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Market Insight

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The Brexit opens a Pandora's box

With its massive interventions, the Bank of England managed to ring fence the shock of the Brexit on the London Stock Exchange and avoid generalized panic. The UK will not escape a recession, starting in the 2nd half of this year already, coupled furthermore to a resurgence of inflation, driven by the ongoing fall of the pound sterling. Between recession and inflation, the choice will be agonizing for the central bank, even if we do not doubt that it will prioritize the first of these evils. The economic impact of Brexit on Europe will be more limited than in the UK, but it is especially the risk of contagion and ambitions for independence within other members of the European Union which will weigh on financial markets. Once again, the good news for financial markets is up to the central banks, which will not fail to extend, or indeed strengthen their accommodative stance.

A far from salutary shock

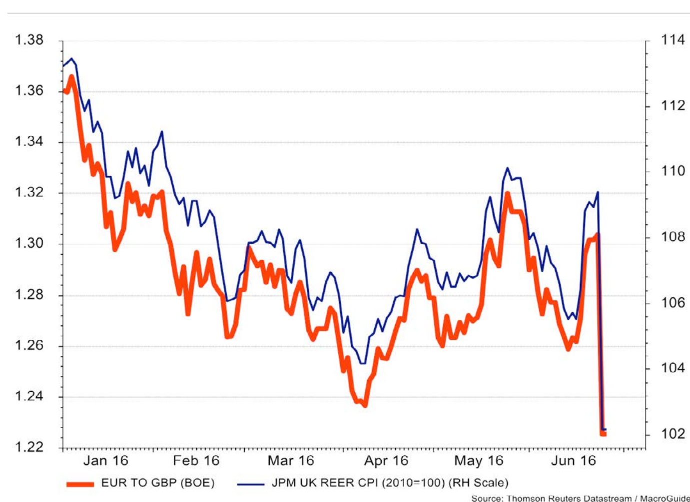
The Brexit did not wait for June 23 to impact the UK economy. Many multinationals were already curtailing their investments in the UK before the vote, or simply postpone them. This is certainly what must have led the OECD to heavily revise down its forecast for growth in the UK for 2016. Now that the Brexit is not merely a fear, recession seems inevitable .

And yet, you do find economists who believe that the Brexit will, ultimately, boost growth in the UK. Such was the prediction made by the movement "Economists for Brexit", before the referendum of June 23. What they do not make ultimately clear is that this growth revival has much to do with a massive fall in Sterling, which is meant to kickstart UK exports, whose main destination is ... the European Union.

The pound sterling was hard hit by the Brexit, as evidenced by the first graph: it shows the evolution of the British currency against both the euro and in real effective terms, namely a basket of currencies of the UK's major trading partners, adjusted by inflation differentials.

Today, a sustainable rebound in the currency seems hardly likely, for at least three reasons. On one hand, the British currency was at its equilibrium level in terms of purchasing power parity (PPP), before the vote of June 23. To be sure, deviations from PPP can at once be large and slow to resolve. Sustainable undervaluation of the pound would not be likely to undermine the theory of PPP. On the other hand, at close to 7% of GDP, the UK runs a large deficit in its current account balance, which may weigh on its currency lastingly. Not least, the Bank of England will not fail to change its policy following the Brexit and slash interest rates to zero, or indeed bring them to negative levels, a move which is already anticipated by the gilts market.

1. The pound took the brunt of the Brexit



A "remake" of 1992 for the UK?

The equation "Decrease in currency = Stronger growth" and, by extension, of the stock market is a classic pattern for economies which are heavily

geared towards exports, like the UK or Japan. In the UK, the supposedly positive impact on growth of Brexit builds on the example of 1992: then, the country experienced a tremendous growth spurt following the fall of the pound after the showdown won by George Soros against the Bank of England.

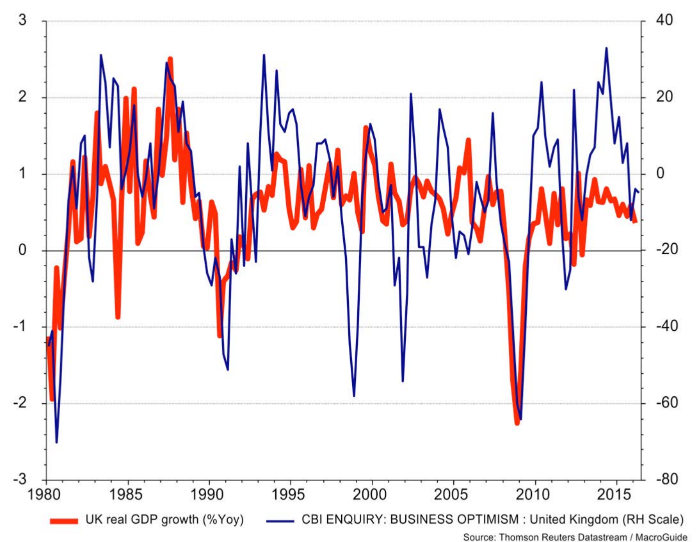
Will the current drop of sterling have the same impact on growth in the UK as in 1992? Surely not. The activity there was already subdued before the Brexit vote and the ensuing shock on investment and financial services will be a major one. In the UK, the financial sector accounts for 15% of Gross domestic product and 30% of exports, quotas unmatched by other G7 countries.

The latest poll of the Confederation of British Industry shows a significant loss of business confidence, as reflected in Chart 2. Released just after the vote of 23 June, the PMI data testifies a sharp fall in investment, for the first time since the crisis of 2008. Capital spending and residential investments have been the main engine of British growth since the turn of the crisis, and we expect a slide into recession during the second half of this year already.

To the lackluster growth environment, we must add yet another problem: that of imported inflation caused by the fall of the pound, which should bring consumer prices increasing by close to 3% by the end of 2017. Such "stagflation" is a headache for the Bank of England, although we remain convinced that priority will be given to the fight against recession, with massive reductions in interest rates and fresh injections of liquidity in the pipeline.

The good news in this bleak panorama of Brexit implications for the UK is that the London Stock Exchange should not suffer too much of the coming recession. The major indices such as the FTSE 100 will prove pretty insulated from domestic factors, for its sensitivity to foreign economic factors is the most pronounced among developed countries. With nearly 80% of their turnover registered outside the UK, the companies of the FTSE 100 index are markedly ahead of the 44% "foreign exposure" within the Eurostoxx, or even 30% of the S&P 500. Thus, although UK growth will not be at the rendez-vous as in 1992, the FTSE should benefit from its heavy dependence on overseas factors, especially as its current development is lagging behind the effective sterling exchange rate (in blue on chart 3).

2. The loss of business confidence will weight on UK growth

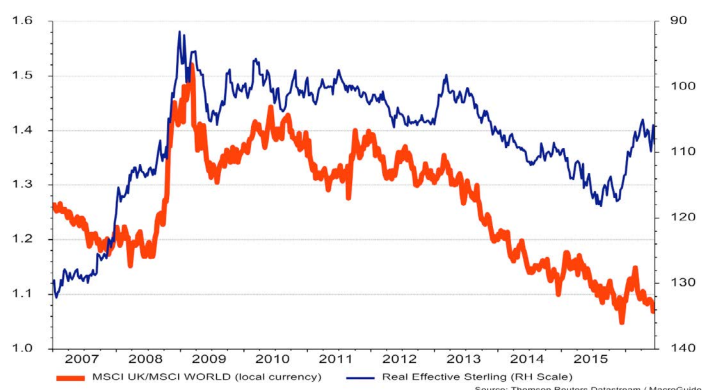


What impact for the rest of the world?

During the crisis in Russia in 1998, many investors questioned how a country that represents less than 3% of the global economy can cause financial turmoil globally. The answer lies in the integration of financial markets and interconnections in the banking system that can result in major and difficult to quantify domino effects.

On a currency basis, it is clear that the European Central Bank will coordinate its actions with the Bank of England as any excessive strengthening of

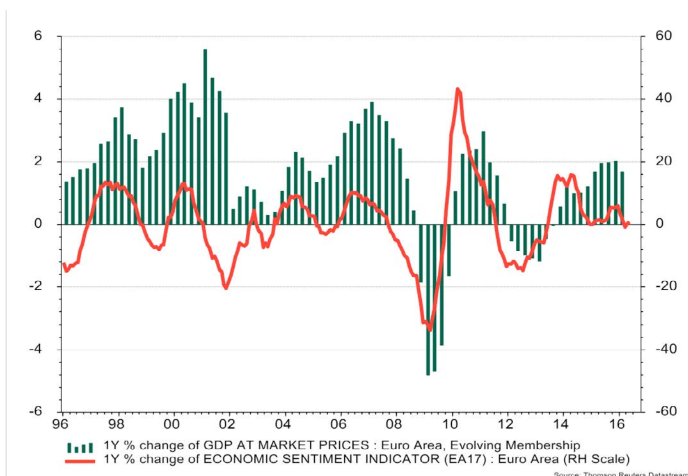
3. Losely exposed to domestic factors, the London Stock Exchange should benefit from the sterling drop



the euro would be very damaging. The Swiss National Bank is facing the same problem, and more acutely, given the upward pressure on the franc against the euro.

Another transmission mechanism of the Brexit shock materializes through foreign trade. The contribution of net exports to economic growth in the UK is expected to increase over the next two years, as the country retains access to the single market during the negotiations of Brexit and benefits in full from the sterling drop. By extension, the Brexit will have a negative impact on growth of the euro area, mainly via higher prices for exports to the United Kingdom. These however representing only 8% of total EU exports (against 44% of British exports to continental Europe), the impact of Brexit on European growth should be limited.

4. The impact of Brexit on Europe should be limited



The Brexit economic impact will thus be a major one in the UK, fairly limited in Europe and not material in the rest of the world.

More than strictly in economic terms, the cost of Brexit will most likely be on the political front. It is possible to calculate the "dependency" on the EU of each, based on the share of exports to the EU, but also financial factors like net transfers to the EU or public debt. On this basis, countries like Hungary finds header dependency, closely followed by all other countries of Eastern Europe. We also find Portugal and Ireland among the countries unlikely to request a referendum to leave the EU. At the other end of the scale dependence on the EU, there are countries like Sweden, France, Denmark and Germany, whose dependency is actually lower than the UK ...

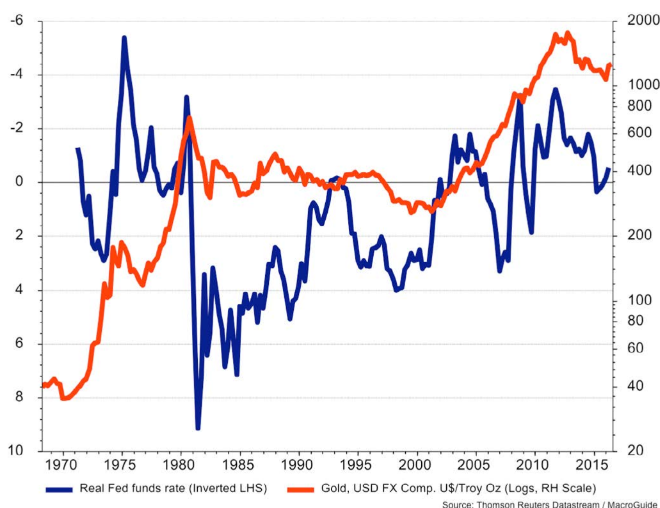
The risk of contagion Brexit to other member countries of the European Union will depend on negotiations between the UK and Brussels. It is clear that EU officials will not make many concessions to the British authorities, so as to ensure that the other members from the EU come to realize that the cost of leaving is non-negligible.

What about the financial markets?

The Brexit opens an era of uncertainty for the UK and Europe. The good news comes from central banks, again on deck to ensure the good performance of financial markets. Thus, the US central bank has not missed the opportunity of Brexit to postpone any tightening of monetary policy, helped as it were by subdued economic data in the US.

We will return on our investment policy below. It will certainly be on the look-out for assets least affected by the Brexit woes. Among these we find currencies like the franc, the yen or the dollar, but also emerging markets, both for bonds and equities. Gold is also included in this category. True, the yellow metal has rallied since the beginning of the year. Yet the fact that the opportunity cost of his detention – defined here as the real short interest interest rate, shown in blue on the reverse scale left of the graph below - is negative should continue to be favorable to gold (shown in red on a logarithmic scale on the right), as was often the case in the past .

5. Negative short rates benefit gold



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Economic Advisor

Money-market and fixed-income

As expected, the Fed left its rates unchanged at its most recent monetary committee meeting in June. The Brexit announcement and its negative impact on European growth has pushed bond yields to their lows. The 10-year Bund yield slid into negative territory, at -0.10%, and the 10-year US sovereign yield fell below 1.40%. Meanwhile, high yield bonds held up well to market volatility. In this uncertain environment, a US key rate hike is unlikely in the coming months. To offset remuneration that is now negative in short-term products, we have decided to gradually add to the portion of the balanced allocation that is invested in investment grade bonds (7%) while keeping modified duration low. Meanwhile, we are reducing the convertibles allocation (4%) and making no change to the high yield bond allocation (14%). Short-term investments and cash have been lowered to 20% of the allocation.

Equities

The announcement of the outcome of the referendum in favour of Brexit on 24 June proved the forecasts wrong and triggered a period of political and economic uncertainty throughout Europe. The risk of contagion to other geographical regions looks limited, particularly emerging markets that are benefitting from a strong US dollar and higher oil prices. We are taking a more cautious stance on Europe (15%) in our balanced allocation and taking on greater exposure to emerging markets (5%), mainly in Asia. We are leaving our US equity allocation unchanged (15%), given the performance of the US market and its reasonable valuation. Our discretionary hedging now allows us to protect up to 20% of the equity portfolio.

Alternative investments

Several alternative investments now offer returns that are comparable to past bond returns, along with low risk levels. We have decided to raise the portion of these investments to 13% in our balanced allocation.

Currencies

European uncertainties are driving investors into the safe havens of the US dollar, the Swiss franc and the yen. We believe that the franc and yen are overvalued and should pull back to more reasonable parities. The US dollar, meanwhile, could continue appreciating if US growth stays on track. We have opened a tactical 5% position in the US dollar.

Outlook

The expansion in global debt since the 1980s has come with a slowdown in nominal growth of developed economies, followed by emerging economies. Meanwhile, global inflation has receded massively, from 25% in 1995 to 2.5% in 2016. This disinflation, combined with weaker growth led to an almost constant decline in bond yields. Central banks then gradually undertook low-rate and even negative-rate policies in order to stem deflationary risks and reflate asset prices. There is nothing abnormal about this but it could last a while. As long as global growth continues to slide and debt continues to expand, interest rates may remain low for a long time to come.

Armand du Pontavice, CIO

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