and the worsening short term growth outlook – as with equities, the financial sector is most exposed.
- **Downward pressure on European equities**, especially for companies with significant UK revenue, trade and investment exposure, and particularly so if the euro rises.
- **Downward pressure on Japanese equities** due to the stronger yen



Investment conclusions

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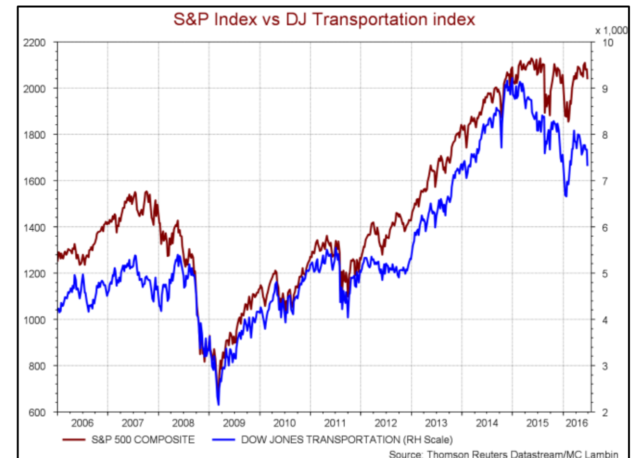
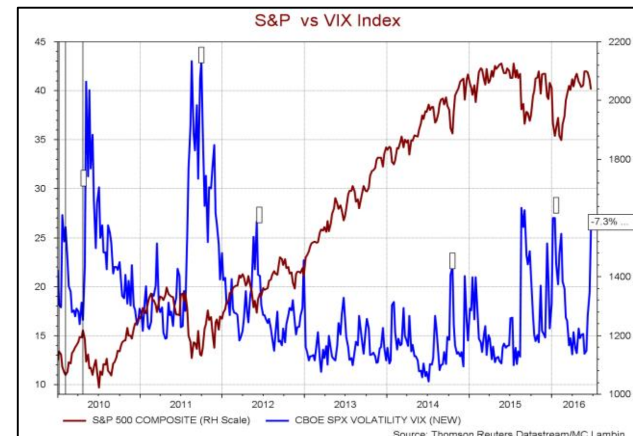
Market adjustments may have further to go

- The near-term market direction will be dominated by policymakers response to the UK referendum and by macro considerations.
- Should euro area member states swiftly announce a comprehensive agenda to continue the integration of the currency union, this would limit the risk of long-lasting stress in financial markets and the impact on growth.
- Alternatively, **if euro area members disagree** on how to proceed and are unable to decide on how to secure the integrity of the euro area, if the situation worsens in Spain and Portugal where public finances are under pressure partly as a result of the political situation, and, last but not least, if Italy votes “No” in October at the referendum on the constitutional reform, paving the way for renewed political instability, then the recession would likely be deeper.
- The performance differentiation across countries and sectors will depend on their exposure to the channels of contagion but confidence and psychology channels might still be more important than trade linkages and trigger financial market contagion, with the dominating factor being renewed concerns over global growth. A stronger USD would likely to cause oil prices to continue falling, adding more fuel to the fire of a major risk-off event in emerging markets.
- **Asset price adjustments may have further to go as** for many large investors it will take time to make and implement new allocation decisions. Investor expectations must now adjust to the new realities in Europe and to a more general risk highlighted by the UK vote. The performance differentiation across countries and sectors will depend on their exposure to the channels of contagion.
- **Volatility** remains elevated. Any fall in the Vix will be a positive signal that the sell-off may be close to over

***The DJ Transportation index** is still trending down, not boding well for the direction of equities according to the Dow Theory*



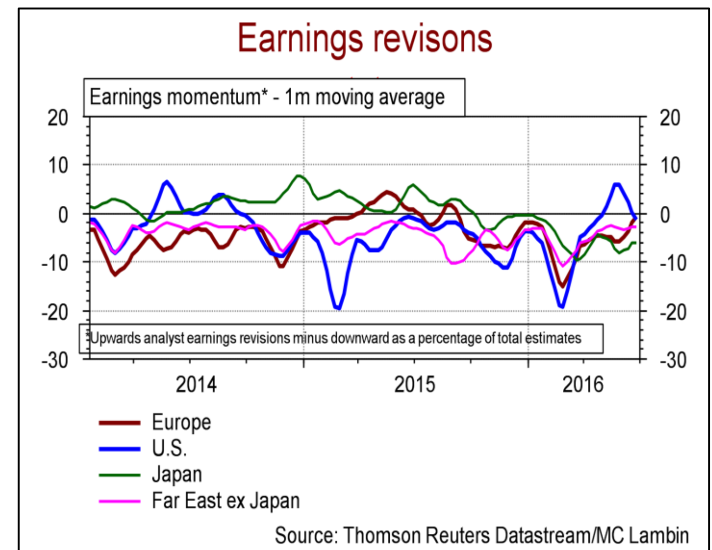


Investment conclusions

Risk off mode – Equity exposure reduced

- Given the lack of clarity on the political and economic consequences of the UK vote, and the market volatility which is likely to remain broad-based over the near term, we decided to take a more conservative stance and cut the **global equity exposure to 26%** from 50% with the sale of futures contracts on the S&P500, the Eurostoxx50 and the Stoxx600.
- But even in this environment, there are still quality companies to be found that are relatively immune to a downturn, those with innovative technologies, leading players in niche markets, or those with dominant products or brands. In the near term, investors will likely benefit from holding companies that operate across different regions. British multinational companies with significant international earnings will benefit from the decline in sterling as the value of their earnings will increase
- **A flight to safe haven assets** is likely to continue over the near term, benefitting our positions in **US Treasuries , Real Estate and Gold**,
- Our portfolio has **limited exposure to the UK** (less than 2% in equities, 2% in bonds mainly high yield) and **no exposure to Japan**
- We now set a **preference for US and Asia ex-Japan** markets which are only marginally affected by the UK's exit from the EU. This being said, the adjustments in global growth forecast could stall the improvement we have been seeing in expected earnings growth for the S&P 500. Earnings growth bottomed earlier this year, along with economic sentiment while analysts estimate revisions had been rebounding back towards positive territory.
- We stay out **Japan** as, contrary to broad expectations, the Abenomics policy has failed to prop up growth and inflation. The move to negative rates and the delay in the sales tax hike signals a poor outlook for the country's economy. An anticipated further appreciation of the yen will not help.

- ***We will be watching earnings revision closely to determine if analysts are losing confidence in earnings growth projections given the recent events overseas.***



Investment conclusions

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Risk off mode

- **In the fixed income**, we continue to find better value in the corporate space as more and more government bonds are now offering a negative yield.
- At this stage, we see no **strong case for buying European government bonds.** Both Bunds have increased and peripheral yields declined due to market expectations that the ECB will respond decisively with more purchases. Unless the ECB fails to meet the markets' high expectations for additional bond purchases, risk premiums for assets purchased by central banks should remain fairly contained, Corporate bonds that are not bought by the ECB and are vulnerable to the impacts of the UK's decision, e.g. bank bonds, are suffering the most.
- Preference is given to **US Treasuries and Us Corporate Investment Grade** (16% of the portfolio).
- We keep an **Overweight in EU High Yield** although it may take a while before investors feel confident enough to invest in European high yield, and global investors may look toward the US even though it is further through the credit cycle and potentially faces more defaults than the European market.
- **The emerging debt** will remain volatile over the near term, dragged down by a renewed dollar strength, another correction in the commodities markets, and concerns regarding the global macro outlook. A delay in US interest rate hikes should mitigate the pressure.

Global allocation		Tactical
Equities US		25.00%
Equities Europe		17.08%
Equities Japan		0.00%
Equities GEM		8.10%
	total equities	**50.19%**
Futures US		-12.06%
Futures EU		-11.59%
Futures JP		0.00%
Futures EM		0.00%
	total futures	**-23.65%**
Equities net US		12.94%
Equities net EU		5.50%
Equities net Japan		0.00%
Equities net EM		8.10%
	Total equities net	**26.54%**
Bonds DM Sovereign		13.47%
Bonds DM corporate IG		3.10%
Bonds DM Corporate High Yield		11.12%
Bonds EM sovereign + corp		8.82%
	Total bonds net	**36.51%**
Gold		5.86%
Mixed		2.36%
Cash		5.08%
Total		100.00%

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