6th July 2016

Key Points:

- Brexit and its impact on the rest of the world
- Political risk steeply increasing and difficult to quantify
- Accommodative policies of central banks continue
- Future political and economic environment in the post-Brexit vote world clouded by uncertainty
- Pace of the US interest rate hike cycle

Brexit vote is taking its toll

The decision by the UK voters to leave the EU came as a shock to financial markets and is likely to have a severe impact on the UK economy, a moderate impact on the Eurozone economy and a marginal impact on the world economy. The political risk has increased and in the absence of a UK political leader with a strong mandate to invoke Article 50 of the Lisbon Treaty (which would immediately trigger two years of discussion to exit from the EU), it is very difficult to get any clarity on future developments. The next UK prime minister will not be known before early September, but the expectation is that the new political leadership will take decisive political steps and also calm down nervous market participants. However until then the uncertainty will continue.

It is highly likely that this uncertainty in the UK economy will lead to diminishing domestic and foreign investment. The real estate sector seems to be one of the most exposed market segments with some real estate funds already experiencing significant withdrawals and suspending redemptions.

The British pound continues its downfall against all major currencies. The pound continues to hover around its lowest level in 31-year, as investors shun the currency in the fallout of the country's vote to leave the European Union.

Just one week before the vote, the IMF warned that leaving the EU could hit British living standards, stoke inflation and wipe out up to 5.5% of UK GDP over time. The IMF used its annual report on the British economy to say Brexit would plunge the UK into recession next year and that it could see no economic advantage in leaving the EU.

Europe ex-UK likely to suffer mostly on trade side

The Eurozone economy is also likely to come under pressure following Brexit. The bloc's economy was just beginning to take off after trillions of euros were pumped into it by the European Central Bank, but now the EU faces the risk of a slower recovery, given that the UK accounts for 13% of Eurozone exports (or around 3% of EU GDP).

In 2014, total UK trade was about EUR 900bn, with a total trade deficit of EUR 140bn. The UK imported predominantly from the EU, with which it had a trade deficit of EUR 93bn, and exported mostly to non-EU countries, with which it also had a trade deficit of EUR 46bn. EU countries accounted for 53% of UK imports and 48% of UK exports. These very important trade flows could be disrupted if the current EU trading framework is broken.

Policy of major central banks remains accommodative

In the UK, the Bank of England is likely to ease policy via a combination of a 25bp rate cut and some credit easing measures while the ECB is expected to revise the parameters of the QE programme (currently EUR 80bn per month) in order to continue bond purchases through 2018 (from the current end-date of March 2017). Easier monetary policy is also expected from Scandinavian and Swiss central banks while a later tightening cycle is expected for the CEEMA region.

The appreciation in the Japanese Yen on the back of Brexit also makes it more likely that the Bank of Japan will ease policy at its July 28th meeting by cutting the IOER by a further 20bps as well as increasing the pace of its open market purchases of stocks and credit instruments.

What does this mean for the US dollar?

The effect of Brexit is clear in the safe heaven currencies with the USD strengthening and the Japanese Yen following suit. We believe that the USD strength will continue given the fundamentals and the negative impact on EU growth by Brexit.

PBoC decided to slightly devalue the Yuan given the strength of the USD after Brexit. It's clear that China has a limited tolerance to lose more export revenue due to the exchange rate.

The value of the USD is a fragile equilibrium of interests going forward. In the political landscape of power, a stronger USD does not benefit two of the main central banks and we acknowledge that a stronger USD could influence Fed's policy actions.

Lower US interest rates price in higher risk

With regards to US monetary policy, we expect that the increased uncertainty and financial market turmoil will force the Fed to put rate hikes on hold. In the US, the initial expectation (prior to Brexit vote) had been that the Fed could raise rates twice this year, with the first hike occurring next month. However, many economists now say a Fed rate hike is off the table, not only for the next meeting but for the rest of this year.

The US economy is performing relatively well and unemployment remains at its lowest levels since 2008. As the recent FOMC minutes mentioned, this can be attributed to supply constraints associated with tighter labour markets, and some Fed members mentioned the "recent firming in wages as consistent with a high level of labour utilization." The FED will look for more data in relation to the labour market and see if there are any additional risks as a consequence of Brexit. If Brexit is a contained risk, the FED and investors will focus on other US macroeconomic data.

Lower economic growth ahead

The available data suggest that the world economy was in reasonably good shape just before the Brexit vote occurred. In June, global activity growth was running at 3.5%, which is slightly below trend, but significantly above the growth rates recorded for the majority of 2015 and early 2016.

However, there is no doubt that Brexit will adversely impact the growth in aggregate global demand as a result of the rise in policy uncertainty, but so far the downgrades to GDP growth forecasts have been relatively minor for the world as a whole. The IMF has already downgraded its global growth forecast this year, projecting a "modest 3.2%" for 2016, a rate pushed up by emerging market economies. Growth in advanced economies, such as the euro zone, is expected to be much lower.

Emerging markets asset class relatively unscathed

The tepid risk-on environment and 'lower-for-longer' rates view adopted by the market have put the spotlight on EM as a potential winner in the Brexit aftermath. With nominal US treasury yields just a few basis points off the lowest levels in decades, the global 'search for yield' theme has come to the fore once again. For investors seeking yield in fixed income assets, EM credit (cash USD-denominated bonds) offer attractive yields.

Bonds

In the short term we expect the Fed to delay any interest hike and wait to see if there is any unforeseen risk coming from the unexpected decision by the UK to leave the EU. We still consider the labour market to represent the key variable influencing the Fed's behaviour going forward. Labour income appears resilient, household saving rates are healthier, US corporates have strong balance sheets, the banking system is recovering and local financial conditions remain accommodative.

After the unexpected Brexit result, the yield in the 10 year US treasury tightened to 1.47% by the end of June, 38bps lower than the May month end yield of 1.85%. After the referendum, the 10 year German bund yield went into negative territory and hit an all-time low before ending the month at -0.13%. At current yields, European bonds, like Japanese bonds, offer no value to investors.

We need to look at the valuations of US treasury on a relative basis. G3 central banks are likely to maintain their accommodative monetary policies (some with negative nominal rates). In the case of developed economies almost USD 11.7trn of sovereign debt is trading at negative yields now. The US interest rate levels and slope of the curve fails to reflect fundamental valuations but are effected by the yield of other G7 economies. This could keep US rates anchored at lower levels than they should be.

With a spread level of 385bps over US Treasuries, you can make the case that EM fixed income remains attractive to large institutional pension funds and insurance companies that are searching for yields in an environment of negative G3 rates or very low yields in general. Especially given we expect better growth prospects for emerging markets compared to developed economies as oil prices stabilise and adjustments are made to current account imbalances.

Equities

The decision by the UK voters to leave the European Union came as a surprise to both us and the rest of the investment community. The result caused an initial shock in equity markets with a sharp sell-off seen across the globe, especially in European markets. There was a violent intra-day move pushing the MSCI World index down 4.9% over the day whilst the GB Pound came under severe pressure falling over 11% on the day to the lowest level versus the US Dollar in over 30 years. This post vote weakness offset what was an initially strong start to the week in European equity markets which appeared to be pricing in a victory for the “Remain” party pre vote. Due to the strong start to the month the actual performance in June was not as negative as it may have been with MSCI World declining ‘only’ 1.1% but the uncertainty in financial markets due to ‘Brexit’ poses bigger questions about the future path for risk assets.

We still think the US recovery continues with improving economic data and accommodative monetary policy helping equity markets to steadily grind higher. In Europe the picture is less clear as the full ramifications for the UK leaving the EU are unknown. The resignation of David Cameron, the UK prime minister, has ensured a delay in negotiations for the UK exit but it has provided central banks with time to be proactive by loosening monetary policies in an attempt to stabilise markets and stimulate growth. We remain constructive on European equities however we acknowledge that the uncertainty surrounding Brexit could weigh on sentiment for a prolonged period depending on economic data in the region and any central bank and political rhetoric.

We remain of the view that equities could be positive over the rest of the year but we now require the UK’s exit from the EU to be well handled and clearly communicated with limited further shocks to the financial system. We continue to believe that investors will continue to search for yield within a low growth/return environment which will result in more money flowing into equities as they continue to offer better value relative to government bonds which should be positive for equity returns over the medium term.

If you have any questions or wish to speak to someone about our investment products, please contact your relationship manager or email us at: **investment.enquiries@gibuk.com**