NBAD

From West to East

Weekly Investment View

3rd July, 2016

Markets stabilize, post-Brexit

With the main exceptions of Eurozone and UK small- and mid-cap stocks, most equity markets regained all they had lost in the big mark-down on the day of the vote result. An important factor in the bounce-back must have been the expectation that global monetary stimulation by central banks (not just the Bank of England) would be increased in the event of any sustained market turbulence and/or further economic weakness. Also, although the consequences for the UK itself will be far-reaching, as well as potentially for the remaining EU members, the impact on the rest of the of the world is actually not that large, or direct. The two-year exit clock starts ticking after Article 50 is triggered by the new British Prime Minister, and there will be no hurry to get to that point.

'Most equity markets recovered all their immediate post-Brexit losses'

The S&P 500 closed 3.2% higher on the week, so almost fully recovering the ground it had lost after the Brexit vote. The dollar closed a bit weaker, with the general risk-off tone in markets moderating. The FTSE 100 closed the week up 7.2%, and 3.8% above the close immediately preceding the Brexit vote, when the narrow consensus had been for a Remain result. While this looks very surprising to many investors given the level of uncertainty in the UK, we should remember that approximately 75% of the corporate revenues of the FTSE 100 originate from abroad, hence these receive a sizeable benefit from the fall in sterling. Eurozone equities were ahead by about 3.2% over the week, although are still lower than immediately before the Brexit (by 4%). The latter probably represents a fair judgement on the negative impact of the Brexit, at least for the time being.

G3 government bonds have seen strong inflows. The US 10-Year Treasury yield closed the week at 1.46% after falling a further 19 basis points on continued buying. Focus naturally remained on the UK gilt 10-year yield, which closed 23 basis points lower on the week, at 0.86% (after an intra-day low of 0.78%), i.e. a significant 23 basis points lower over the week, driven by 'easing' remarks by Mark Carney, the Bank of England Governor. Mr Carney has continued to be the epitome of everyone's favourite central bank Governor, on the one hand stating honestly that the UK's economic outlook has worsened, but on the other hand serving notice of imminent renewed monetary easing – but not to negative numbers in terms of bank rate, as he doesn't want to damage the UK's banks.

'We expect Sterling to continue to trade lower'

By the end of last week short-covering in Sterling saw the currency pair stay above $1.30, and closing the week at $1.3264. Our expectation remains for at least one 25 basis point reduction, which could eventually lead to rates going to zero. For the moment such thoughts have prevented Sterling from bouncing by very much, as has the extra political uncertainty caused by the circumstances of Boris Johnson stepping aside from the prospective PM shortlist. Indeed recent days have arguably seen Westminster at its most vicious, although seemingly leading to Mr Johnson's exit making way for Teresa May, currently the UK Home Secretary, who is credible and a safe pair of hands. The fact that she was on the 'Remain' side shouldn't matter. Angel Merkel, the German Chancellor, intimated a rapid and seamless exit process by the UK from the European Union would be a desirable outcome regardless of the new UK leadership.

Longer-term we believe the UK will successfully reposition itself, once its political scene has settled. The initial months ahead will be difficult, with a recession predicted. At the same time markets will begin to price this in. UK investment opportunities will become apparent. The possibility of the secession of Scotland will complicate the outlook. On

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balance we expect a small net positive economic result from Brexit for the UK beginning in a few years, especially if a candidate like Teresa May becomes Prime Minister. Beyond that, a lower regulatory burden should help the SME sector. More immediately exporters will get a shot in the arm at the top-line from weaker Sterling, part of which will be dissipated by higher imported inflation on the way to the bottom-line. For the Eurozone (ex-UK), we would expect a fairly immediate but not a large hit to GDP growth. This would be somewhere in the order of 0.2% in the current year, and we predict a 1.3-1.5% growth range. This is in line with what Mario Draghi has suggested the effect could be (a negative effect of 0.5% over the next three years). The Eurozone economy as a whole has not picked up much during the last few years, and an increasing number of analysts expect renewed deflation that could lead to a recession.

'Some good bargains could be seen in UK property'

Many of our readers will own real estate in London, or elsewhere in the UK, and may be concerned about the effect of Brexit on their investments. Fortunately, most real estate investors are in for the longer term. For those foreign investors who don't yet own any UK real estate, maybe the correction in Sterling has made the asset class considerably more attractive. Timing is of course the key. After all, the steep fall in Sterling means the average prime property in central London is now about $96,000 cheaper for GCC buyers, who are pegged to the US dollar. We expect to see investors operating in an opportunistic manner in the coming months. There may be some over-levered holders who become forced sellers if the value of their collateral falls, to cover losses. In short, some bargains could be had by relieving distressed sellers. However we expect the well-financed players to be ready and waiting for quality stock that comes onto the market that is traditionally hard to come by in better times. We believe the fundamentals of UK property remain intrinsically strong, and that any fall in average prices will be relatively short-lived.

Crude oil continues to hover around the $50 level, investors having questioned the logic of crude selling-off with other risk assets in the wake of the Brexit result. During the last few months we have suggested that oil prices could quite easily recover to the $60 level by year-end; perhaps more importantly, the downside risk in the meantime appears increasingly limited in the face of the various kinds of outages that have come along. Global demand for oil has remained solid. We maintain our core range staying in the $42-$55 a barrel on WTI.

'Gold has technically confirmed its bull market'

Gold ended the week well, helped by some dollar weakness; dollar gold prices are well capable of performing when the dollar is firming, however, and especially when interest rates are trending lower. As we write the yellow metal is trading at $1,341.35, up about 2% since the day of the Brexit result. Good flows have continued into gold ETFs, and we see little chance of these reversing in the months to come. Investors have quite understandably seen the need to add to their 'safe haven' and/or portfolio insurance positions. In the industrial metals space, iron ore and palladium continued to trade well. Palladium touched a six-week high last week, driven by continued low US interest rates. Following our buy recommendation on palladium at $535/oz, the price has risen by 13%, and is currently quoted at $605. Our initial target had been $600 and with that in mind our Tactical Asset Allocation (TAA) Committee last week decided to take profits in the related ETF position held. The outlook for this metal still looks bullish for the longer term, although there could be softening in Chinese auto demand, autos being the industry where the metal is mainly used. Technical resistance on the chart close to $600 remains.

So what will be the drivers of markets in the short-to-medium term? US manufacturing data came in last week at a one-year high after seeing a soft patch in recent months. Next will be June's US Non-Farm Payrolls (NFP) this Friday, where expectations are in the region of 180,000, with some forewarning possible from the earlier ADP report the previous day. Last month's NFP came in at a disappointing +38,000 and markets will be keen to see if revisions to that number will be made. The US earnings reporting season is due to begin in mid-July and is expected to show a fourth quarter of consecutive earnings decline. All-importantly, politically, the Republican National Convention is scheduled for 18th-21st July, followed by the Democratic National Convention between 25th-28th July. Elsewhere, the Chinese authorities could continue to devalue the renminbi which may cause concern for markets. Returning to politics, the focus will increasingly be on the run-up to the US General Election in November, the result of which is expected to represent something of a watershed in market perceptions. As we have just seen, politics always has the potential to throw a spanner in the works, being so unpredictable - and even more so in an era of heightened populism and rejection of the status quo.

'US rate normalization will be back on the table in 2017'

With the shock of Brexit on most central bankers' minds, the outlook for increases in US interest rates have been pared back until at least after the US elections. The possible contagion effects of an exited UK from the EU will remain a concern. Pre-emptive rate hikes now look off the table for some months, with so-called 'normalization' delayed until next year. We have reverted to our forecast at the beginning of the year of no rate rises in the US for the rest of 2016. Once market volatility subsides and the US election picture becomes clearer, however, US rate rises should take place provided US data remains supportive. We still expect US rates in terms of Fed Funds to be normalized to the 1.5%-1.75% mark (vs. the current reference range of 0.25%-0.50%).

As mentioned earlier, the TAA met last week, and decided to make the following changes to its model portfolios: (1) To reduce eurozone equities to 'underweight' from 'neutral', given further expected estimate downgrades; (2) To maintain the overall equity exposure, that cash was allocated to US equities moving to an 'overweight' position from 'neutral'; (3) Increase Emerging Market bonds to 'overweight' from 'neutral', reflecting continued attractive spreads that are available; (4) The TAA closed the 'underweight' in MENA bonds to become 'neutral', with a similar rationale to emerging market bonds, together with more stable crude oil prices; and (5) To once again fully-hedge the Euro FX exposure, as we expect Euro/dollar to test 1.05 in the coming weeks and months. The EU is expected to prolong easy money policies through further Quantitative Easing.

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