Early Impressions: Perspectives on Brexit

As at 27 June 2016

This document has been written by senior members of BMO Global Asset Management (EMEA)'s Investment Management teams, to give a first-hand view of, and initial reaction to, the United Kingdom's referendum result to leave the European Union (EU).

We begin with some brief summary headlines and a factual review of how markets initially reacted to the surprise result. We then move on to set out our views on the immediate macroeconomic implications of the referendum result before providing a detailed review of all of the main markets where we manage money for clients within EMEA, discussing portfolio impact and future positioning. We recognise that the UK's referendum result means that markets are now entering a period of uncertainty, therefore if you would like to discuss any of the issues covered in this document please do not hesitate to contact a BMO GAM representative.

Our headline thoughts:

Short-term

- We expect uncertainty on all sorts of levels and we know markets hate uncertainty, so it is perfectly plausible to anticipate that it will be at least several days before markets stabilize.
- The resignation of Prime Minister David Cameron slows the EU exit negotiations, which will place as much of a cloud over European stock markets as it does over the UK.
- Inward investment into the UK can reasonably be expected to stall until the nature of the UK's trading relationships with the EU are confirmed.
- UK gross domestic product (GDP) growth is likely to slow, inflation will most likely rise as sterling devalues further, meaning UK exporters would continue to be a haven.
- US interest rate hikes look very unlikely for now.

Medium-term

- From here, the outlook for the EU as a whole has to be the main global worry. There will likely be talk of exits by other EU member states, but this may not become clear for months or even years.
- The threat of a gradual break-up of the remaining 27 EU countries will leave an elevated atmosphere of geopolitical risk across the entire region (even if Scotland wants to remain).
- Overseas manufacturers in the UK could shift production to mainland Europe and if trade tariffs are established, this could result in UK job losses and put a further brake on GDP growth.

Long-term

- The Brexit vote smashes the accepted status quo. What the United Kingdom in particular needs now is healing and visionary leadership to help establish its future relationship in Europe and the wider world.
- The United Kingdom's global political privileges could well be lost (UN Security Council etc.) and the UK's ability to influence may be dramatically reduced.

- Sterling as a global reserve currency could at some point (in the next 10 years) be called into question: falls in purchasing power parity (PPP) and falls in the UK's share of global GDP are likely to accelerate, but it is much less clear what the future holds for Europe.

Overview of macroeconomic implications

The implications of Brexit have been widely discussed but, for all of the scenario analysis before the event, the realisation of the result came as a huge shock. Indeed, polls ahead of the event showed an overwhelming majority of the population thought that the 'remain' vote would win. Rarely are such well-flagged events so mis-priced but the result in the UK will surely have implications for how investors think about political risk going forward.

In this context, before the referendum, it had been our view that events in the UK represented the "end of the beginning" of political upheaval. Trump, le Pen, Sanders, Podemos and even Corbyn represent a nascent and growing backlash against the establishment. Simple solutions to complex problems seem appealing to disenfranchised voters who have not benefited from globalisation. More inward looking economic policies and protectionism are clearly growing trends. The point is, however, that the underlying trends which are giving support to these politicians are only likely to continue and intensify and so, while Trump, for example may not win this time, traditional politics will continue to lose ground with unpredictable consequences.

> It seems reasonable to assume that there will be a modest recession in the UK as investment grinds to a halt, corporate and consumer uncertainty rises and financial instability increases. Monetary policy responses are likely to be relatively ineffectual but we should reasonably expect cuts in UK base rates and more by way of quantitative easing (QE).

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For investors, this means that political risks will continue to grow. Markets simply do not know how to price these issues and are unsurprisingly poor at interpreting implications. This suggests more skittish behavior and generally higher risk premia in affected areas.

Aside from the broader political point, the implications from Brexit as a base case, in our view, are likely to hit Europe and the UK hardest, as markets are already indicating. It seems reasonable to assume that there will be a modest recession in the UK as investment grinds to a halt, corporate and consumer uncertainty rises and financial instability increases. Monetary policy responses are likely to be relatively ineffectual but we should reasonably expect cuts in UK base rates and more by way of quantitative easing (QE). The relative attractiveness of large cap UK equities will increase if, as is widely expected, sterling continues to slide.

For Europe, Brexit will have a direct economic impact but, more importantly, the event clearly raises the stakes for politicians and may give momentum to various populist movements in Europe and raises the risk of future crises. It is interesting that, in the week of Brexit, UK equities rose modestly, Germany was broadly flat but it was the periphery which really suffered. These trends, on a relative basis, should

be expected to persist. Italy and France appear vulnerable but European equities overall now have a reasonable valuation cushion.

European ex-UK equities look attractive versus US equities on a value basis: in the US, relatively low unemployment and higher wages are leading to a squeeze of margins, limiting the scope for earnings growth and resulting in a subdued outlook for returns from US equities.

Even ahead of Brexit, government bond markets were acting as if the global backdrop was weakening. We do not expect that Brexit will push the US and other economies over the edge into recession but feel that we cannot ignore the signals which continue to suggest increasingly dysfunctional economic growth and inflation dynamics. More creative policy tools must surely be enacted, perhaps before the end of 2016.

For the UK economy, the medium-term economic consequences of Brexit are likely to be severe. UK growth was already slowing well before the 'referendum effect' made itself felt and house price inflation has fallen significantly. Foreign investment is one area of concern, particularly given the dominance of flows from non-EU financial services companies that have historically viewed the UK's membership of the EU as a key attraction. In all likelihood, they will divert some of this investment away from the UK and into Europe. The Scottish National Party (SNP) has already begun pushing for a second referendum on an independent Scotland. European leaders are likely to adopt a tough stance when negotiating the UK's exit and it will be interesting to see how a series of upcoming key political events play out, including Spanish elections (resulting in renewed uncertainty as there was no majority win for any party), a European Council meeting and an Italian referendum on Senate reforms. The stakes are high with the entire 'European project' seemingly in danger.

Market views

Against this macroeconomic backdrop, we would expect the Bank of England to cut the cost of borrowing and fiscal stimulus is likely ahead of the next UK general election.

We believe there will be limited impact on Europe's economy: on balance, the political ramifications of the UK's 'leave' vote are potentially bigger than the economic effects. As a percentage of their GDP, the likes of Spain, Germany, Italy and France conduct relatively little trade with the UK. The European Central Bank (ECB) is likely to remain proactive as it works to avoid giving up the gains already made through its stimulus programme. Further easing from the ECB is likely. European ex-UK equities look attractive versus US equities on a value basis: in the US, relatively low unemployment and higher wages are leading to a squeeze of margins, limiting the scope for earnings growth and resulting in a subdued outlook for returns from US equities. The prospects for European ex-UK equities appear brighter. Credit conditions in Europe have improved notably, with interest rates on new business loans falling significantly and credit demand picking up. Economic growth forecasts in Europe have proved to be resilient (compared to downward revisions in the US) and relatively high unemployment offers scope for European earnings to regain some of the considerable ground lost relative to the US.

The market may have over-reacted to Brexit by pricing out Federal Reserve tightening. Brexit and the weak May US employment report have led the market to severely reduce its expectation of the pace of Federal Reserve (Fed) tightening. Nevertheless, US wage and price inflation are slowly headed higher, in response to low unemployment. If, as we suspect, the impact of Brexit on the US is limited, we believe the Fed will hike twice this year leading to higher yields on US bonds and a stronger dollar.

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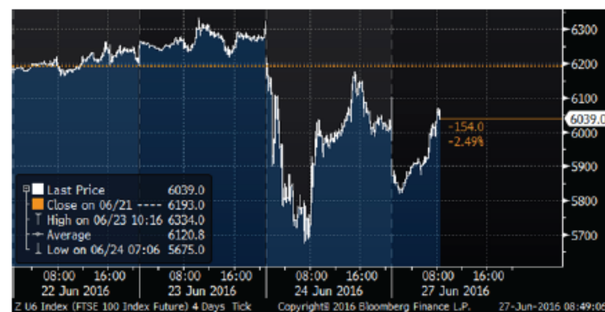
As it happened: reflecting on the immediate market reaction to Brexit

Our first observation from the early morning activity on Friday (2 GMT) is how orderly markets traded across all asset classes. There has been no suggestion of capitulation. Price makers have done their job, liquidity providers have not completely shut their books and circuit breakers / intra-day auctions on exchanges have triggered correctly.

Equity futures hit a low with the opening of European futures markets, at this point FTSE 100 futures were down around 9%, (see Chart 1) S&P E-minis down 5% and Eurostoxx opened down 12%. Over the following hour, we saw markets tread water in anticipation of the opening of UK/European equity stock markets. It proved to be an extraordinary open with Financials taking the brunt of the punishment as the likes of Barclays fell 29%, RBS down 34% and Deutsche Bank down 17%, to name a few. From there we saw a sharp +4% rally in the FTSE 100 as the market absorbed Cameron's speech and comments from the Bank of England (BoE). That level was held and we sat at the day's highs, comfortably above the 6,000 level. Volumes are also worth a mention: the Eurostoxx index traded at 373% versus the 20-day average volume whilst the UK traded at 230% versus the 20-day average volume.

Currency Markets

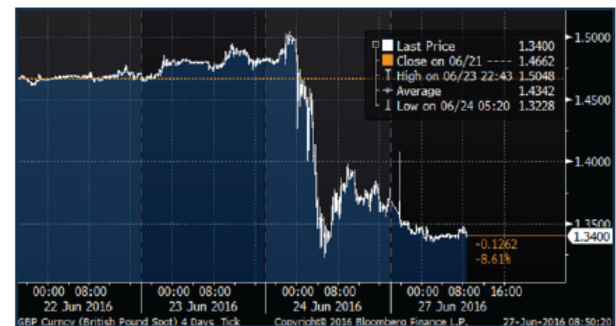
Chart 1



Source: Bloomberg

Foreign exchange (FX) markets reacted through the early hours of Friday morning as the results started to emerge. Sterling plummeted from its initial level of 1.5048 to its low of 1.3228, down 12% (see Chart 2). Through Friday morning and following Cameron's resignation, sterling recovered around a third of these losses. The yen continued to be a safe haven and the Swiss franc saw a lot of European defensive positioning with the Swiss National Bank (SNB) confirming that it had intervened to stem the strength. There were also indications of support from the other major central banks. Early morning liquidity was extremely poor.

Chart 2



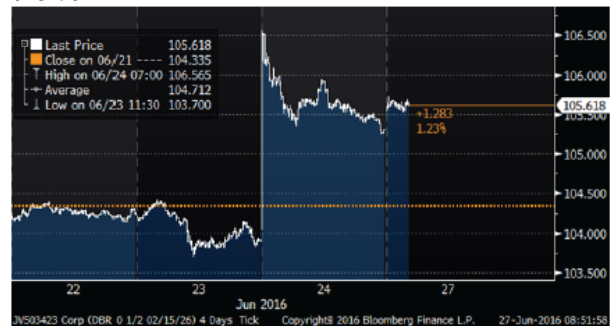
Source: Bloomberg

Bond markets

US Treasury futures were pushed aggressively higher through the Asian trading session and into the European open, being the first to bear the brunt of the large scale moves as it became clear "leave" was taking the lead. US 10-year yields were around 30-35 basis points (bps) tighter (at 1.404%) heading into the European open before paring back as the market started to digest news of Cameron's resignation and comments from the BoE.

German Bunds were next to open. Strong buying volumes were seen, as expected, with the 10-year yield recording a low of around -0.17 bps, around 25 bps tighter. Bund futures rallied around 5% recording a high of 168.86 before the market started capitulating as the morning progressed and equities began to rally (see Chart 3). On the flipside, the risk-off tone was aggressive as Italian government bond (BTP) futures traded down notably as the market opened and remained volatile as we headed into midday. It is worth noting that BTP futures had a delayed open of around 5 to 10 minutes due to circuit breaker interruptions.

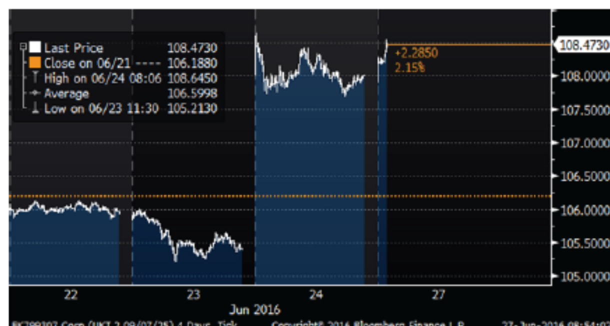
Chart 3



Source: Bloomberg

Gilts (UK bonds): another volatile open with the 10-year yield rallying by around 35 bps to record a low of 1.013% (see Chart 4). Again, futures trading volumes were high in a volatile first 30 minutes, reaching a high of 127.44 before trading back down to settle in the 126.40 / 127.00 range as Cameron and Carney made statements. Given the magnitude of these moves, the market did appear to remain strangely orderly.

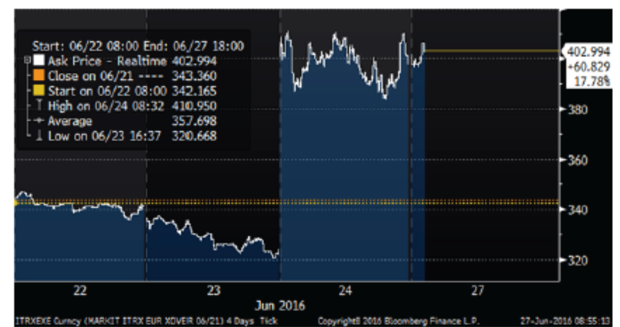
Chart 4



Source: Bloomberg

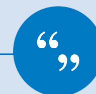
Credit spreads opened notably wide. As the day progressed, we had a fairly orderly move tighter (see Chart 5). Cash bonds have been a moving target. Additional Tier 1 (AT1) financials were down 4 to 10%, depending on the name. Offered side liquidity was very thin, however, and prices recovered some of the weakness as lower prices brought out better buyers on balance. We ended Friday lower versus overnight levels, but higher versus where we were a week ago.

Chart 5



Source: Bloomberg

The overall uncertainty created by Brexit results in dealing spreads remaining wider post the result and therefore the cost of trading has increased. We would expect this to narrow and have already started to see this, however, there is a risk that we will not return to pre-Brexit levels in the short-term. Liquidity has been partly withdrawn and tradable sizes have reduced, but we would expect to see this reverse as the implications of the vote become clearer.



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