



Illumination: Equity strategy and market outlook

June 2016

Global perspectives: Brexit - Leaves on the Line

- **The UK's vote to leave the EU has created a political crisis and a significant degree of economic uncertainty.** Global markets fell sharply on the day that the result was announced but have bounced at least in part due to the perception that central banks will offset slowing growth with even looser monetary policy.
- **In terms of Brexit there is real uncertainty over the leadership, timing and process.** No option can be fully discounted, including a no-Brexit, even if that appears unlikely at this stage. The referendum was advisory and Leave supporters need to secure a majority of MPs in parliament to enact legislation to exit the EU.
- **Mutually assured economic destruction is clearly a negotiating tactic and not a strategy, in our view.** Investors should expect a combination of tough talk and willingness to compromise on both sides. Following the loss of a faster-growing member, the EU can ill-afford sub-optimal trade relations with the UK. Similarly, on the UK side, compromises can be expected in terms of border control.
- **We expect the uncertainty to slow the UK economy.** Business investment and manufacturing PMI indices were already slowing notably in the months before the vote. In this environment it is straightforward to blame any bad news on Brexit and in only a few days we have seen a number of profit warnings which have done so.
- **Equities fell sharply initially but have now recovered.** We believe investors are once again too ready to look through slowing fundamentals and are focused only on the direction of monetary policy. In this respect bonds may be headed in the right direction given the dovish stance of the US Fed, but we remain cautious on equities.

Analyst

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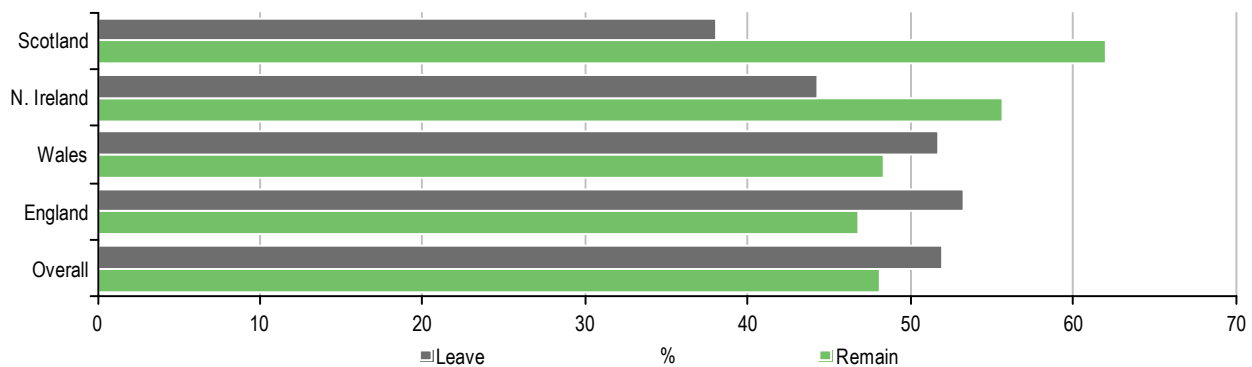
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Brexit: Leaves on the line

So, in the event, we got it wrong. The anticipated surge for Remain in the closing days of the referendum campaign failed to materialise and the result to exit the EU shows a nation split between Leavers in England and Wales, with Scotland and Northern Ireland voting to Remain, Exhibit 1.

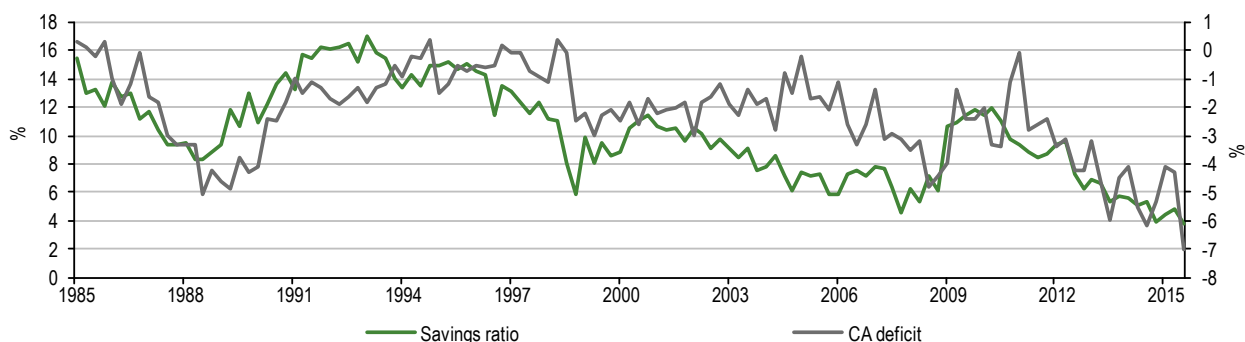
Exhibit 1: UK referendum vote result



Source: Thomson Reuters Datastream

The obvious target for short-term traders following the vote was sterling, which fell by 12% against the dollar on the Friday after the vote. We had highlighted sterling as one of the more obvious weak points in the event of a vote for Brexit well ahead of time. The UK is running an exceptionally large current account deficit of just over 7% at present and the savings rate for UK households has fallen to levels not seen since before 2008.

Exhibit 2: Sterling riding for a fall – current account deficit and savings ratio



Source: Thomson Reuters Datastream

In our view, sterling was riding for a fall and as expected, this referendum has proved to be the trigger. In our view, this is a necessary adjustment and provides an important shock absorber which offsets in the broadest sense the upcoming competitive disadvantages (notably the sheer uncertainty over the terms of exit and duration of the exit process) now faced by the UK. For this reason we do not expect sterling to bounce hard from here and as the slowdown in the UK's economy becomes more evident, sterling could easily come under further pressure.

Separately, the recent move in gilt yields from 1.4% to less than 1.0% over the last few weeks needs careful interpretation to avoid confusing the global and domestic picture.

We believe the evidence of a slowing US economy and more dovish Fed policy has been responsible for the majority of the significant decline in global bond yields, which preceded the pick-up in fears over Brexit in the week before the referendum.

Second, for the UK specifically we believe the Bank of England will be very much working on the Plan B economic model and is likely to cut rates at its next meeting, in line with market expectations.

However for investors currently long gilts, we would also highlight the UK was placed on creditwatch negative by Moody's and downgraded from AAA to AA by S&P following the vote. The UK also continues to run a significant budget deficit which would be expected to widen in the event of a slowdown in UK economic activity.

Furthermore, the decline in sterling, while largely welcome, will lead to sharply rising inflation next year. We note consensus forecasts for 2017 have risen beyond the Bank of England's 2% target. There may therefore be a limit to how much monetary stimulus the BoE can provide in the circumstances, just as Mark Carney – correctly in our view – warned before the vote.

We therefore think 10-year gilt yields are unlikely to continue to move lower from here – and we cannot but wonder if their safe haven status may be questioned by international investors during this period of uncertainty.

Limited visibility on process and leadership

In terms of the process, we believe the uncertainty is real, which is to say that at this stage, nobody really knows how this will unfold as there are just too many moving parts. At one extreme, there are for example several million signatures for a second UK referendum on Brexit. Such a referendum is in our view a low probability scenario that may also sound rather anti-democratic – but it would not be the first time voters in the EU were asked twice to get the 'right' result.

The UK's European Union Referendum Act of 2015 does not in fact bind the UK government to do anything, other than hold a referendum. We have to acknowledge that it is not clear at present there is a parliamentary majority in favour of exiting the EU or making a notification under Article 50. Therefore, the probability of the UK leaving the EU at this point may be high but is still not 100%.

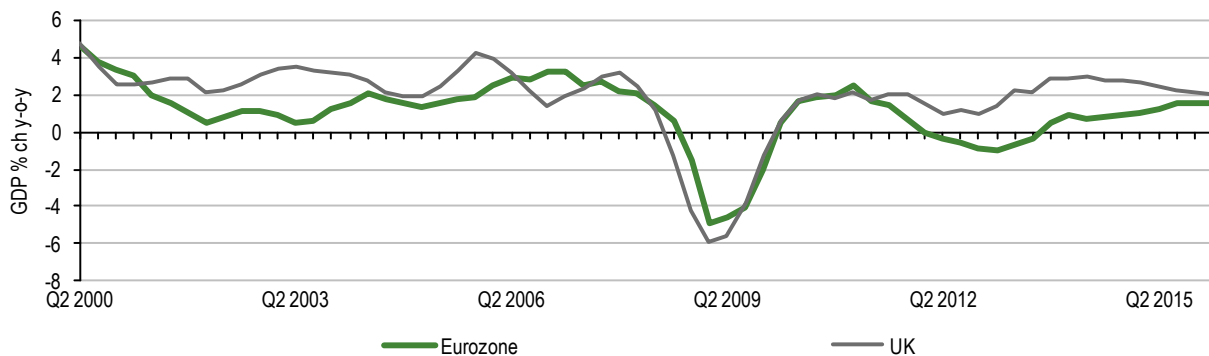
During the campaign, Boris Johnson has already floated the idea of renegotiating the UK's relationship with Europe and calling a second referendum, should the terms be sufficiently attractive. Recent comments from European leaders indicate this thinking is unlikely to progress at present. However, we believe there may be a temptation for views to soften over time as there is only a marginal swing required in the UK to change the outcome to Remain in such circumstances.

It is far too early to know who will lead the UK or even the Labour opposition party or the composition of the UK cabinet in October. These are very early days and any potential leaders will need to establish a credible policy for disengagement from Europe in order to win the Tory leadership contest.

One point is clear and it is that the UK retains the initiative in terms of the timing of any notification under Article 50, which governs an exit from the EU. We have already seen a typical stumble from the EU following the UK vote; a hastily convened group of six founding EU foreign ministers requested an immediate notification which Merkel flatly contradicted in the same city immediately afterwards. Any 'deal' between the EU and the UK will have to be agreed by the nations within the EU, the most important of which is clearly Germany.

While the process will be unpredictable – and both sides may try to use economic stress to their advantage during the negotiation period – Merkel's comments underscore our belief there is no policy of mutually assured destruction, for Germany at least.

Our base case therefore is that the UK is too important for Europe to 'cold shoulder'. The correlation between the UK and eurozone GDP over the past 15 years is over 80%, Exhibit 3, and European policymakers need to be careful what they wish for in terms of 'punishing' the British electorate.

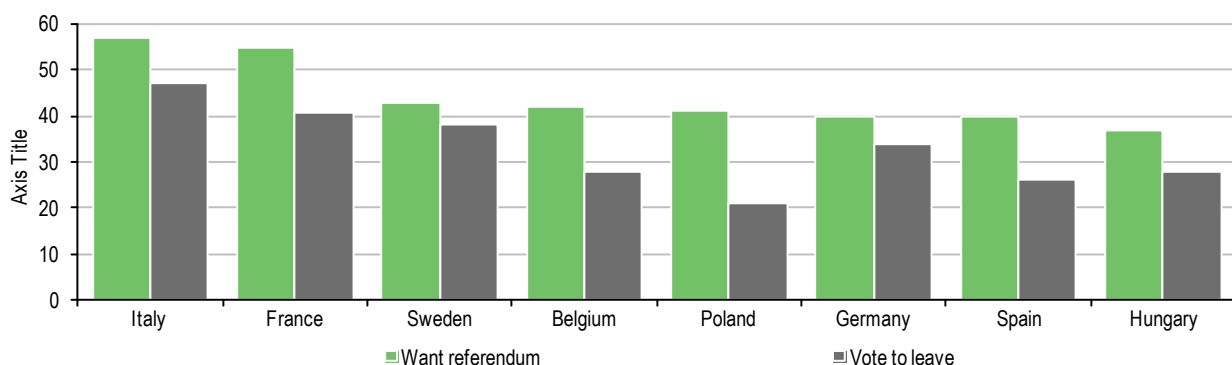
Exhibit 3: 80% correlation between EU and UK GDP growth


Source: Thomson Reuters Datastream

The gains from trade appear to be too large for both sides to ignore and the extent of cross-border market access will depend on the degree to which each side is willing to compromise principles, notably free movement of people. The next British Prime Minister will aim to secure an independent political future and control of Britain's borders; the EU's trump card is the extent to which firms based in the UK can provide services in EU markets.

We also believe the relationships between the UK and nation states within Europe, notably Germany, should not be underestimated. In matters of defence for example the EU is irrelevant, with decisions being taken by NATO, while UK defence spending dwarfs that of other EU nations at 25% of the total. There is more than economic welfare at stake for all parties; it is also in the interests of the US push for a resolution which does not impair either geopolitical or economic prospects.

We expect the process to be a multi-year, complex and sophisticated but relatively rational negotiation, even if this may not be obvious from the inevitable populist headlines. The EU will also have to face the fact that if a key dissatisfaction with the EU is its ability to foster acceptable levels of economic growth, the risks of disintegration will only increase if it insists on a growth-unfriendly relationship with the UK.

Exhibit 4: Demand for EU exit referenda in EU


Source: Ipsos Mori

While it is too early to call a domino effect where popular movements in, for example, France or the Netherlands succeed in pushing for other exits from the EU, these are risks which investors will price into markets until there is convincing evidence populism has peaked. There is significant voter interest in holding EU membership referenda in Italy, France, the Netherlands and other European nations, even if polls currently indicate that these votes would likely favour remaining in the EU, Exhibit 4.

Tempting as it is, investors should however be careful not to join-the-dots prematurely in our view; Brexit may yet be the wake-up call the remaining nations within the EU need to come off the fence and decide whether they are in it for trade and growth – in which case policies to improve growth must be forthcoming. If it turns into a drive for further integration, voters will need to be assured of significantly increased EU democratic accountability. Either way, the UK could be leaving a very different EU from the one in place at the time of the referendum.

And another thing...Scottish independence

The irony of the Scottish independence referendum of 2014 is that the vote to remain in the UK was linked to the UK's continued membership of the EU. Popular support for the EU remains strong in Scotland with over 60% of Scottish voters voting in favour of remaining in the EU.

The political incentive to capitalise on this support to push for Scottish independence is clear, and the position is similar in Northern Ireland. However, we would not get carried away at this stage, as only once the shape of the agreement between the UK and the EU is known will Scottish voters have a legitimate choice to make in any future independence referendum. Scotland's largest trading partner by a wide margin is the rest of the UK, which accounts for over 75% of EU-bound exports.

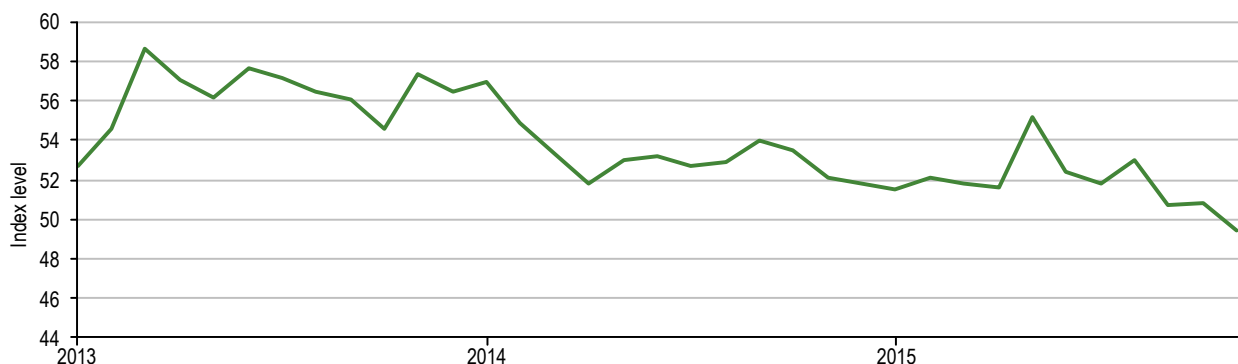
Economic impact in short term driven by uncertainty

Turning to the economic, rather than political impact of Brexit, here we would reiterate that the primary impact in the short term is likely to be the period of uncertainty which will slow business investment in the UK, in terms of both domestic and international companies but in particular non-EU companies looking for a sensible base to access EU markets.

From a psychological perspective, it is unfortunately now the case that central bankers, politicians and executives have an obvious scapegoat for any shortfalls in inflation, GDP or profits – there will be limited career risk when announcing such disappointments and as a result, we would not be at all surprised to see a steady flow of such news over the remainder of 2016.

Notably, close to one-half of the UK's population were against exiting the EU, potentially fearing the economic consequences. As a result, a slowdown in aggregate consumer demand and confidence due to the widely held popular belief that a downturn is now inevitable should be anticipated.

Exhibit 5: UK manufacturing PMI already indicating a slowdown



Source: Thomson Reuters Datastream

The UK's economy appeared to be losing momentum well before the vote, Exhibit 5, and a hiatus in business investment would now seem unavoidable. Investors who have exposure to the UK's domestic economic performance may wish to reflect that a period of sub-par growth, whether or not officially a recession, now seems highly likely to occur over the next few quarters.

In this respect it was notable that the domestically focused FTSE250 significantly underperformed the FTSE100 in the days following the vote; the FTSE100's weighting towards large global

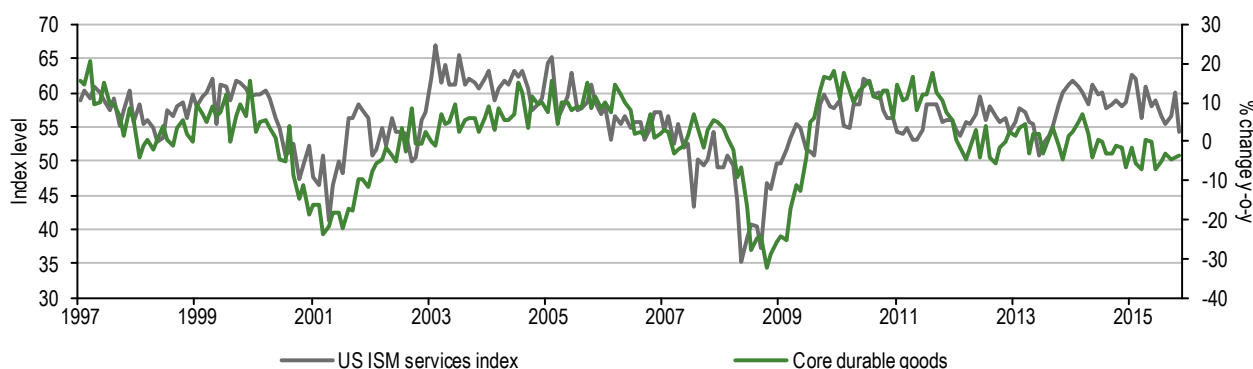
organisations, many of which happen to be listed in the UK rather than being dependent on the UK economy offset much of the damage done by the falls in large-cap financials.

The big question for the UK is how to minimise the negative effect of Brexit on the UK's financial services sector and London. This is not going to be easy as events will be seen within continental Europe as an opportunity to grab market share if not to wrest from London the role of Europe's financial centre.

The knee-jerk market reaction to sell financial services companies aggressively is therefore quite understandable. However, as we have mentioned previously access to the market for financial services may be the EU's trump card but it does not hold all the cards; a major UK recession could easily tip EU growth negative and create the very EU constitutional crisis it is seeking to avoid. Volatility in the financial services sector is likely to be elevated until this matter is settled.

If we now turn to the context in which we are dealing with Brexit, we should also mention that the global economic recovery post 2008 has been both slow and fragile compared to prior recoveries; there is no doubt that international groups such as the IMF are right to be concerned that Brexit disruption could trigger a sequence of negative economic events. The knock-on impact on the eurozone could easily put that tentative recovery off course, given the high correlations between activity either side of the English Channel.

Exhibit 6: US activity weakening in 2016



Source: Thomson Reuters Datastream

It is also clear that even before Brexit there has been increasing evidence of a deterioration in US economic prospects with a significant slide in the services PMI index, Exhibit 6, even if manufacturing new orders data has had something of a bounce following the recovery in the oil price. Core durable goods orders have also been negative year-on-year for some time, data which is normally associated with US recessions. The most recent jobs report was very disappointing, leading to a sharp lowering of US 10-year bond yields, representing a flattening of the yield curve which has historically been a good predictor of a slowdown in US economic activity.

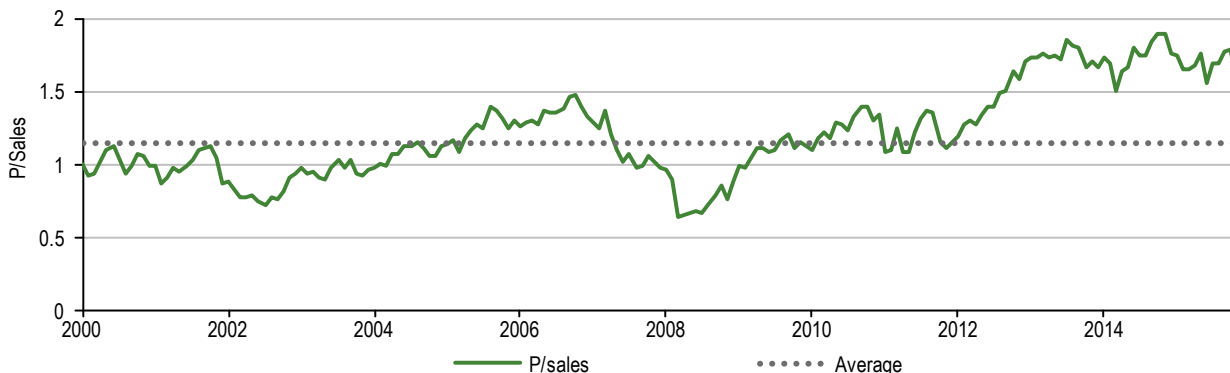
Equity market switches from interest rates to growth

Global equity markets are therefore now preoccupied with a very different set of risks from that seen earlier in the year. In Q1, the risk was that the Fed would continue to tighten policy and strengthen the US dollar, potentially causing a credit crunch in emerging markets which would blowback to developed economies with a lag.

The risk of the Fed prematurely tightening policy now seems much lower if not remote and the trade weighted value of the US dollar is no longer appreciating; with commodity prices significantly higher than in Q1, emerging markets stand to benefit from looser than anticipated US monetary policy, at least provided there are no negative surprises out of China during the summer.

However, in terms of equities, we believe developed markets in the US, the UK and Europe still look expensive. While UK stocks may appear a little less overvalued now, the median non-financial stock is still well above its long-run average prices/sales ratio, Exhibit 7.

Exhibit 7: UK median non-financial price/sales



Source: Thomson Reuters Datastream, Edison calculations

Therefore, we are still operating in an environment where equity valuation multiples appear stretched and the levers for improving the valuation metrics – margin expansion or sales growth – are not in an encouraging position. EBITDA margins are still forecast to expand to record highs and median sales growth forecasts are running at 2-4% rather than the 8-10% of prior cycles.

We would also highlight that in the UK for example, payout ratios are also at all time highs for the last 20 years. Growth in aggregate dividends appears challenging from here; FTSE100 dividend futures currently price in a dividend decline of 25% from current levels by 2022.

The numbers have not in fact changed significantly since our previously published views – at current levels of yield, equities may deliver only 5-6% total returns which offers, statistically, no guarantee of outperforming bonds, even over time periods as long as 10 years. While it is difficult to argue the expected return on equities has not fallen significantly, the same cannot be said for expected equity market volatility. In this respect, we can find little evidence to support the view that equities will be less volatile in future than they have been in the past.

To the contrary, the combination of significant political uncertainty, economic fragility based on debt-driven GDP expansion and relatively high market valuations points to the scope for elevated equity market volatility compared to history.

We continue to believe investors should remain cautiously positioned, which means keeping portfolio risk lower than normal at present, and in any case at least until valuations are closer to long-run averages and any Brexit-related slowdown has been embedded in profits forecasts.

In this regard, we also note something of a consensus developing in terms of likelihood of a deflationary outcome for the global economy, as implied by the very low or negative nominal bond yields.

If only to improve your scenario planning, we would finally highlight the previous period of ultra-low rates was followed by a 20-year surge in bond yields and inflation. The days following the Brexit vote may not be tactically the right time to be increasing precious metals allocations, especially in sterling terms, but this year's rally in gold prices is quite understandable given the increasing willingness of central banks to experiment with negative interest rates.



Conclusion

To conclude, we are now in a world of real political and economic uncertainty, following a failure to solve an EU-wide economic growth problem which over a period of time has metamorphosed into a challenge to the existing political structure. While it may seem that everything is up in the air at the moment, we believe we will see Brexit policy coalesce around new UK leadership during the summer.

It is not in the interests of the EU, nation states within the EU or the UK to pursue policies of mutually assured economic destruction and for that reason that scenario is of relatively low probability, but may feature strongly at various times during the UK's exit negotiations.

We do however fear the combination of the fragility of the economic recovery and the uncertainty over the terms of Brexit which could do real economic damage in the short run. Equities have recovered much of their losses in the days following the UK's referendum and remain at extended valuation levels. We believe investors' portfolios should remain cautiously positioned.

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