MARKET FLASH

Document intended for professional clients

Brexit - The United Kingdom is leaving the European Union

Macroeconomics – Analysis by Philippe Waechter
Chief Economist

The experience will start rapidly after the vote for a "Leave" at the British referendum. Rules will change dramatically and this is a direct experience for economists to measure the width of a persistent shock. The will to exit from the European Union will have a strong and durable impact on Brits' life but also on the whole Europe.

Nevertheless, in the very short term, nothing will happen on the economic side. But expectations will change dramatically and this is this phenomena that will weigh on financial markets. Central banks will not be neutral and they will have to intervene in order to avoid a spillover effect of the British shock. The global growth momentum is currently too weak to allow the diffusion of such a shock. As during the 2008/2009 crisis, swap agreements between central banks will be reactivate to provide liquidity to the global financial market.

For the economy, the question is quite simple: relationships between the UK and the rest of the world will deeply change. Rules will never be the same for the fifth most powerful economy in the world. The weight of the UK is by itself a source of concern for the rest of the world. Relationships and rules will change in an environment of low growth momentum and where central bankers already have adopted, and for an extended period, very accommodative monetary policies. In other words a negative and persistent shock with little capacity to adjust because of the low interest rate policy can have a long lasting effect on the UK and the world.

That's what is worrisome. A period of strong growth would have limit the impact of such a shock with stronger endogenous adjustments. Moreover in this type of period David Cameron would not have asked the question of the EU membership.

The main source of the shock is that UK will have no more access to the single market in the same conditions than now. A new framework will have to be defined. It will take time and will create uncertainty. In the short term, we don't know the type of conservatory measures that will be taken during the negotiations. But we can imagine that the British negotiators will want to cut relationships rapidly as it is the decision of the referendum. With the rest of the world, trade's conditions are for the British conditioned by all the trade agreements that have been signed by the EU. In the case of Brexit, the UK will be excluded from them.

In a period during which the global trade doesn't play anymore its role of transmission and of accelerator of growth, the Brexit shock will add confusion and will weigh on the global outlook. This phenomena plus the fact that many banking activity on euro will be displace in EU will change expectations on the downside even if these fractures are not perceived in the very short term. It will take time to find a solid agreement and to define a robust framework between UK and EU and between UK and the rest of the world leading to uncertainty and risks. It will then be a drag on economic activity in the UK but also in Europe.

In the short run, perception of the environment will be driven by political declarations. David Cameron will have to find an impossible majority at the Parliament. He will have to quit. The impossible majority reflects the fact that the Conservative party is now split between supporters of the two options proposed at the referendum. General elections will be required rapidly in order to define a new but very different political equilibrium.

We will also wait for the reactions on the future of Europe by all the institutions and governments of the rest of EU. A common dynamic will have to be found in order to avoid that the British referendum be the catalyst for other votes of this type in Europe. This is the effort to do for a Europe that needs to be unified but which has lost its utopia.

European equities – Analysis by Yves Maillot

Head of European Equities Investment Division

What will be the market reactions over the short and the medium term ?

In the short term : Given the strong recent rebound (in average +7% to +8% from the lows (June 16th) up to the latest highs (June 21st and 23rd), the risk-return profile of the equity market was becoming to be asymmetric with a narrowed upside potential and at the opposite, a substantial short term downside potential of 10% to 12% with technical targets closed to the previous 2016 lows (CAC40 supports at 4050 and 3900 points, EuroStoxx50 supports at 2800 and 2700 points and Stoxx600 supports at 320 and 305 respectively). Please let note that the daily volumes have been weak during the previous 'pre-vote' sessions and that we are now entering in a period of sharp increase volatility with much higher traded volumes.

What are the main equity market expectations ?

Looking for quality and safe heavens, we are going to see a large shift to bonds triggering again a downward trend on bond yields, especially on the 'Core' Sovereign debts (but periphery Sovereign yield spreads are going to widen), the US dollar, the Japanese Yen and the Swiss Franc are going to move up, and due the fall of the Sterling, the outperformance of companies with a large international exposure is going to be significant versus pure domestic names performances. And also because of the currency weakness, it seems probable that the stock markets moves in Continental Europe will underperform UK equity indices changes (in local currency).

Main consequences on the UK equity markets

In relation with the Government long bond yields (Gilts) and the currency down trend (£), the most negatively exposed sectors are the **financials names** (mainly the domestic banking groups and the international banking groups with a large domestic market exposure), **the real estate, the construction sector, the pure domestic based consumption companies** and the **transportation.**

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The most resilient sectors to the current Brexit scenario are **Health care** (and pharmaceuticals), the **non- cyclical consumption sectors** (staples- food-beverages-HPC), **the energy** and finally all companies with a large exports exposure that will benefit to the currency weakness.

Main consequences on Continental Europe equity markets

The main relative moves are favorable to 1/ the **'Core Equity markets'** in Europe (Germany, Switzerland), and, on the other hand, unfavorable to **periphery equity markets** (Spain, Portugal, Italy) 2/ the defensive sectors **(Health care, telcos, non-cyclical consumer goods, utilities** in some extent) and **real estate** also.

Fixed Income – Analysis by Axel Botte

Fixed Income Strategist

Britain opted out of EU last night. This stunning outcome came in at odds with this week's risk-on environment in equities and FX markets. This certainly will usher in a prolonged period of economic and political uncertainty and financial volatility that global central banks have chosen to accommodate via monetary easing.

A combination of rate cuts, special refinancing operations, cross-currency swaps will aim at avoiding liquidity shortages across world financial markets over the coming months. Bond yields have fallen in synch with the negative response from financial markets. However, short-term bonds may outperform reflecting hopes of policy rate cuts in the near term. Positioning over the last few days had been tilted towards risk indicating expectations of an 'IN' vote.

The unwinding of liquid risky positions exacerbated the knee-jerk reaction on Bunds/US Treasuries but market depth and traded volumes are very thin as uncertainty and volatility prevent financial intermediaries from making markets. Looking out a few weeks or months, markets will reassess the safe haven status of German and other core debt markets as Brexit entails a failure of EU as a whole. Curve steepening may thus result from increased political risk as renewed concerns over the viability of EU/euro area emerge. Corporate credit, especially bank bonds which are not eligible to CSPP, will widen in spite of extensive ongoing ECB support. We are scaling back exposure to corporate credit and high yield. USD-denominated including select emerging markets may fare better in relative terms.

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Allocation – Analysis by Nuno Teixeira

Head of Institutional & Retail Solution

British vote in favor of a "Brexit" (52% vs 48%) has taken financial community short, as most investors were either neutral or positioned with a moderate positive bias towards a "Bremain". This relative over-confidence of financial markets in the results of the last polls triggered a significant rebound of European equity markets over the last week.

At the time we are writing (10:00 am CET), and while David Cameron has announced he would leave office in the next 3 months, the main impacts on the markets are the following:

- A significant slide in Asian equity markets, with the Japanese equity market tumbling by close to 8% (largely influenced by the rise of yen to 103 vs the dollar), while EM equity markets have remained relatively resilient in the storm ;
- A collapse of 8% of European equity markets, while UK equities have only fallen by circa 5%;
- A significant fall in yields for Gilts – the 10 year issue falling to 1.10% from 1.37% - while investors expect BoE to cut interest rates – while the 10-year Bund moved clearly in negative territory (-0.07% and -0.17% at the lowest);
- A widening of 35-37 bps on Italian and Spanish Government Debt' spreads vs Bund – with a more significant widening in 2-year issues – and a widening of circa 18-20 bps on European investment grade corporate issues;
- A collapse of British pound from 1.48 to 1.36 USD, but a relatively moderate slide of sterling vs Euro (1.23 vs 1.30 yesterday).
- A rise in gold price by 4% to around 1312 USD.

After the shock, the essential question to be asked for a multi-asset portfolios is the following: beyond the massive sell off observed today in risk assets, can this vote trigger – via a major contagion effect - a global or a European recession? Could we witness a major move from investors towards a « risk off » strategy, which would hit riskier asset classes for a sustained period of time, beyond the significant volatility observed in the past few hours?

Several dimensions should be taken into account:

1. Economic impact: the overall impact from the "Brexit" on UK growth will probably be negative, not the least since it will generate a major uncertainty for British companies and foreign investors related to future negotiations with UE. It should be mentioned, however, that the EU has no interest to favor new sources of conflict with the UK. We consider that, impact on global growth - or even growth in the Eurozone - should remain under control, a reality which markets should incorporate in the near future ;
2. Political impact: although there is a risk "Brexit" could worsen centrifugal forces in the EU (one should monitor closely the next Spanish elections), the downturn in UK growth, should it materialize, could have a deterrent impact on the most vulnerable public opinions;

3. Financial impact: despite Europe/UK large connections within the banking sector, there seems to be no systemic risk potential; indeed, since UK is not part of the Eurozone, this tends to limit significantly the amount of leveraged positions between the two areas;
4. Capacity of European institutions to react: one can image political and above all monetary initiatives (already started in terms of liquidity provision by central banks) aiming at providing comfort to the economic and financial community, having in mind that nobody wishes to bear the risk of a new crisis in this area.

While waiting for the outcome of the vote, the tactical asset allocation team of Natixis AM has taken the following options for its cross-asset portfolios:

1. In terms of overall portfolio structure: maximum diversification of portfolios, considered as the best protection when investors are faced with uncertain events triggering very « binary » consequences;

2. On equity markets: neutral exposure in terms of relative weightings, but defensive in terms of internal structure (countries and sectors). On European equities, despite short term volatility, we still adopt a "constructive" approach in this area, considering that a « Brexit » is not likely to derail the positive growth momentum in the Eurozone;

3. On European bond markets: profits had been taken on part of our sovereign bond positions in the EMU, following the sharp decline in bond yields observed in June. In a context of nearly zero interest rates for « core Europe » sovereign issuers, bond markets offer a limited protection in the case of an extended « risk off » scenario and could even suffer from a sell off from non-European investors; in addition, periphery spreads could widen further until the end of 2016, as political uncertainty is likely to remain high in Italy, Spain and Greece.

4. On global bond markets: we've been adding exposure to the US yield curve, acknowledging the end of any meaningful « normalization » of the US monetary policy ; we've also build positions on hard currency Emerging Market debt, which should benefit both from lower US interest rates and from a medium-term downward trend in the dollar.

Our balanced portfolios are today characterized by:

- An exposure to risky assets in line with a moderate but positive outlook for global growth (2 to 2.5% in 2016 and 2017), which suggests we should favor yield vs capital gains;

- A neutral to slightly overweight exposure to equities, with a positive bias towards developed markets and a focus on relatively defensive countries or sectors (healthcare and telecoms);

- A defensive position on Emerging equity markets and commodities - with the exception of gold which we continue to favor;

- A few « carry trades » aiming at taking advantage of relatively attractive spreads on Eurozone « investment grade » corporates as well as hard currency emerging market debt.

MARKET FLASH

Beyond short-term volatility and the psychological shock related to the "Brexit", **this vote should**:

- accelerate the downward trend in US bond yields and allow 10 year Treasury bonds to converge to a 1% to 1.5% trading range in the second half of 2016;
- have a negative impact on both sterling and euro against the dollar, which should in turn generate buying opportunities in export-led sectors and companies;
- help to maintain an overall a positive environment for gold, likely to benefit from a looser than expected monetary policy from the Fed and lower US real yields.

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Limited liability company - Share capital €50,434,604.76
Regulated by AMF under no. GP 90-009 RCS Paris n°329 450 738
Registered Office: 21 quai d'Austerlitz – 75634 Paris Cedex 13 - Tel. +33 1 78 40 80 00

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